CAPITAL ECONOMICS

# EMERGING MARKETS ECONOMICS UPDATE

## Takeaways from our EM roundtables

- **Over the past couple of weeks we have held a series of roundtable discussions with clients across Asia and North America on the outlook for EMs. In this *Update* we provide our thoughts on the recurring questions that we received, including on China's reopening recovery, sovereign default risks, banking weak spots, inflation and global economic fracturing.**
- **Does China's reopening recovery still have legs?** We think the reopening recovery has a little further to run despite the activity data for April undershooting expectations. In particular, the tightening of the labour market should help to support income growth and consumption. Our forecast for GDP growth of 6.5% this year still looks achievable, especially given the weak base for comparison from last year's downturn.
- However, the recovery is likely to fizzle out during the second half of the year. Fiscal support will be pared back to meet budget targets. The rebound in credit growth is already stalling and the housing market appears to be struggling for momentum again. (See Chart 1.) Meanwhile, a challenging global demand environment will prevent much of a pick-up in Chinese exports.
- **Where are sovereign default risks the greatest?** Sovereign dollar bond spreads have widened again in many EMs over the past month or so and spreads over US Treasuries are above or near 1,000bp in several frontier economies. (See Chart 2.) Leaving aside Zambia, Sri Lanka and Ghana (all of whom have already defaulted over the past 12 months or so) we are most concerned about financing strains and fiscal risks in Pakistan and Tunisia. Both countries have among the largest budget deficits and debt burdens across frontiers.
- Developments in both countries have worsened recently. Tunisia's President called out against the IMF's hard-line fiscal consolidation mandate last month, sending bond spreads sharply higher. Pakistan had been making slow progress to unlocking IMF financing, but has been rocked by protests in the past month and an IMF deal now appears much further away. In both countries, there is a high risk of a sovereign default.
- **EM banks came through the global turmoil unscathed, but are there any pain points?** The big unknown is whether banking problems flare up elsewhere – as the events of the past couple of months have shown, only one bank needs to fail to cause wider turmoil in a country's financial sector. On the liabilities side of balance sheets, loan-to-deposit ratios are generally low but some EMs including Czechia and Hungary are worryingly reliant on large amounts of banking sector inflows to finance current account deficits.
- On the asset side, most EM banks appear well placed to weather a rise in NPLs from a period of subdued economic growth. But risks do lurk in a handful of places. In Poland, a key risk stems from further adverse court rulings regarding the country's Swiss franc mortgage problem and the possibility that banks have to accept losses on their loan portfolios if contracts are cancelled. Meanwhile, the rise in unsecured lending to households in India has probably boosted bank profitability there but leaves the sector vulnerable to rising defaults, a concern that is exacerbated by relatively low loan loss absorption capacity. In Vietnam and Korea, property sector risks, partly stemming from tighter monetary policy, are becoming more acute.
- **On your forecasts, why does inflation end the year so much lower in Asia than in other EM regions?** Inflation has dropped this year not just in Emerging Asia, but across other EMs as well. And many of the same factors, such as more favourable base effects from fuel and food inflation, easing disruption from the pandemic and slower economic growth will mean that headline inflation rates continue to moderate over the course of this year. But whereas we expect inflation across Asia to come down to 2-6% by the end of the year and generally be within or close to central bank target ranges (see Chart 3), inflation elsewhere will end the year much higher, and a long way above targets.
- In part this reflects the fact that inflation in these regions rose much further in the first place, partly because they were more exposed to the surge in food and energy prices. What's more, services inflation is particularly strong in Emerging Europe and, to a lesser extent, Latin America; it is much weaker in Asia. While lots of factors influence services inflation, we think one key explanation for this difference across regions is the state of EM labour markets, which are much tighter in Emerging Europe and Latin America than elsewhere and are generating stronger wage pressures. (For more, see our Focus.)

