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News

Emerging Markets Spotlight

Rising commodity prices will have a powerful impact on emerging markets, for exporters and for those that import and subsidise the 'Three Fs', food, fuel and fertiliser

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Following the initial shock of the Russian invasion of Ukraine, it is becoming possible to focus on the secondary effects around the world. These substantially result from the disruptions to the supply of many commodities.

Although highly volatile, prices of many basic commodities have moved very sharply since the start of the year. Compared to 31 December 2021, the Brent crude oil price is (at the time of writing) up 41%, wheat futures are up 37% and urea prices are up 21% (but had already doubled in Q4 2021).

Although other commodities which Russia is a major exporter of have also risen, the trinity of fuel, food and fertiliser is absolutely key for the world's poorest countries.

Many of these countries are significant importers of these products, subsidise them for their populations and/or have large weights of these in their inflation baskets. This means that sharp price rises stress both the fiscal and current account balances, while increasing inflation and reducing the ability of consumers to purchase other goods and services.
Some of these effects are being seen in major frontier countries, whose equity markets are too small to be in the mainstream emerging market equity asset class.

For example, in Pakistan - recently demoted from the MSCI EM Index - a developing political crisis (where the opposition has been seeking to bring down the government through a vote of no confidence) coincides with the need to renew Pakistan's USD 6bn Extended Fund Facility with the IMF.

Without IMF funding, Pakistan will almost certainly face a balance of payments crisis, as foreign

exchange reserves have fallen in recent months to just two months of import cover. The ramping price of imports has pushed inflation to 12.7% in the year to March, accompanied by a sharp fall in the Pakistani rupee.

Meanwhile, the combination of Sri Lanka's poor agricultural policies and collapse of tourism due to Covid has created a weak starting point from which to deal with soaring prices in the country. Rampant inflation and widespread street protests over severe shortages of food and power led to the resignation of the entire government cabinet and central bank governor.

In a sign of the depth of the crisis, the new finance minister then resigned after fewer than 24 hours in post. Sri Lanka faces soaring inflation (18.7% in the year to March) and a probable sovereign debt default in July.
For the mainstream emerging markets, there are three countries potentially exposed to these kinds of risks: Egypt, India and Indonesia.

Egypt is the most exposed of the three. Egypt imports over 60% of its wheat – which is a particularly significant component of the typical diet in the Middle East & North Africa - while Russia and Ukraine are major wheat exporters. Inflation has been accelerating in recent months to 8.8% in the year to February, and policymakers have begun to react by devaluing the Egyptian pound by 15%, hiking interest rates and imposing price controls on bread. While these steps are likely to help and though Egypt is a net oil exporter, the non-oil component of the economy is already showing stress with PMIs declining sharply. The risk is a repeat of the political unrest that led to the overthrow of the Mubarak government during the Arab Spring in 2011. There are, so far, no signs of unrest but Egypt must be carefully monitored in the months ahead.

India has been historically vulnerable both as a major importer and significant subsidiser of these commodities. Although India's current account deficit will weaken with oil prices above USD 100/barrel and despite inflationary pressures now surfacing, India is in a much better position than in previous periods of commodity price inflation. Firstly, the reforms to the subsidy regime have essentially removed the risk to the fiscal balance. Diesel subsidies were removed in 2014; direct LPG subsidies were replaced with cash transfers to poorer citizens; and fertiliser subsidies have been substantially reduced in recent years. Secondly, India has in recent years become a major producer of wheat and has even become a small exporter, while a series of rich harvests have seen wheat reserves reach 21mn tons against a 7.5mn-ton target. The government's economic reforms have absolutely moved India onto a safer and more sustainable footing and the country should feel the benefit of this in coming months.

The other major emerging market with historical fuel-subsidy problems is Indonesia. Indonesia also had problems in the mid-2000s from the fiscal effects of fuel price subsidies. In 2004-5, newly elected president Yudhoyono faced a budget crisis as spending on fossil fuel subsidies for gasoline, diesel and kerosene had reached USD 8bn. The government was forced to trim fuel subsidies to alleviate the budget deficit, but this both lifted inflation and hit growth. Fuel subsidies have since been first reformed and then, under current president Widodo, removed. Additionally, inflation in Indonesia is very benign, reaching just 2.6% to March, making commodity price pressures far more manageable.

Emerging markets are generally countries with macro-economic vulnerabilities, but the examples of India and Indonesia show that good planning and effective economic reform can limit these vulnerabilities. While frontier equity markets and some of the major emerging market sovereign debt issuers may face a difficult 2022, emerging equity markets look to have lower secondary risks from the conflict in Ukraine.

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