Perspectives
Emerging Markets

First quarter 2022

Key messages

- Asia and Latin America experienced a weak third quarter
- Turkey's home-grown currency crisis has so far not spread to other countries, but a tighter monetary policy by the Fed will pose challenges for many emerging markets in 2022
- China: the real estate market is slowing, a looser monetary policy and foreign trade are shoring up growth

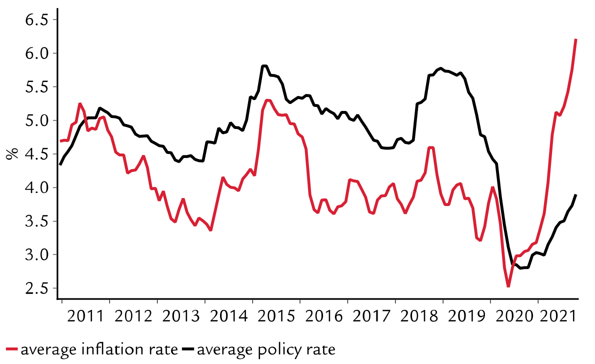
Number in focus

28%

The Turkish lira depreciated 28% against the USD in November after the central bank cut its policy rate for the third time since September. President Erdogan's influence on monetary policy and his preference for lower interest rates were already known. However, in an environment of robust growth (3Q GDP was 13% above pre-crisis levels) and high, rising inflation (annual inflation stood at 21.3% in November), this last move in interest rates triggered panic. Evidence of greater tolerance to currency devaluations makes a quick reversal of the dangerous experiment unlikely.

Chart in focus

23 largest emerging markets: inflation and policy rates



Sources: Macrobond, Swiss Life Asset Managers

Central banks in the other emerging markets are more in line with the textbook. In 13 of the 23 largest developing countries, key interest rates have increased since the start of the year. This is in response to rising inflation and currency depreciation risks. In November 2021 alone, eight central banks continued to raise interest rates, although their economic recovery is lagging behind Turkey's. These included the central banks of Mexico, Russia and the Czech Republic, although GDP in these countries has not even reached pre-crisis levels. Inflation, however, has risen further on average and is putting pressure on the central banks. A tightening by the US Federal Reserve could further accelerate the rate cycle (see page 2).

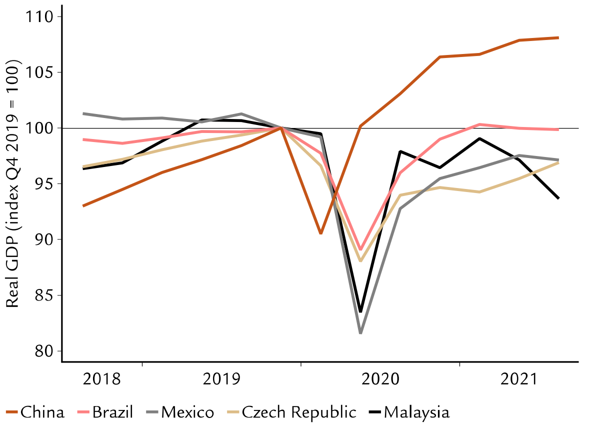
Weaker 3Q growth dynamics

Growth momentum slowed in most developing countries in the third quarter. In China, a mix of energy bottlenecks, a zero-tolerance policy towards new Covid-19 outbreaks and the crisis in the real estate market slowed economic growth to 4.9% (vs. 7.9% annual growth in the previous quarter). The fight against new waves of the pandemic also left its mark in other Asian economies in the third quarter. The sharpest economic slump was in Malaysia at 3.6%. However, momentum in Asia is likely to have picked up again in the fourth quarter thanks to opening measures. This is suggested by the Purchasing Managers' Indices (PMI) which, with the exception of China, remained above the growth threshold of 50 in November. Compared to other regions, inflation in Asia has increased at a slower pace so far, allowing central banks to wait with a tightening. Only the Central Bank of South Korea has so far raised interest rates twice, with inflation reaching 3.7%. The situation in Latin America is different. The two largest economies, Brazil and Mexico, have recorded inflation rates of 10.7% and 7.4% respectively, in spite of several interest rate increases since March 2021. At the same time, Brazil was in technical recession in the third quarter after two quarters of negative growth, and Mexico's GDP also declined in the third quarter. Similarly, industrial PMIs remained below the 50 mark in November. Emerging markets in Europe recorded a robust third quarter, but they must expect weaker momentum in the winter quarters due to the pandemic.

Risk: tighter US monetary policy

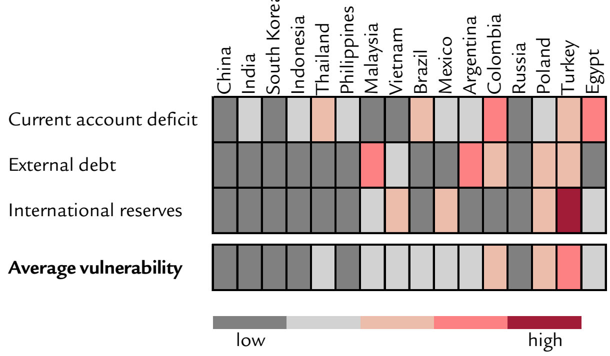
In addition to concerns about the spread of the new virus variant Omicron, fear of currency crises in developing countries has recently increased. In Turkey, the latest interest rate cut in an environment of rising inflation once again highlighted the president's influence on monetary policy and sent the Turkish lira spiralling downward (see number in focus). In other developing countries, central banks have so far been more in line with the textbook. The greatest threat to these economies does not come from home-made monetary policy experiments, but from the US Federal Reserve. An expected tightening of monetary policy in the US can put pressure on developing countries' currencies. This was demonstrated, among other things, by the "Taper Tantrum" in 2013, which led to capital outflows from high-yield currencies. Weaker currencies and, as a result, higher inflation forced central banks to raise interest rates. Developing countries with current account deficits, high external debt and low currency reserves have proven particularly vulnerable to higher US interest rates in the past. Our proprietary risk scores based on historical scores from 79 developing countries show that Turkey is particularly vulnerable, followed by Poland and Colombia. At the end of November, the US Federal Reserve pointed out that inflation was no longer merely temporary. US rate hikes may thus be on the agenda sooner than previously expected. This is likely to exacerbate the already challenging monetary situation in some developing countries in the coming months.

