Emerging markets: The resilient and the vulnerable

Emerging Markets Outlook 2023

Triodos Investment Management

In 2023, emerging markets will continue slowing down, with below-trend growth. Inflation will be peaking in many of them, but it will generally remain above central bank targets. And because the global economy is likely to avoid a recession, it is time to build the conditions for a broad-based resilience if we want to prevent yet another, in depth and duration unprecedented global crisis. This will require collective actions, including cementing common values on how people and planet can prosper and creating capabilities to guide us all in mitigating and adapting to widespread disruptions. And facilitating sufficient and steady private investment flows so that the more vulnerable countries can manage these shifts, while generating the necessary buffers for the future. We have been learning the hard way that to become more resilient, it is no longer good enough to take a piecemeal approach confined to one's territory, but instead to look at fundamental transformations.

The resilient and the vulnerable

After two global shocks with severe adverse spill-overs and recurrent natural disasters, emerging markets are facing a challenging landscape. And yet, some countries are weathering the storm better than others. Indeed, not all countries have been equally affected and some have even had a strong rebound. But when countries do rebound, many are not sufficiently resilient or prepared to adapt, endure future shocks, or reduce the impact that a rebound may have on the environment.

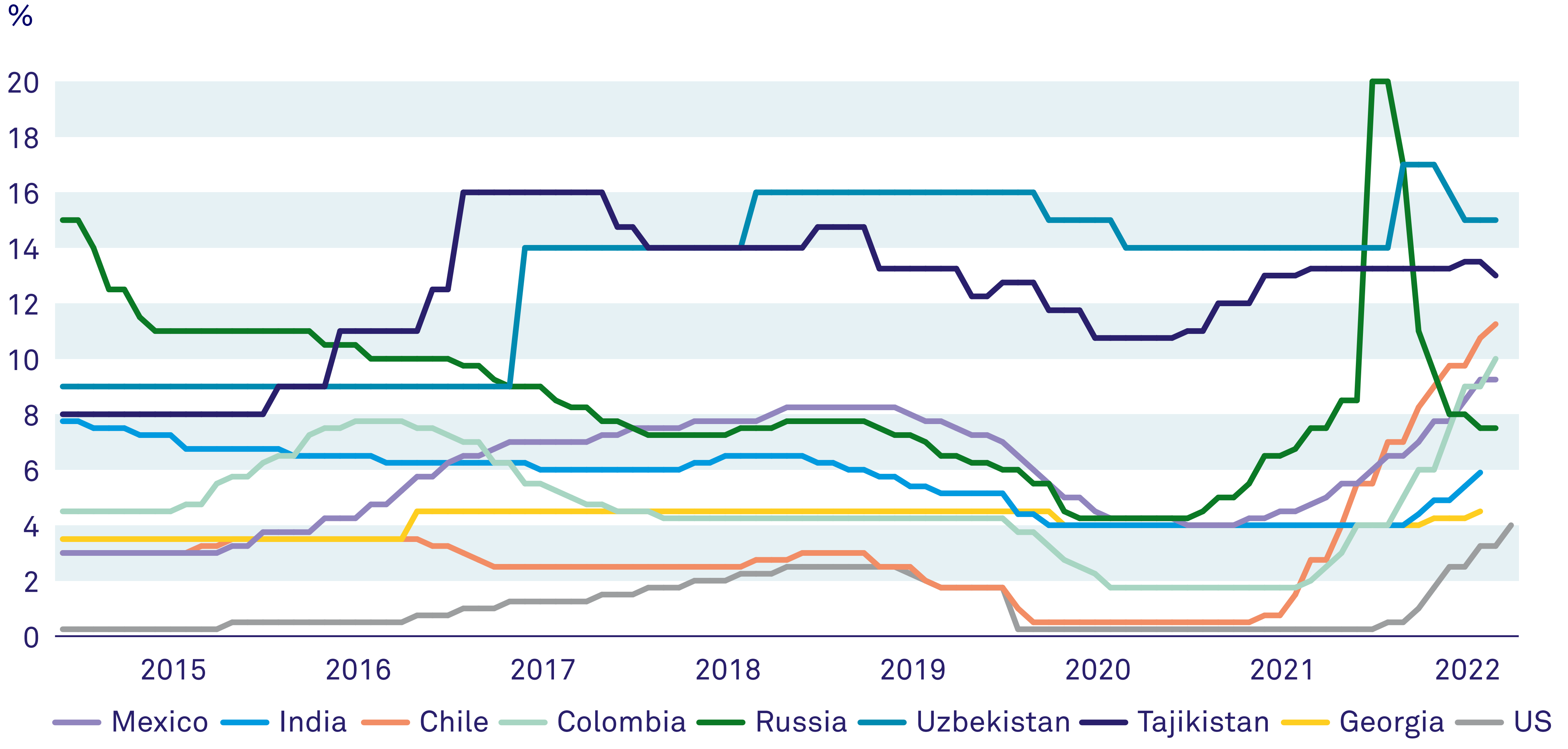
The more vulnerable countries are even worse off than the rest, because before the shock they were already facing high inequality, poverty and wide current account and fiscal deficits, financed with unsustainable debt levels. These problems are often seen as isolated issues confined to the relief that each individual country can provide. But as previous crises have taught us, including the 2008/09 Global Financial Crisis and the COVID-pandemic, it is not only about rebounding as a country, it is also about making systems across the global economy more resilient.

