Perspectives
Emerging Markets

Fourth quarter 2020

Key messages

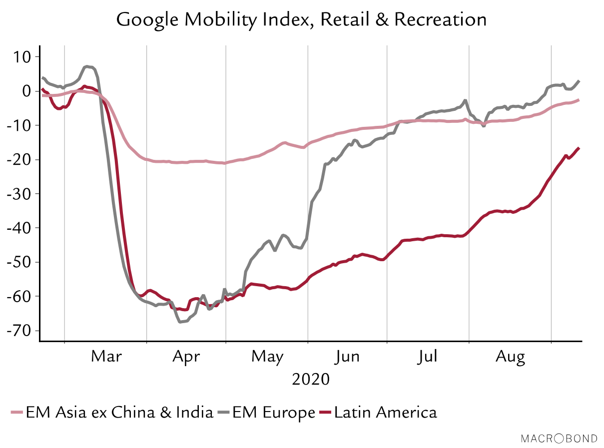
- China's economic recovery gains steam as consumption joins industrial recovery
- The economic recovery in Latin America lags other regions, as lockdown measures remain strict
- Monetary policy to remain supportive, but room for further rate cuts is limited

Number in focus

295

Emerging central banks slashed their interest rates by cumulative 295 basis points so far this year, to counter the hit the pandemic has caused to their economies. However, the easing cycle is coming to an end for most of the countries, as they await the impact of their record interest rate reductions to yet filter through to the economies. Still, monetary policy will remain supportive and will not be revoked any time soon, despite a slight uptick in inflation, triggered by currency depreciation and supply distortions.

Chart in focus



After a very sharp slump of economic activity due to containment measures to rein in the virus spread, emerging economies are gradually recovering. Based on Google mobility indices that measure visitor numbers in specific locations and compare them to the situation before the pandemic broke out, the recovery progress is, however, uneven. While emerging Asia (India excluded) and emerging Europe recovered rather swiftly, Latin America remains the laggard and will likely report among the weakest third quarter GDP prints this year.

Sharpest GDP contractions ever recorded

Emerging economies experienced their biggest contraction ever recorded in the second quarter this year, as lockdown measures to rein in the pandemic led to a virtual standstill of economic activity in some sectors. Not surprisingly, those countries that implemented the strictest lockdown measures, also suffered their sharpest GDP contractions. With its GDP shrinking by 23.9% compared to a year ago, 3.4 percentage points below consensus estimates India reported the second largest contraction in the emerging world, right after Peru. While first economic indicators point to a gradual improvement of economic activity in the third quarter, the pace of the recovery remains very uncertain. On the one hand, fiscal stimulus has been and is likely to remain limited, due to budget constraints. Moreover, on the pandemic front, developments are not encouraging, as India has the world's highest daily infection rate, which is not expected to decline any time soon. South Africa's strict nationwide lockdown implemented on March 27 delivered a big blow to its already ailing economy, with its GDP contracting by 17.1% in the second quarter. Meanwhile, a record-high unemployment rate of above 30%, weak confidence as well as longstanding issues, such as electricity outages that intensified, will constrain the country's recovery. Besides India and South Africa, the crisis dealt a violent blow to a number of Latin American economies, such as Peru, Mexico and Chile. This comes as no surprise, given that this region has experienced the pandemic in a particularly painful way, recording the highest mortality rates among emerging countries, while daily new deaths remain at elevated levels. As a result, in those countries containment measures remain among the strictest, according to the Oxford University's Containment Stringency Index, which will weigh on the future recovery progress in the last quarter of this year.

