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Is the monetary tightening cycle in developing countries coming to an end?

MONETARY POLICY CHALLENGES IN DEVELOPING ECONOMIES

With the banking sector turmoil rattling global financial markets in recent weeks, all eyes have been fixed on the United States Federal Reserve (Fed). By deciding to raise its key policy rate by another 25 basis points in late March, the Fed signaled that the fight against inflation was not over yet, while underscoring confidence in the resilience of the domestic banking sector. The latest rate hike—the ninth during the past 12 months—brings the target range of the fed fund rate to 4.75–5.00 per cent, the highest level since 2007. Earlier in the month, the European Central Bank (ECB) had increased its three main policy rates by 50 basis points each. The Bank of England (BoE) and the Swiss National Bank also raised interest rates in March.

KEY MESSAGES

- » With monetary tightening in developed economies approaching an end, the external pressure on central banks in developing countries to increase interest rates is expected to ease.
- » Inflation is gradually softening in many developing countries due to lower food and energy prices, fewer supply-chain disruptions, and lower depreciation pressures, but remains well above pre-pandemic levels.
- » Monetary policy cycles in developing countries will increasingly diverge in 2023 as several central banks are expected to further raise interest rates, while others may find policy space to hold, or even cut, rates.

These latest developments have brought a mixture of good and bad news to monetary authorities in developing economies. On the one hand, further tightening of financial conditions is adding to an already challenging economic outlook marked by high uncertainty and significant downside risks (*figure 1*). On the other hand, the monetary tightening cycle in the major developed economies seems to be nearing its end, with the recent banking sector turmoil increasing the pressure on central banks to halt rate hikes. In the United States, the Fed's dot plot – which presents the Federal Open Market Committee members' outlook for the federal funds rate – points to only one more rate hike in 2023.[1] The BoE and the ECB are also expected to exercise caution in the coming months.[2] Prices of derivates, such as interest rate swaps, indicate investors' belief that the tightening cycle is almost over. Markets are currently pricing in a significant probability of interest rate cuts before the end of the year in several economies, including the United States.

A monetary policy shift in the United States and other developed economies would further reduce pressure on central banks in developing countries to tighten their monetary policy stances. Changing expectations about global monetary prospects, associated with wide swings in investors' risk sentiment, have strongly affected financial conditions in developing countries during the COVID-19 recovery period. In the first half of 2022, as the Fed and other developed country central banks accelerated the pace of interest rate hikes, non-resident portfolio capital flows to emerging economies declined sharply (*figure 2*). Since then, capital flows to emerging economies have recovered, albeit with significant volatility. In parallel, most developing country currencies have in recent months recouped some of the losses that they suffered against the dollar throughout most of 2022.

On the domestic front, many developing countries are still grappling with elevated inflation despite weak and incomplete recoveries from output losses caused by the pandemic.[3] In 2022, more than three quarters of developing countries with available data recorded a negative output gap, implying that actual output remained below potential.[4] At the same time, average consumer price inflation in developing countries surged to the highest rate since the mid-1990s, reaching multi-decade highs in many economies. While upward price

1 Ten out of 18 members of the rate-setting Federal Open Market Committee expect only one more rate hike in 2023, resulting in a peak rate of 5.1 per cent. Seven members see the rate ending the year at a higher level. As of late March, derivative markets indicated a significantly lower fed funds rate of only about 4 per cent in December (Financial Times, 27 March, 2023, Investors slash expectations of global interest rate rises after banking turmoil).

