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What to watch: OPEC+'s faltering grip, Germany's budget freeze, and pivoting central banks in emerging markets

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Executive Summary

This week, we look at three important issues:

- First, **OPEC+'s faltering grip on oil prices.** While the global economy feared oil prices at USD100 per barrel (bbl) a few months ago, they stand close to USD80/bbl today, in line with our forecasts. Indeed, the disappointing data releases from China and Europe have increased concerns about demand. In this context, we expect OPEC+ to extend existing cuts. Yet, we kept our previous forecasts as tighter-for-longer supply should yield to USD85/bbl on average in 2024, before edging down to USD83/bbl on average in 2025. Last, as refining capacities remain stretched, the decrease in retail prices should be delayed for at least a few months.

- Second, **Germany's budget freeze: when the music stops.** The Federal Constitutional Court's ruling has stripped the German government of the financing for climate and industrial policy projects: at least EUR60bn (costing -0.7pp of GDP) and a further EUR200bn set aside to aid the economic recovery from the economic stabilization fund (so called WSF; -1.9pp loss for GDP in total). In the short-term, the coalition should act fast as the situation creates immense uncertainty for companies, households and investments, besides cutting competitiveness in an already unstable economic environment. In the long term, to avoid jeopardizing the green transition, the debt brake needs a solid reform.

- Third, **emerging market monetary policy pivots: cutting the line.** EMs have remained remarkably resilient despite the uncertain economic environment. Most are currently recording moderate current account deficits, or even surpluses, with Emerging Asia enjoying the best external positions: Thailand reversed last year's deficit into a surplus and India's external shortfall has narrowed markedly. Improving current account balances alongside better inflation outlooks and stabilizing currencies have prompted several countries in Latin America (Brazil, Chile and Peru) and Eastern Europe (Poland and Hungary) to kick off interest rate cuts. So far, markets are reacting positively, but we expect a EM fixed income rally to pause until the first cuts in advanced economies, followed by a contained decrease in local yields (going from 6.5% to 6% by end-2024 and 5.5% by end-2025). The asynchronized monetary easing could pressure EM currencies, and affect the economic recovery in an election-packed year.

OPEC+'s faltering grip on oil prices

OPEC+ will likely extend its production cuts but oil markets are worried about demand. Brent prices were on a bull run from May to September, reaching almost USD97/bbl, thanks to strong demand and the OPEC+'s tight grip on production. The intensification of conflict in Israel and Gaza in early October also briefly pushed prices up further. But the "war risk premium" has now disappeared. Brent prices have been falling over the last five weeks – a trend not seen since 2021. This has OPEC+ members worried amid disputes over production quotas. In this context, we expect OPEC+ to extend existing cuts. Saudi Arabia in particular should roll over its cuts, while furthers cuts from the wider group are a possibility but not expected. This "tighter for longer" supply should support oil prices into the next months and into 2024. Overall, we expect oil prices to average USD85/bbl in 2024 and USD83/bbl in 2025 (Table 1).

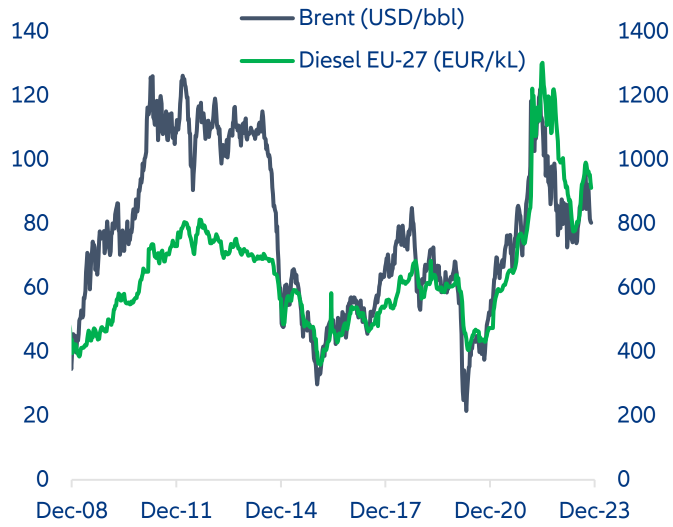
Table 1: Oil price forecasts

	Last (Nov-28)	2024 Q1	2024 Q2	2024 Q3	2024 Q4	2024	2025	2026
Brent (USD/ bbl)	81.7	83	84	85	86	85	83	80
WTI (USD/ bbl)	76.1	77	78	79	80	79	77	75