**Shilan Shah**, Deputy Chief EM Economist, shilan.shah@capitaleconomics.com

- **Can EM central banks begin loosening policy before their DM counterparts?** EM central banks were quick off the mark to hike interest rates and, unsurprisingly, they also brought their tightening cycles to an end long before DM central banks. And in recent history, EM central banks have tended to turn from tightening to loosening monetary conditions quite rapidly, *without* having to wait for DMs to move first. For instance, EM central banks shifted to interest rate cuts in early 2016 and again in late 2018 when the US Fed was tightening policy. (See Chart 4.)
- Instead, shifts in expectations for US interest rates have tended to play a bigger role. The four shifts in EMs from tightening to easing monetary policy between 2008 and 2019 were preceded by or coincided with declines in the 10-year US Treasury yield. And as for domestic conditions, weakening growth and decelerating inflation are of course key triggers for looser policy across EMs. So if history is any guide, it looks like the conditions will be in place for an easing cycle to start from around July/August.
- **Where might the non-aligned countries fall in a fracturing global economy?** In our mapping decoupling work, we attempted to place all countries according to whether they fell in the China or US camp or were non-aligned. The non-aligned countries are generally in South East Asia (e.g. Indonesia) or commodity producers (Brazil, Saudi, South Africa). The alignment of the latter group was frequently questioned.
- Our mapping is something that we will refresh regularly. But the short point is that Saudi, Brazil and South Africa all appear to be tilting – to varying degrees – towards the China camp. As major energy and metals exporters, their economic ties with China have deepened significantly over the past few decades. Political ties with the US have frayed, and those with China have warmed.
- One of the most important global angles is that, if these countries move further into China's camp, that will help China secure access to key commodities. For the countries themselves, it reduces the likelihood that Western firms will invest – perhaps limiting the spread of technology and know-how – although that might be offset by greater integration into Chinese supply chains. There would probably also be reduced aggregate foreign capital inflows. For South Africa and Brazil, which have structurally low domestic savings rates, that will limit investment and may hold back potential GDP growth.

**Chart 1: China Residential Real Estate Activity (SA)**

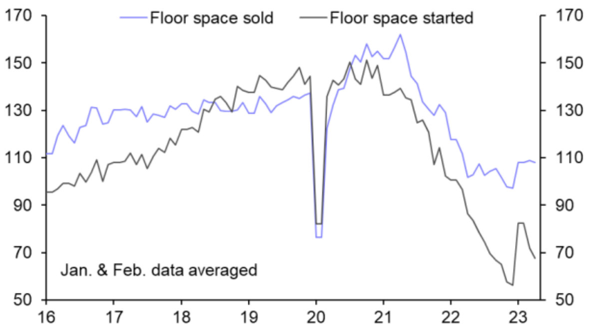



**Chart 2: JPM EMBI Stripped $ Bond Spreads (Latest, bp)**

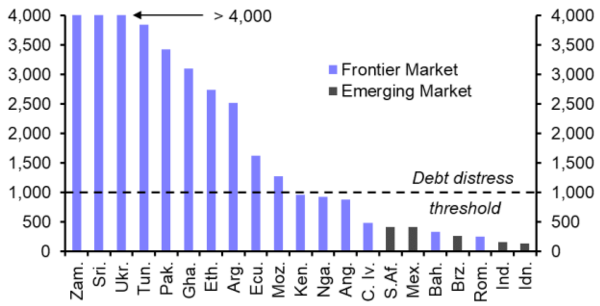



**Chart 3: CE Headline Inflation Forecast and Mid-Point Inflation Targets (End-23, %y/y)**

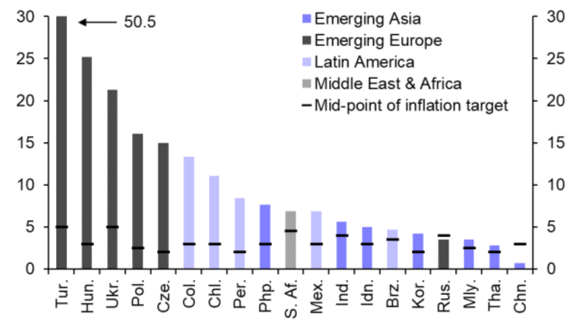
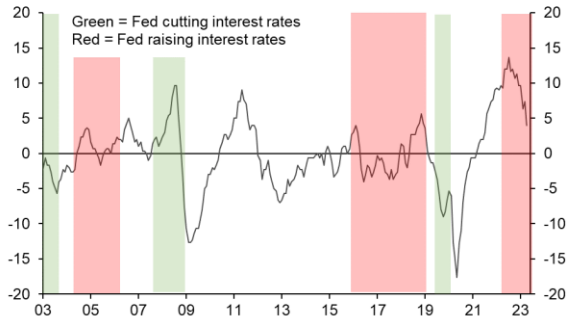



**Chart 4: CE EM Diffusion Index (No. of Hiking Less Cutting Rates)**




Sources: Refinitiv, CEIC, Capital Economics