2 ECB officials signaled that rates will likely have to rise further, but at a slower pace.

3 United Nations (2023). *World Economic Situation and Prospects 2023*. New York: United Nations.

4 International Monetary Fund (2022). World Economic Outlook. October 2022. Washington DC.

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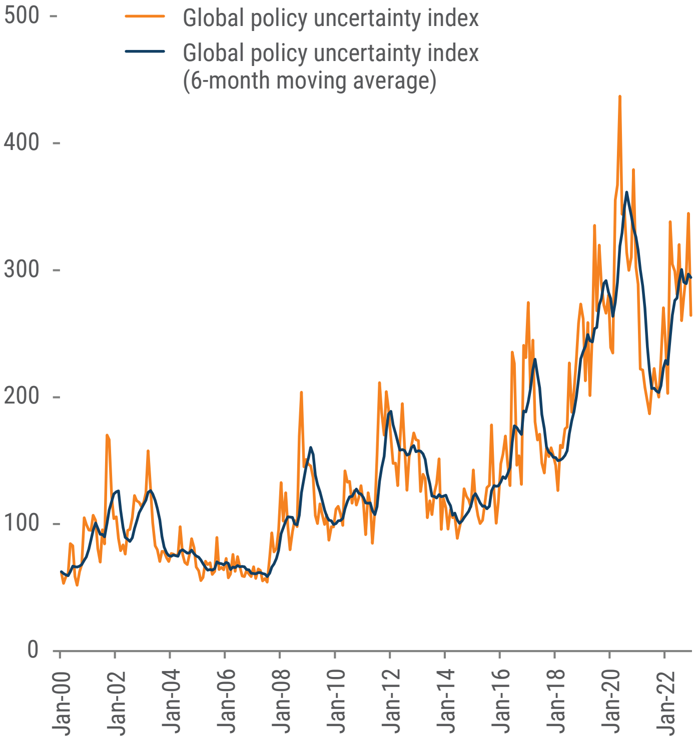
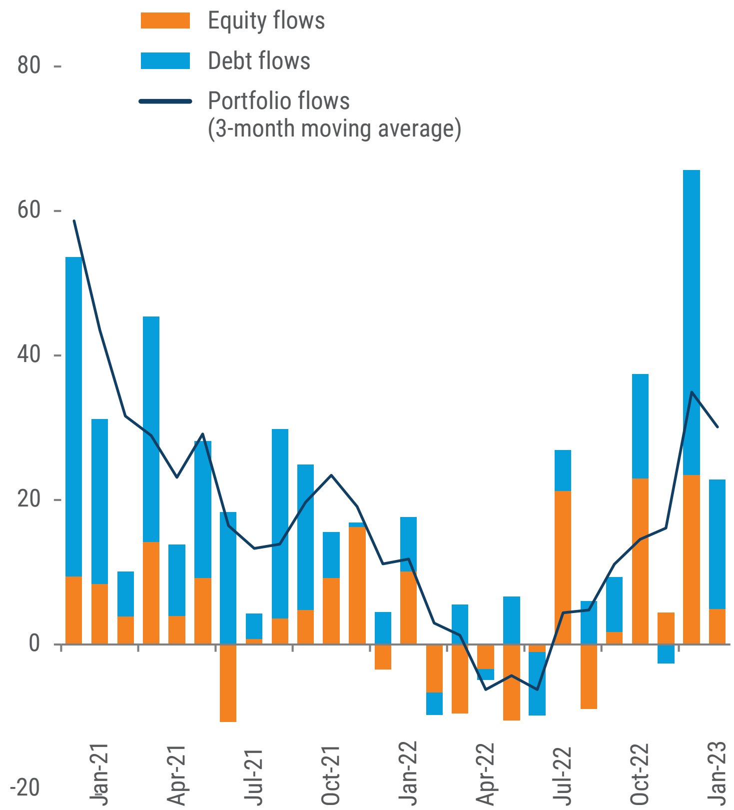
Figure 1
Global economic policy uncertainty
Index



Source: Global economic policy uncertainty available at https://www.policyuncertainty.com/.

Figure 2
Non-resident portfolio flows to emerging economies
Billions of United States dollars



Source: UN DESA, based on data from the Institute of International Finance (IIF).

pressures were initially driven by supply chain disruptions from the pandemic and soaring energy and food prices, concerns about de-anchoring of inflation expectations have prompted broad-based monetary tightening in developing countries over the past two years. In a sample of 50 developing country central banks, 43 increased interest rates in 2022. In Latin America, several countries had already started to raise interest rates in early 2021, while pursuing even more aggressive tightening in 2022. Asian economies, by contrast, mostly increased interest rates from the second quarter of 2022 onwards.