Sources: Refinitiv, Allianz Research

However, consumers will not feel the respite in fuel prices for a few more months. Pandemic lockdowns shut down the equivalent of about 4.5mn barrels per day in global refinery capacity. This combined with fast post-pandemic growth has led to higher margins for US and European refiners, compared to their Asian peers. This year has also seen a number of unplanned refinery outages in Asia and elsewhere, which have contributed to tightening fuel supplies. Besides stretched refining capacities, inventory levels are low all over the world and that has also driven up margins. In Europe, diesel prices stood at about EUR910/ 1,000 liters, EUR100 higher than in 2011-2014 when oil prices were north of USD100/bbl (Figure 1). As new capacity becomes available in 2024, pressures should ease in the second quarter. Combined with slowing demand, that will eventually bring down prices significantly.

Figure 1: Oil and diesel prices



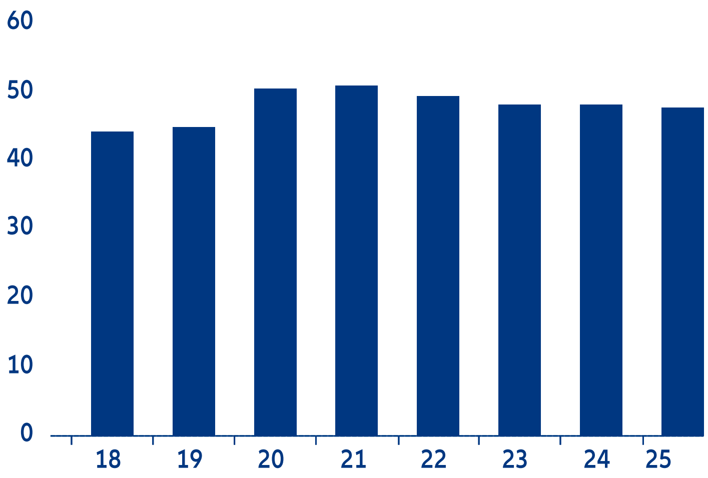
Sources: Refinitiv, Allianz Research

Germany's budget freeze – when the music stops

The Federal Constitutional Court has stripped the German government of fiscal leeway. The German government has been bypassing its debt brake, particularly to finance its program to combat climate change. However, on 15 November, the Federal Constitutional Court ruled that the transfer of EUR60bn to the climate and transformation fund (KTF) via a credit authorization was unconstitutional, given the mismatch between the origin of the funds (the 2021 supplementary budget, originally intended to cushion the impact of the pandemic) and its actual use, as well as the annuity principle (credit authorization to be spent in the same year) and lack of retroactive changes to the budget law. The fiscal consequences of bypassing the debt brake are still being assessed but likely to be huge, with the debt limit being exceeded by over EUR130bn in 2023 alone. Consequently, the Ministry of Finance has put a spending freeze on almost the entire federal budget. Existing liabilities will continue to be honored, but no new ones may be entered into – especially no multi-year projects.