To become more resilient, it is no longer good enough to take a piecemeal approach confined to one's territory, but instead to look at fundamental transformations. Indeed, individual reactive actions to tackle inflation by major central banks are bringing about significant costs to the more vulnerable countries through weaker currencies and higher borrowing costs. The same holds for commodity export bans to safeguard a country and across the board subsidies to mitigate the loss of purchasing power of its citizens. When not targeted, both create distortions in pricing and shortages of goods instead of positive impact. And without an integrated global framework for climate change, we will not reach the speed needed to avoid new disasters, especially in poorer countries.

The year central banks declared a war on inflation

2022 started on positive footing, with emerging economies rebounding after the COVID pandemic. Contrary to past rate hike cycles by the US Federal Reserve, emerging markets' fundamentals were strong, with lower debt levels and higher foreign currency reserves (although some have been down-sized recently), while more flexible foreign exchange regimes allowed countries to better absorb external shocks compared to the times when central banks had to defend fixed exchange rates. And to avoid aggressive rate hikes, many emerging markets, particularly in Latin America, had already started hiking rates in 2021 in anticipation of Fed monetary tightening (see graph 1).

Figure 1 Emerging markets central bank policy rates



Source: Refinitiv

However, a lot has changed since the outbreak of the war in Ukraine. The positive start withered and turned into a slowdown of GDP growth in emerging markets. We expect GDP growth to fall to around 3.5% in 2022 compared to 6.5% in 2021. Fortunately, a broad recession and systemic defaults in emerging markets have been avoided.

Indeed, China and India are contributing to a modest lift in global growth. India has become one of the fastest growing economies with 13.5% GDP growth yoy in the second quarter. And although China has paid a high price for the many local lockdowns to reduce COVID contagion and its zero-tolerance policy, successive packages to support the property market have resulted in a 3.9% GDP growth yoy in the third quarter, higher than China watchers expected.

A tale of two giants: Not yet resilient

China's GDP growth per capita amounts to around 8% since 1980, an extraordinary performance matched only by a handful of other countries - including India (4%). The cases of China and India illustrate how the search for resilience differs across countries and that high GDP growth is not necessarily a synonym of resilience. Strong economic fundamentals and high saving rates have helped these countries weather difficult times. The policy choices for their development path have also been critical. And given their size, the search for resilience has had spill-over effects elsewhere, occasionally helping and at other times even compromising the sustainability of other countries.

China managed double-digit GDP growth for long periods, but since 2007 China's growth has been slowing down. In the 1990s strong growth was driven by rural-urban migration with an impetus for infrastructure building and manufacturing. This allowed China to move from a low-income to a medium income country, while reducing poverty. Later on, China chose to transition from an investment to a consumption-driven society and all along giving priority to the rise of innovation and technology. Throughout these stages of development, China has been increasing its international influence, providing manufactured goods to the world and linking financing to the extraction of natural resources in commodity-rich emerging countries.