INFLATION IS TRENDING DOWN, BUT REMAINS ELEVATED

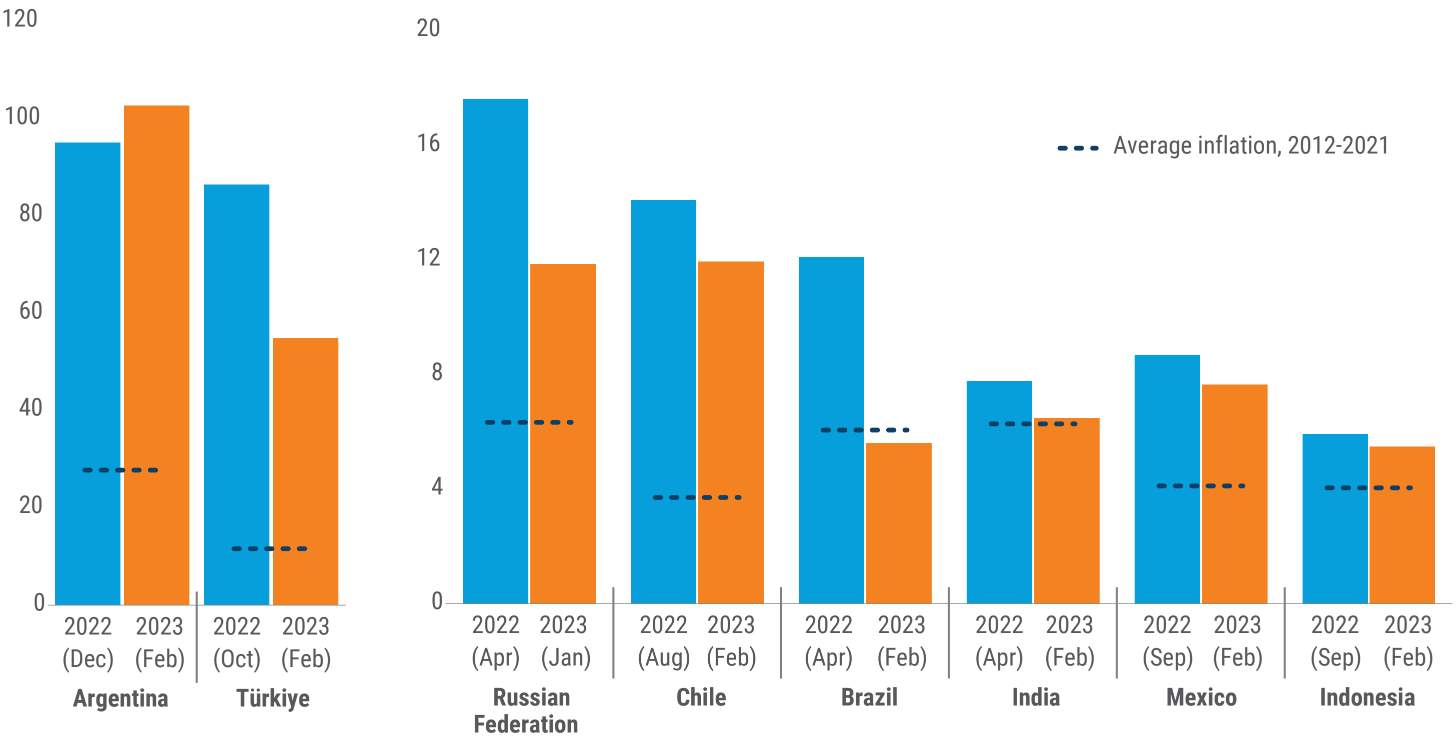
Headline inflation rates in many developing economies have been gradually softening in recent months due to lower energy and food prices, fewer supply-chain disruptions, and strengthening domestic currencies (*figure 3*).[5] The FAO Food Price Index averaged 129.9 in February 2023, a decline of almost 20 per cent from the peak in March 2022, driven by lower cereal and vegetable oil prices. Energy prices have fallen even more sharply, with the World Bank Energy Price Index dropping from 172.0 in mid-2022 to 110.5 in February 2023. While lower fuel prices have contributed significantly to the drop in inflation, there has been a more broad-based easing of price pressures.