More is at stake amid mounting economic challenges. The government coalition is struggling as the rational of the ruling could also affect a further EUR200bn set aside to aid the economic recovery from the economic stabilization fund (WSF). Overall, the macroeconomic impact could be dramatic in an already cyclically and structurally weak economic environment. Germany is the only big economy that will be in recession in 2023 and the loss of the EUR60nm will shave off 0.7pp of GDP or 1.9pp including the WSF. But this situation also illustrates how Germany has managed to control its public debt. While government spending in relation to GDP was 45% in 2019, it is currently 48% (after over 50% in 2020 and 2021, Figure 2). This means that almost half of economic output is still funneled through public coffers, which leaves enough room for maneuver. Nevertheless, the result of the ruling is immense uncertainty for German companies and households, as well as essential private investments. And amid rising concerns over deindustrialization, the spending freeze could also be costly for competitiveness.

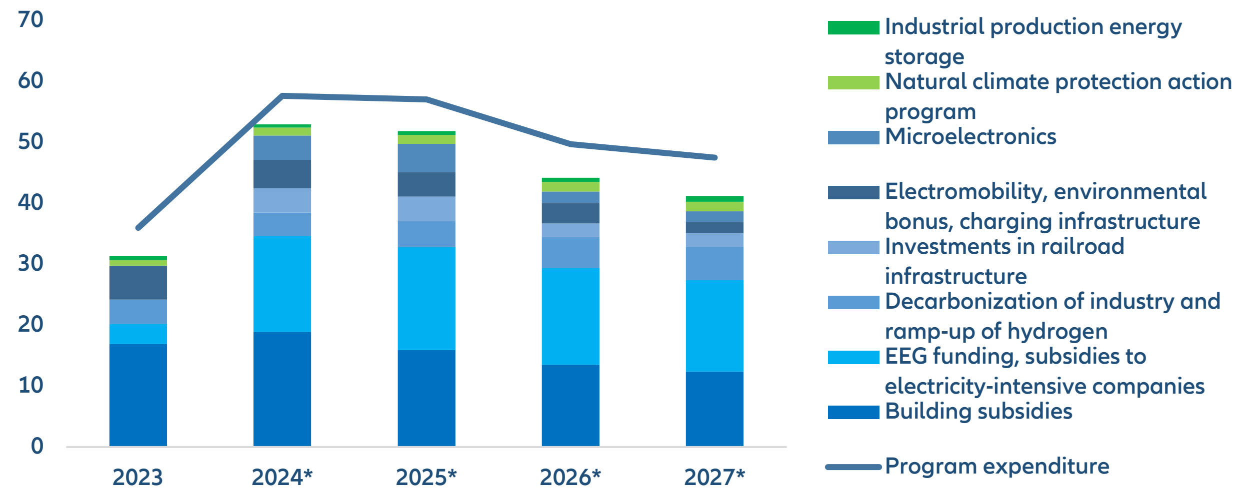
Figure 2: German government spending in relation to GDP, in %



Sources: Refinitiv Datastream, Allianz Research

The budget freeze puts the financing of numerous climate and industrial policy projects at risk. If the government does not quickly turn things around and reset priorities, Germany is not only at risk of falling behind in terms of climate protection, but also of becoming increasingly less attractive as a potential location for climate-friendly future technologies. The pot earmarked to decarbonize the economy also includes the electricity-price compensation, with a budget of at least EUR2.6bn for 2024. This is key to the establishment of a hydrogen economy and the promotion of semiconductor and battery-cell production. Other projects that might be jeopardized include climate protection agreements, the EEG law, electric-vehicle bonuses, rail infrastructure and energy-efficient renovations. For 2024 alone, EUR4bn was to be set aside for the rail infrastructure and another EUR12.5bn until 2027 (Figure 3). While the full consequences are still to be determined, what is certain is that the ruling poses an immense challenge for both the current and future governments to manage the green transition.