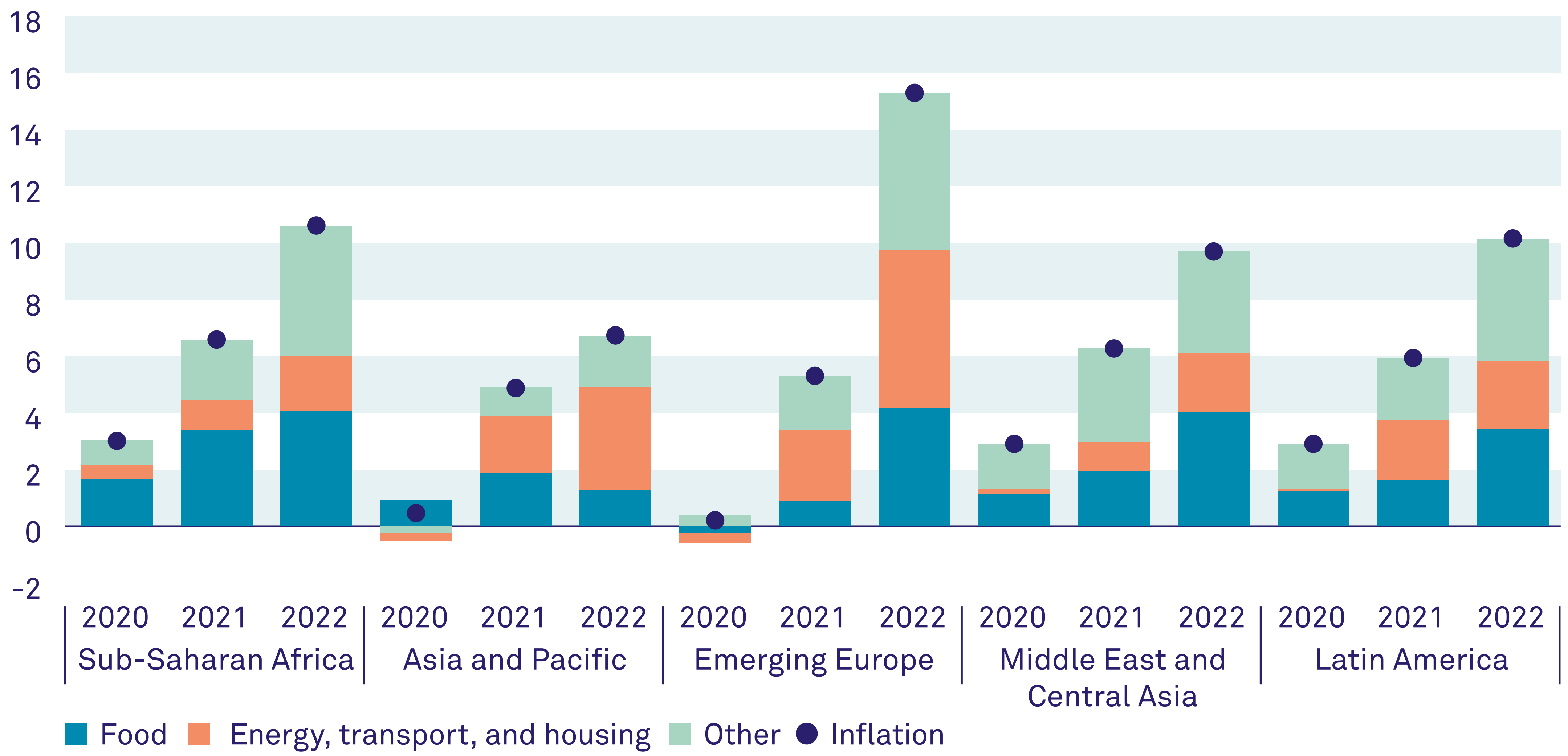
As the factory of the world, China's CO_2 emissions peaked in 2007, but so did GDP growth at 14% yoy. However, China has more recently managed to decouple its growth from its territorial emissions somewhat, partly because of its shift to consumption but also to some extent because the emissions have been transferred to other countries. From 2007 to 2020, Chinese infrastructure financing in emerging markets was 2.5 times as large as that of other bilateral institutions combined and it has accounted for more than **a quarter of total public debt** in seven of the twenty-two countries with debt sustainability problems. This strategy may have helped reduce the domestic emissions and prices of the commodities they imported, but the environmental, societal, and financial costs abroad have increased.