Beyond this general trend, the picture varies significantly across economies. Some countries in Latin America and the Caribbean, such as Brazil, the Dominican Republic and Uruguay have seen a consistent drop in headline inflation rates since early or mid-2022. Other economies, including Ethiopia, India, and South Africa, have experienced a more tepid decline. And in some economies, inflation is still trending upwards (for example, Colombia, Nigeria, Pakistan, Egypt), or remains exceptionally high due to country-specific factors (Argentina, Lebanon, Türkiye). Moreover, in a vast majority of countries, inflation—especially food price

5 The Global Supply Chain Pressure Index, which integrates transportation costs data and manufacturing indicators, has significantly declined in the last six months. According to this index, global supply chain conditions returned to normal levels in recent months (https://www.newyorkfed.org/research/policy/gscpi#/interactive).

Figure 3
Consumer price inflation rates, selected emerging economies

Percentage



Source: UN DESA, based on data from CEIC and national sources (accessed on 22 March 2023).
Note: The figure shows the month with the highest year-on-year inflation rate in 2022 for each country and the latest available data.

inflation—is much higher than it was during the previous decade. According to the World Bank, food inflation is above 5 per cent in 94 per cent of low-income countries, 86 per cent of lower-middle-income countries, and 93 per cent of upper-middle-income countries, with many experiencing double-digit inflation (Egypt, Uganda, Pakistan).[6]

According to the World Economic Situation and Prospects 2023, average inflation in developing countries is projected to decline only moderately from 10.8 per cent in 2022 to 8.5 per cent in 2023, well above the 4.2 per cent recorded in the pre-pandemic period 2015-19. Regional inflation is estimated to range from about 3 per cent in East Asia to 14 per cent in Africa, and 16 per cent in Western Asia and Latin America and the Caribbean.[7] There are, however, significant risks and uncertainties associated with the trajectory of inflation in the near term. Further geopolitical fragmentation, an escalation of the war in Ukraine or new export restrictions, pose major risks to food and energy prices and supply chains. In addition, changes in market expectations in the United States could trigger sudden and large adjustments in global financial conditions, leading to capital outflows and renewed depreciation pressures in developing countries. The disinflation trend could also remain slow if market rigidities limit the pass-through of lower energy and food prices to households and businesses.

COUNTRIES ARE AT DIFFERENT STAGES OF THE MONETARY TIGHTENING CYCLE

Given changing dynamics on the external and domestic front, the monetary tightening cycle in developing countries is gradually shifting. In many countries, policy trade-offs have further intensified in recent quarters due to weakening growth prospects and rising downside risks. As a result, many central banks have adopted a more cautious approach to further tightening monetary policy, while others have stayed the course. As such, cumulative increases in policy rates have declined significantly, after peaking in the third quarter of 2022 (*figure 4*). With central banks now at very different stages of the tightening cycle, there will be more divergence in monetary policy stances going forward.

Several central banks have likely already ended the monetary tightening cycle. In Brazil, where the central bank embarked

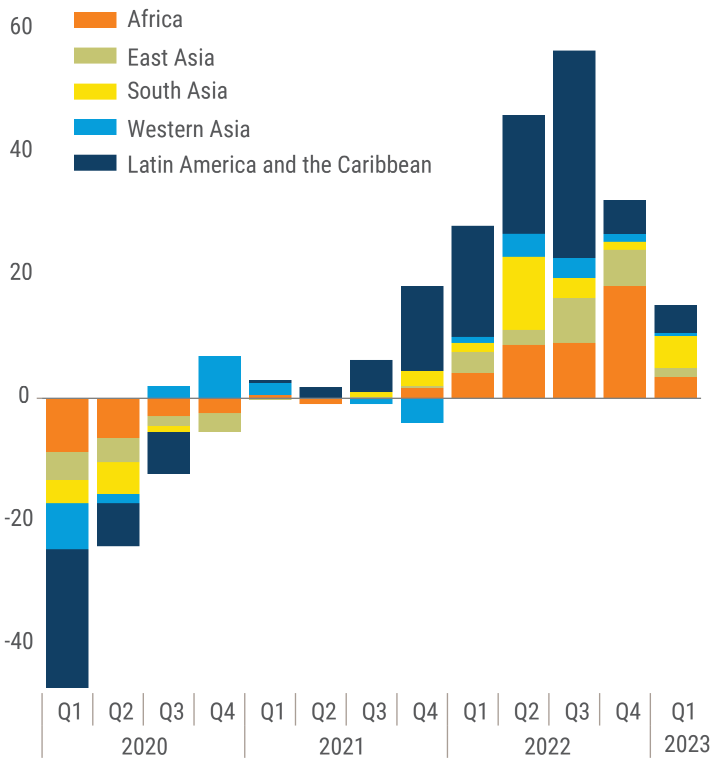
6 World Bank (2023). Food Security Update, 9 March.