Figure 3: Program expenditure of the Climate and Transformation fund, in EURbn 2023-2027



Sources: German Federal Government, MCC, Allianz Research

A comprehensive political realignment is required... The controversial question is how to solve the dilemma in the short term. For 2023, a supplementary budget was approved by the cabinet on 28 November, which allows an exception to the debt brake given the consequences of the energy crisis and the polycrisis environment. This puts all payments from the current year on a sound footing and provides a basis for next year's federal budget. However, other commitments, such as energy-price subsidies for the coming year or further support for companies, are not secured. The challenge now lies with the budget for the coming year(s). The most appropriate response to a tighter financial framework would be to use the core budget – which still has a lot of fiscal leeway – and prioritize. In this sense, the debt brake does not obstruct the most important government spending, but rather the least important ones. The problem is that the coalition partners are still unable to agree on what should be prioritized, which is why the debt brake was circumvented in the first place two years ago.

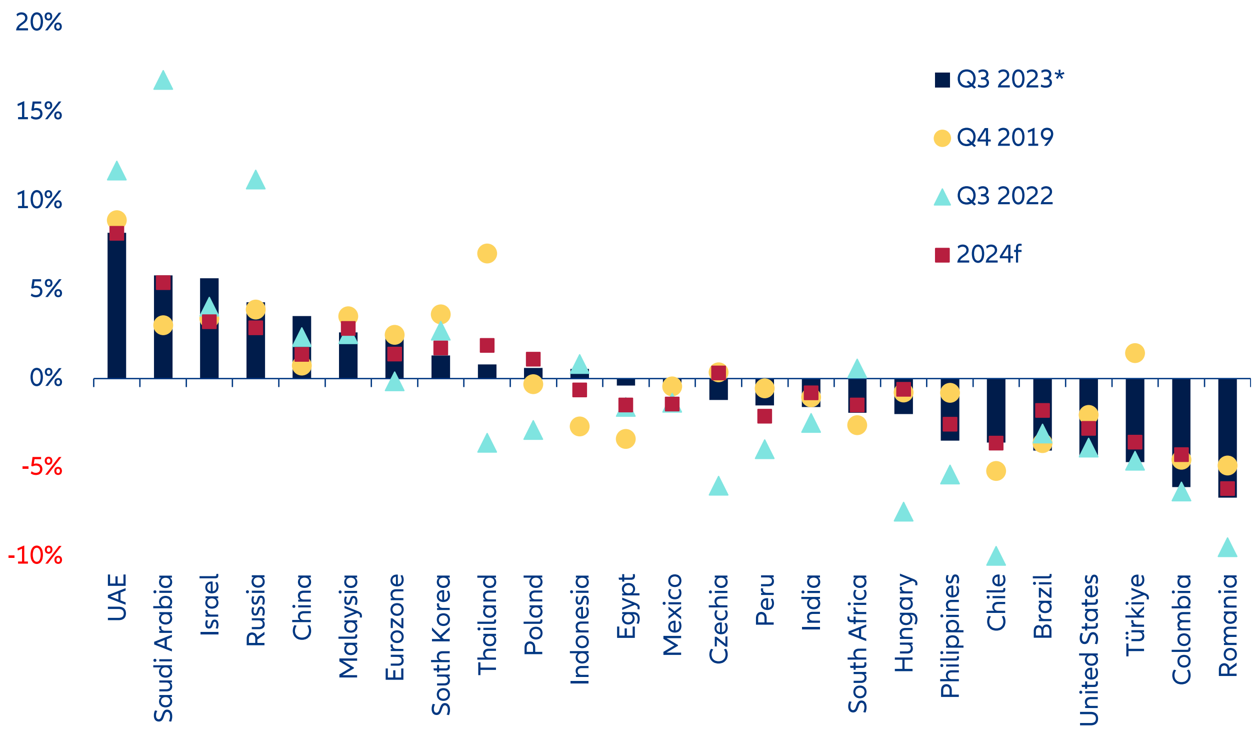
...but a comprehensive reform of the debt brake is the most economically sound solution to avoid jeopardizing the green transition. Besides better prioritizing where public funds are to be directed, two possibilities are crystallizing: reforming the constitutional debt brake or setting up another special fund. The latter is worth considering as it could bridge the funding gap, but the political hurdle is very high with a two-thirds majority required. Regarding the debt break itself, the debate is often one-sided as if only an unchanged continuation or abolition were possible. However, the right approach requires differentiation: The debt brake made sense in its 2009 form; today it is a burden. A reform is long overdue even though there is currently no two-thirds majority to do so. Yet, even if the debt brake were raised from its current level of 0.35% to 1.5% as structural debt in relation to GDP, the debt ratio would still fall significantly year after year. This would allow additional debt of around EUR50bn in 2024 alone without endangering the sustainability of public finances. A reform should include an investment clause that makes exceptions for certain expenses. It would also be worth considering taking the interest rate level into account when taking out net borrowing, i.e. by using the interest-tax ratio as a leading indicator. If interest expenses increase as a share of tax revenue, new net debt must be reduced. When interest expenses are low, the credit potential increases. Yet, in principle, it remains correct for the finance minister to put a stop to too many social-political endeavors.