Brazil: recovering swiftly but at the backdrop of higher debt

While South American economies are suffering quite a bit from the pandemic, in Brazil economic activity is rebounding quickly. Brazil's second quarter economic contraction of 10% has been much less severe compared to peers. Moreover, retail sales reached pre-crisis levels already in the month of June and expanded by 5.5% in July from a year ago. Consumption in Brazil has been boosted by cash handouts to the informal sector and job protection programs. These monthly payments are to be extended until end of year, will however be cut by half. Therefore, although further readings are expected to show positive growth, the recovery progress will likely moderate. Meanwhile, Brazil's steady recovery in goods demand comes unfortunately at the cost of a considerably higher debt burden that is piling up rapidly and is widely expected to exceed 100% of GDP this year. While Economy Minister Guedes remains determined to keep governmental finances in check, he will likely be pressured by President Bolsonaro to keep fiscal aid ample. Despite the fact that Brazil suffers its deepest recession since record began, and although the very high coronavirus death toll continues to rise, Bolsonaro is enjoying all-time high popularity ratings that were boosted by the monthly cash handouts. If the debt burden is not contained later on, it could raise fiscal solvency concerns and dent investor confidence, which would result in higher interest rates and then again weigh on economic activity.

Chart 1: The stronger the lockdown measures, the sharper the economic slump

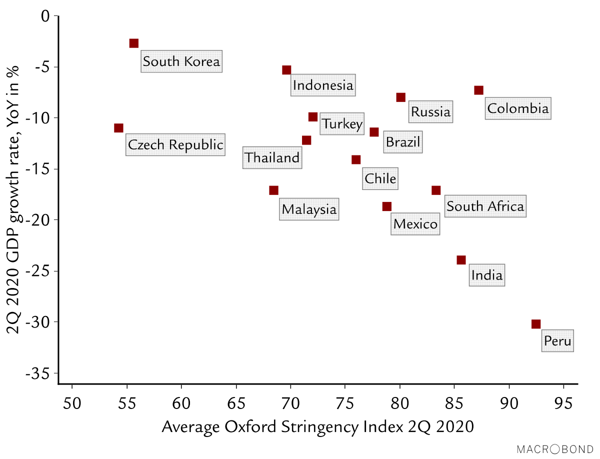
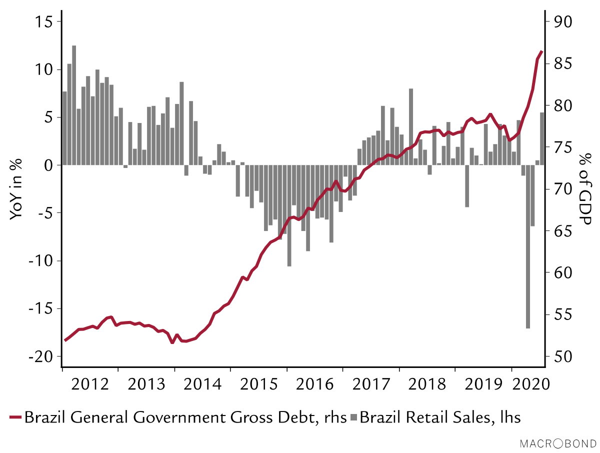


Chart 2: Brazil: Cash handouts boost retail sales, but fiscal position deteriorates



Turkey's fundamentals deteriorate sharply

Already before the pandemic outbreak, Turkey's economic fundamental situation has been weak, with a chronic current account deficit as well as a high burden of foreign currency debt, which both could not be covered with its foreign exchange reserves – leaving the country with a substantial need of foreign financing. Meanwhile, the pandemic has made this fundamental vulnerability much worse. The current account deficit is soaring once again, with exports and tourism revenue collapsing. At the same time, the country has wiped out a large amount of its foreign currency buffer in order to defend the Turkish lira. These developments are spooking investors and exert even more downward pressure on the lira, which already lost roughly 20% of its value against the US dollar so far this year. As lockdown measures have continuously been eased, and as the government rushed through a strong credit push, economic activity is recovering. Nevertheless, ongoing downward pressure on the currency is leading to inflationary pressure, which could hit economic activity once again.