Figure 1: A mainly weak third quarter



Sources: Macrobond, Swiss Life Asset Managers

Figure 2: Vulnerability in the face of tighter US monetary policy highest in Turkey



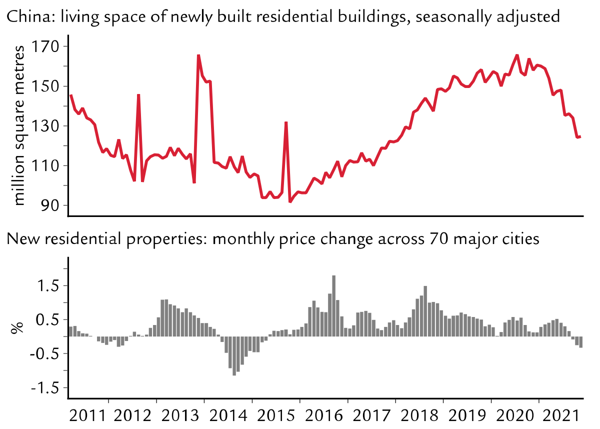
Source: Swiss Life Asset Managers

China: Balancing act on the real estate market

The situation of highly indebted real estate developers in China has worsened. Evergrande's rating, by far the largest affected company, was downgraded by Fitch to “restricted default” at the beginning of December after the grace period for a coupon payment expired. Thus, the path outlined in the last issue of this publication seems to be true: in order to maintain pressure on indebted real estate developers and, in a way, to set an example, the Chinese authorities have so far refrained from providing bailouts. The pressure is also maintained rhetorically, with the Politburo reiterating the credo that real estate is for housing and not for speculation. At the same time, most observers still expect that "uncontrolled" bankruptcy is unlikely and that the authorities will do their utmost to isolate the problem and prevent the crisis from spreading to the banking system and previously healthy real estate firms. In particular, the state is likely to have an interest in holding private households that have pre-financed projects as harmless as possible in order to prevent a collapse in real estate demand and falling real estate prices. Whether this balancing act succeeds remains to be seen. The crisis has left its mark on both the supply and demand sides (see figure 3). Activity in the real estate sector, especially new construction activity, continued to decline.

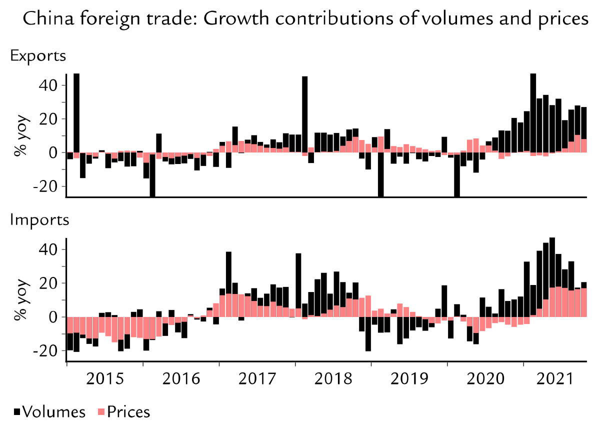
This supply-side response is desirable to some extent in order to let some air out of the bloated sector. However, it has a negative impact on upstream and downstream sectors. On the demand side, the reluctance of buyers is now affecting prices. Prices for new residential properties fell in September 2021 for the first time since the 2014/2015 real estate crisis. In order to boost lending and thus support the domestic economy, China's central bank recently lowered the bank reserve ratio from 12.0% to 11.5%. Further monetary easing is likely and should stabilise domestic economic growth at a moderate level. The biggest impulse for growth, however, is likely to continue to come from the foreign economy. Global demand is buzzing, capacity bottlenecks in freight transport are gradually easing, and Chinese export figures are likely to take the surprisingly good momentum of the second half of 2021 into the new year. It is worth noting that the good export performance was not primarily driven by rising prices and base effects, but by rising volumes (Figure 4). This contrasts with the import figures, which are weak in real terms and increased in September and October almost exclusively due to rising year-on-year prices – a sign of slowing domestic demand. Despite the positive industrial cycle, momentum could take a hit at the start of the year. In addition to the latent risks of the pandemic, there is still a threat of a temporary decline in energy and (heavy) industry production as the authorities want to contain air pollution during the Olympic Games.

Figure 3: Chinese investment property prices have fallen for the first time since 2014



Sources: Macrobond, Bloomberg, Swiss Life Asset Managers

Figure 4: China's foreign trade is buzzing, with exports driven by rising volumes



Sources: Macrobond, Swiss Life Asset Managers

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