EM monetary policy pivots – cutting the line

The majority of large EMs is currently experiencing moderate current account deficits or even surpluses after the unwinding imbalances that emerged in 2022, mostly related to energy imports. However, a few EMs continue to face substantial current account shortfalls that pose some risk of a balance-of-payments crisis. In Emerging Asia, while China, South Korea and Malaysia have been posting current account surpluses for many years, Indonesia has experienced surpluses since 2021, Thailand has reversed last year's deficit into a surplus and India's external shortfall has narrowed markedly, all three benefiting from the China Plus One policy of multinational companies.

The Philippines has been the regional laggard in terms of rebalancing, but we forecast its current account deficit to narrow from -3.5% of GDP currently to around -2.6% at end-2024. The picture in Emerging Europe is more mixed. Poland, Czechia and Hungary have largely unwound their current account imbalances from last year while the rebalancing in Romania and Türkiye is going very slowly and we forecast them to continue to post elevated external deficits in 2023-2024.[1] The trend is similar in Latin America: Mexico and Peru have reduced their external shortfalls to favorable levels. Chile's current account deficit has also narrowed substantially from -10% of GDP last year, but it remains elevated at -3.6% currently, which we also forecast for end-2024, though this is lower than the -5.2% posted in 2019. Meanwhile, Brazil and in particular Colombia continue to post higher deficits than in 2019. In Africa, Egypt's external deficit is shrinking, thanks to import austerity and an increase in revenues from the Suez Canal, which has also contributed to maintaining the primary balance in a surplus on the fiscal side. And South Africa will likely post manageable current account deficits in 2023-2024 after surpluses in the previous two years, while foreign investment flows are on the way up. In the Middle East, Saudi Arabia and the UAE are forecast to continue to post sizeable current account surpluses in the next two years despite lower energy-related revenues, particularly from crude oil (Figure 4).

Figure 4: Current account balance (% of GDP, 4-quarter rolling average)



*Sources: IMF, National statistics, Refinitiv Datastream, Allianz Research. * Due to data availability, the sum of the last 4 quarters of current account balances ends in Q2 2023 for Colombia, India, Israel, Philippines, Saudi Arabia, South Africa, UAE and the US.*

In this context, some EM central banks have already started to pivot. While EMs would usually be expected to take a reactive stance when it comes to monetary policy easing, this time they have not waited for central banks in advanced economies. Several countries in Latin America (Brazil, Chile and Peru) and Eastern Europe (Poland and Hungary) have already kicked off interest rate cuts, prompted by both improving current account balances and improving inflation outlooks, as well as stabilizing currencies. We expect regional peers to follow in the first half of 2024 as inflation continues to fall, albeit at a decelerating pace, and longer-term expectations remain anchored. Even Türkiye, which has hiked massively in H2 2023 on the back of a 180° shift back to orthodox policies, may begin monetary easing in H2 2024, when inflation should eventually fall back to lower double digits. However, EMs in

[1] *See What to watch 24 November 2023, p.4-7, for more details on the current account rebalancing in Central and Eastern Europe.*