China's shift to self-sufficiency has become more prominent because of geopolitical divides. At the recently concluded 20th Party Congress, China announced prioritising security and governance, which may involve more authoritarianism and perhaps conflict, downplaying global cooperation and wellbeing. China's strategy is to become more robust by being less integrated, but this transition needs to be orderly, because of China's role in global trade and financial markets.

India is currently one of the fastest growing economies in the world. However, internally there is a large divergence across states. In fact, inequality grew in India when growth lifted off. We now see a divergent India. Goa has manged to reach middle-high income levels, while Bihar remains a low-income state with high poverty levels. Dispersity that leads to more inequality, makes countries in the long-run less resilient.

Efforts to integrate the country are ongoing. This includes the introduction of a national manufacturing programme, granting subsidies for specific sectors, massive digitisation, and online government services, as well as national policies to develop green finance. And as manufacturing and exports are already shifting from China to India, the development path that India takes will be critical. As the world's third largest CO_2 emitter, India depends on fuels like coal which **generates 58% of its power**. In 2022 for the first time, two-thirds of the county were hit by extreme heat conditions for the longest period ever, limiting agricultural production and exports, while increasing food insecurity worldwide. So, the best bet is not growth, but improving the environment and the quality of life for its citizens, only then will India become more resilient.

Figure 2 Inflation drivers, inflation is now double-digit and more broad based
Annualised %



Source: IMF

Meanwhile, Emerging Europe (incl. the Caucasus countries) reported better growth than expected, despite the looming energy crisis in the region. Reallocation of workers, companies, trade, and capital flows from Russia are likely helping. And Latin America, as commodity exporting region, has reported respectable growth rates so far. But several low-income emerging economies – the commodity importers - including Sri Lanka and Pakistan and some Sub-Saharan African countries, are suffering disproportionately from the food and energy crisis and a shortage of funding.

As for inflation, which was already on the rise in 2021, it has only worsened as the food and energy crises have spilled over to other products, with inflation moving to double-digits in a large part of the world. Additionally, the stronger US dollar has led to weaker emerging market currencies and higher inflation pressures. Emerging Europe has reported the largest increase in prices (see graph 2), followed by Sub-Saharan Africa.

Among the poorer segments of the population, where food accounts for up to 50% of the consumer basket, food insecurity is taking its toll. But global food inflation seems to have peaked. Central bank tightening, improved supply conditions and the suspension of Russia's blockade of Ukrainian grain exports are driving this decline. Several emerging market central banks are even slowing the pace of rate hikes and becoming more tolerant on inflation overshoots. Perhaps because central banks are aware that interest rate hikes often take time to work through the economy, with an estimated lag between twelve-eighteen months.