China: demand follows supply side recovery

China's economy rebounded in the second quarter this year and expanded by astonishing 3.2% from a year ago. This strong rebound has been supported on the one hand by strong global demand for Chinese goods, such as medical equipment as well electronic devices, that kept exports buoyant. On the other hand, government stimulus measures have pushed real estate and infrastructure investments. Therefore, China's initial recovery path has been very much industry-driven, consumption and services have lagged. Meanwhile, however, China's economic progress is getting more even. While the country experienced new regional clusters of coronavirus infections, it has been able to avoid a further spread across the country. Therefore, it has substantially eased its social-distancing measures. This new shift has been evident in recent economic indicators. August retails sales surpassed year-ago levels for the first time this year, while also the official NBS non-manufacturing PMI remained well in expansionary territory, with a reading of 55.2. Therefore, we expect the recovery in the services sector to gain steam and revise up our annual GDP forecast to 2.5%, from 2.3% previously. However, headwinds remain, with pent-up demand for certain goods that will likely lose steam, and Beijing that is determined to cool the property market, as housing prices in Tier-1 cities started to soar. Moreover, the US-China conflict over a large range of topics, including financials, technology and geopolitics, is not abating. With multiple threats looming, such as bans of various Chinese applications as well as restrictions of US technology exports to Chinese semiconductor company SMIC, the risk of a decoupling between the two superpowers has increased. This on the other hand, would not only dent Chinese growth in the short-term via dented manufacturing investments and weaker exports, but also in the long-term, since China's potential growth would be hit due to weaker productivity growth if technology transfer comes to an end. Also, a potential democratic shift in the upcoming US elections would not be a boon for China, since the hawkish view towards China is not limited to the Trump administration. What could change however, is that policies under Joe Biden would likely be less unpredictable and shift away from trade and technology barriers towards human rights issues.

Chart 3: Turkish lira in free-fall amid depleted foreign currency reserves

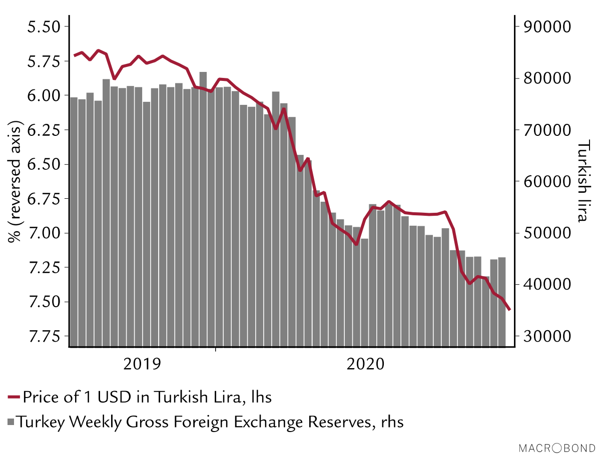
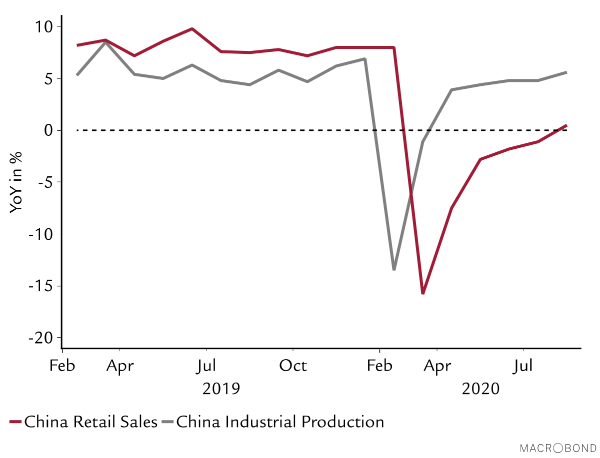


Chart 4: Consumption recovery joins the industrial expansion



Economic Research

Marc Brütsch
Chief Economist
marc.bruetsch@swisslife.ch
@MarcBruetsch

Damian Künzi
Economist Developed Markets
damian.kuenzi@swisslife.ch

Josipa Markovic
Economist Emerging Markets
josipa.markovic@swisslife.ch

Francesca Boucard
Economist Real Estate
francesca.boucard@swisslife.ch
@f_boucard

Rita Fleer
Economist Quantitative Analysis
rita.fleer@swisslife.ch

Consensus Economics
Forecast Accuracy Award Winner
Switzerland 2019

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Forecast Accuracy Award Winner
Euro zone 2019

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