Asia, excluding China[2], have been more cautious. In fact, Thailand, Indonesia and the Philippines executed moderate 25bps rate hikes in September-October, although inflation rose markedly only in the Philippines. One reason is that Asian central banks have not hiked as massively in the last two years as their peers in other regions. As a result, Emerging Asian currencies have shown some weakness during 2023 and some economies have experienced capital outflows. Overall, we expect most Asian central banks to wait until H2 2024 for their first rate cuts. South Africa may be the only outlier in Africa, with some easing possible in H1 2024, while monetary authorities in the GCC states will continue to closely follow the Fed's monetary policy to maintain their currency peg to the USD. More generally, the strong USD has already limited the size of rate cuts across all regions and played a more fundamental role than domestic inflation in financial stress in smaller EMs (e.g. Egypt, Sri Lanka).

Table 1: Where each country stands in the monetary policy cycle

	Cutting	Cutting soon (H1 24')	Paused, no cut before H2 24'	Further hikes on the table, no cut before H2 24
Did not face inflationary pressures	China			
Inflation below 5%	Brazil Peru	Mexico Morocco South Korea	India Indonesia* Malaysia Philippines* Thailand*	
Inflation still above 5% but growth worries > inflation worries	Chile Hungary Poland	Czechia Romania South Africa	Colombia Kenya	
CB action still guided by inflation and/or financial stability worries				Egypt Nigeria Türkiye

*Sources: Refinitiv, Allianz Research. * Indonesia, Thailand and Philippines proceeded with minor 25bps hikes after June, the rest of countries in cautious pause have hold these rates for at least 5 months. Additional note: Middle-Eastern countries are not included as their monetary policy/currency regime is tied to that of the US.*

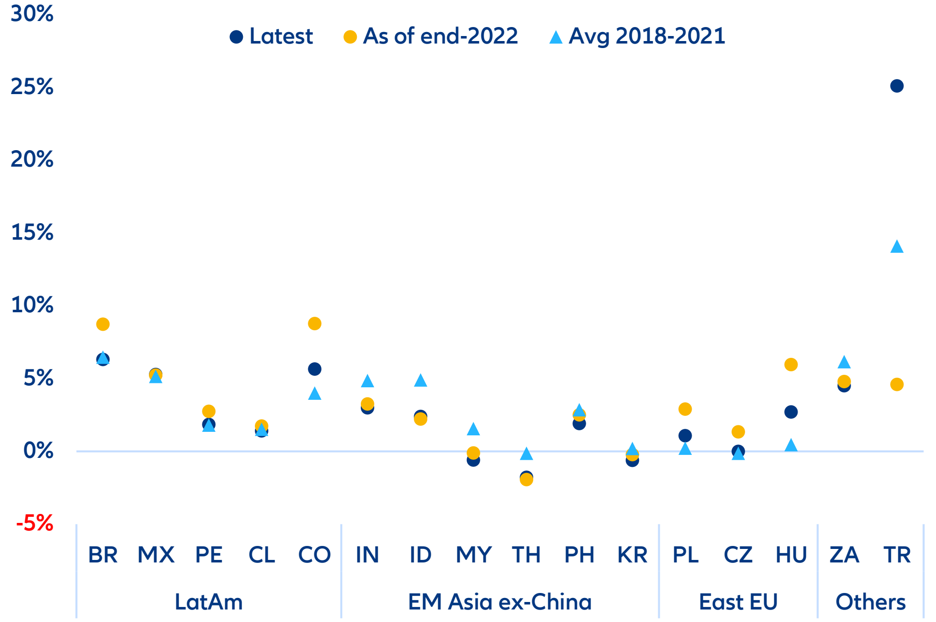
So far, markets have not reacted negatively to the early rate cuts. An orderly normalization of monetary policy, even if it takes place slightly ahead of advanced economies, should not fundamentally change the appeal of EM fixed income. Effective monetary policies have managed to reduce inflation, while the compression of risk premia in financial markets has helped make financial conditions less tight than the sharp increase in Fed Funds rate would have indicated. Put together, this has allowed EMs to preserve financial stability in a complicated environment. As growth and fiscal concerns overtake inflation concerns, real interest rates go from negative to a relatively high (positive) level and interest rate differentials with the US approach the averages of the last decade (Figure 5), markets are reacting positively to the first rate cuts. Thus, we do not expect local monetary policy to be the main risk to EM fixed income, though this does not mean we are overly optimistic. Downward inflation trends need to be confirmed, fiscal concerns are starting to rise and, although markets seem to be calm, the magnitude of the recent tightening should keep players alert for possible accidents of global impact (e.g. through dollar liquidity). We expect a muddle-through in EM fixed income in the upcoming quarters until AEs perform their first cuts, followed by a contained decrease in local yields (which for our benchmark for EM local yields means going from 6.5% to 6% by end-2024 and 5.5% by end-2025). Emerging Europe has more downward potential in yields, while it is more limited in some of Latin America's recent fixed income stars. Emerging Asia, which has not experienced any rebound in