7 All regional and global inflation estimates exclude the Bolivarian Republic of Venezuela.

Figure 4

Cumulative policy rate changes in developing countries

Percentage points



Source: UN DESA, based on data from CEIC and national sources (accessed on 22 March 2023).
Note: The sample covers 35 developing countries, based on data availability. Q1 2023 does not cover the full first quarter but reflects policy rates information as of 22 March 2023.

on one of the earliest and most aggressive tightening measures globally, interest rates seem to have peaked. The central bank has kept its main policy rate unchanged at 13.75 per cent since August 2022, after raising it sharply from 2 per cent in April 2021. Annual inflation declined from a peak of 12.1 per cent in April 2022 to 5.6 per cent in February 2023, amid higher interest rates, tax cuts on fuels and telecommunications services, and lower global oil and commodity prices. In Chile, lower price pressures and prudent fiscal management, together with falling consumer spending, have been fueling expectations that the central bank could cut interest rates in the coming months. Costa Rica's central bank has already lowered its policy interest rate by 50 basis points in March 2023, after raising interest rates from 1.75 to 9.0 per cent in 2022.[8]

Several central banks seem to be approaching their terminal policy rates, that is the rate where they will pause or end the current rate-hike cycle. In India, for example, the central bank may lift its policy rate in April to a terminal rate of 6.75 per cent, after a cumulative increase of 225 basis points in 2022. Yet, after falling temporarily at the end of 2022, consumer price inflation has again picked up, surpassing 6 per cent in recent months and adding uncertainty to the outlook. In addition, consumer spending remains relatively robust, which allows producers to pass higher input costs on to consumers. As a result, inflation may be more difficult to tame in the near term. Provided that inflationary pressures abate, the central bank may start cutting rates in late 2023 or early 2024.

By contrast, many other central banks are expected to further tighten monetary policy as the fight against inflation continues. In Colombia, annual consumer price inflation reached a multi-decade high of 13.2 per cent in February 2023. Escalating inflation, coupled with ongoing depreciation pressures and a large current account deficit, will likely force the central bank to implement additional rate hikes in the coming months. Similarly, in Mexico there are expectations that the central bank will continue to raise interest rates, which increased from 4 per cent in mid-2021 to 11.25 per cent at the end of March. However, with the Fed shifting to a more cautious stance and domestic inflation easing in recent months, the central bank may slow the pace of rate hikes. In the Philippines and South Africa, central banks are also expected to raise interest rates further. In January, annual inflation in the Philippines climbed to a record-high of 8.7 per cent, while inflation in South Africa edged up to 7 per cent, only moderately down from the peak of 7.8 per cent in July 2022.

Overall, monetary policymakers in developing countries continue to face significant challenges and difficult trade-offs. Amid ongoing price pressures, still-rising interest rates in the major developed economies and subdued economic prospects, the trade-offs between growth, inflation and financial stability have become more complex, especially given significant uncertainties and risks. Moreover, there are rising risks that a prolonged period of higher borrowing costs could further undermine investment, growth, and development prospects. Against this backdrop, an end to the monetary policy tightening cycle in major economies, particularly the United States, could provide much-needed policy space for central banks in developing economies to pivot and recalibrate their monetary stances.

8 After the devastating earthquake on 6 February, the Central Bank of Türkiye cut interest rates to boost economic activity and reconstruction efforts.