[2] *More on the specifics of China's monetary policy and its relation to the ongoing challenges here: A slow landing for China (allianz.com).*

2023, could be a bright spot in 2024 as countries refrain from early cuts but continue to show stronger fundamentals in terms of growth and fiscal policy.

However, the asynchronized monetary easing could pressure EM currencies. In general, currencies in EMs with high interest rates have performed well this year (notably in LatAm), despite the effects of Chinese growth concerns and further US exceptionalism in H2 2023. But some central banks (e.g. Chile) have had to slow down their rate cuts amid increasing pressure on their currencies. While carry has not eroded in Asia, low rates have left many Asian currencies vulnerable, with few exceptions (e.g. the Indian Rupee, INR). With the USD set to remain strong through Q1 2024, the question is how much central banks can continue easing before currencies weaken. Carry erosion in LatAm currencies, particularly the Chilean Peso (CLP) and to some extent the Brazilian Real (BRL), will introduce some softening, but this is not expected to happen for some time. Early in the year, intervention should contribute to more stability in Asian FX and a closer link to the USD. We expect diverse performances in CEEMEA FX, with the Polish Zloty (PLN) and Hungarian Forint (HUF) likely to be supported by better local risk sentiment and carry, respectively, while the Czech Koruna (CZK) and South African Rand (ZAR) are expected to underperform.

Figure 5: Nominal interest rate differentials vs. the US of selected EMs (calculated with 5Y LC sovereigns), in pps



Sources: LSEG Datastream, Allianz Research.

As we enter a long election year, culminating with the US presidential election, watch out for misalignments or mistakes in monetary policy trajectories that may affect the economic recovery. EMs exposed to current account deficits due to structural imports in hard currency and/or national election cycles are particularly at risk as political campaigns could interfere with central banks' objectives – these countries may form a "Cut rates before elections cut you" cluster.[3] Gulf countries will likely follow US monetary policy, given the currency peg with the USD and already-stretched fiscal policy, as the ongoing conflict in the region hits investment appetite (directly impacting real estate and services). Like the Gulf countries, Mexico and Morocco are also affected by the movements of a major central bank and could also be included into a "Ties that bind" group of countries. Among the "Outliers", Türkiye, Egypt and Nigeria remain exposed to the risk of currency devaluation, even if import austerity in the first two, the partial recovery of exports of liquefied natural gas in Egypt (thanks to the resumption of flows from Israel) and crude oil and refined products in Nigeria may support the current account in 2024. These factors alone may not be enough to completely mitigate the risk of currency devaluation, political instability and high levels of liabilities in foreign currency.

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[3] *The election calendar is an element to bear in mind with regard to the balance between inflation and growth, as seen in Poland and Türkiye before May 2023. Next year, South Africa could become another example.*

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