Governments: limited support but could do better in building resilience

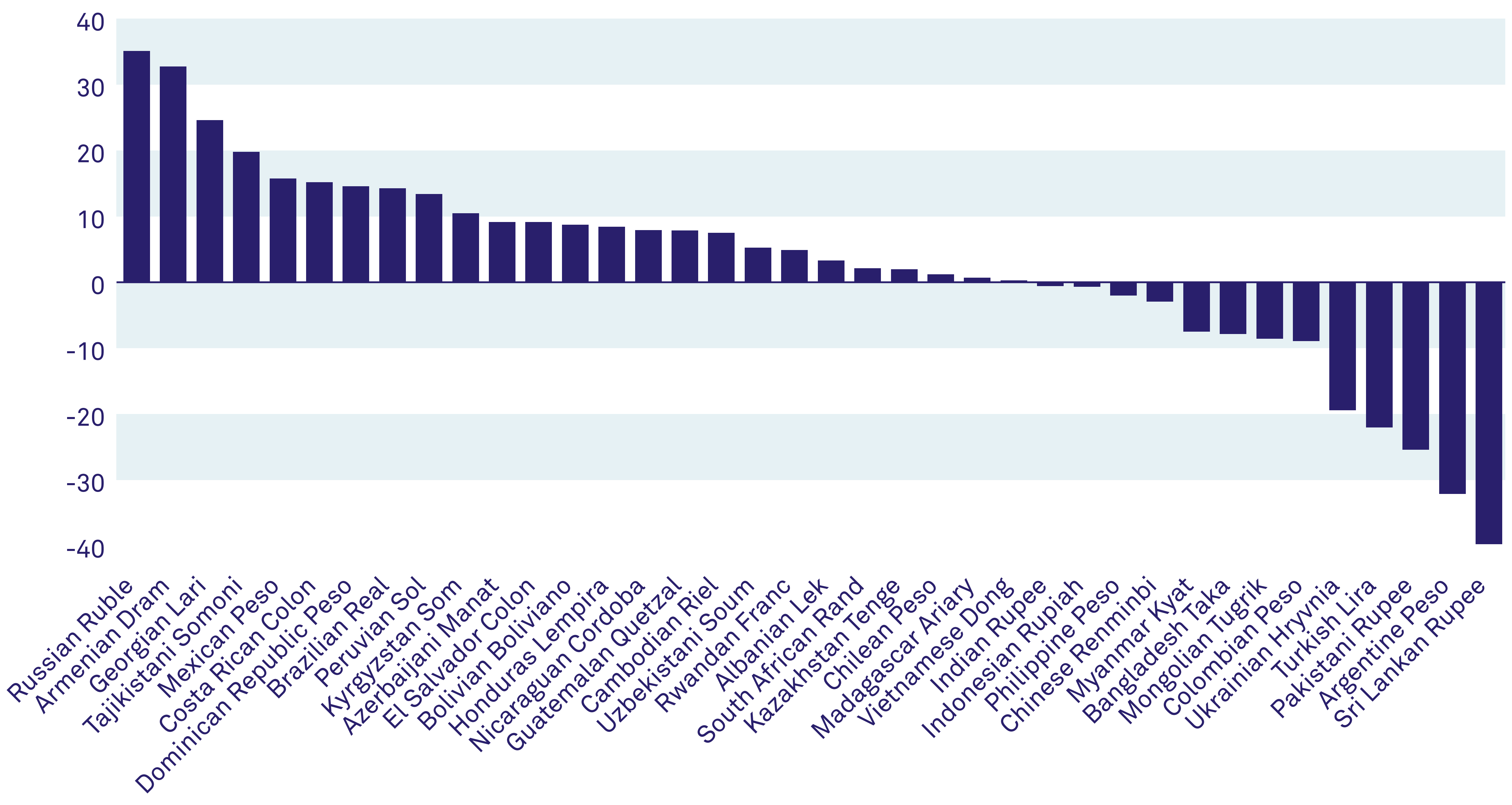
At the same time, governments in emerging markets are focusing on putting out fires and trying to mitigate the impact of higher energy and food prices through different measures. These include tax cuts or providing direct energy and food subsidies, while only a small number is providing targeted support to the most vulnerable. In the current circumstances, fiscal consolidation would have been better, because larger fiscal deficits mean more financing needs at higher costs for countries with increasing risk premiums. In truth, however, public funding in emerging markets will never meet the needs to build more resilient economies, but government choices can make a difference to 'nudge' citizens to making better choices for people and planet. Governments with their decisions can help countries to adapt successfully and recover from shocks, maintaining a base level of welfare for all people even after a shock occurs.

Stronger US dollar adding to emerging markets financing costs

In this uncertain environment with the Fed still in a tightening mode, recurrent COVID outbreaks in China, and a flight to safety the US dollar index with its major trading partners strengthened. Consequently, the euro and an overwhelming number of emerging market currencies have depreciated against the US dollar, particularly in the past few months. The weaker economies including Sri Lanka, Myanmar and Pakistan saw their currencies plumet, without any say (see graph 3).

Other emerging economies, including India, Indonesia and Mexico, were able to manage their currency depreciations and reduce the losses by hiking rates and/or through foreign currency interventions, as a temporary solution. In many cases, this has come at the cost of their international reserves. But what is important is that this has not triggered a new financial debt crisis across countries or regions, but instead an economic slowdown across emerging economies.

Figure 3 Emerging market currencies held up well despite external backdrop
% returns year-to-date



Source: Bloomberg, updated 24 November 2022

Global fragmentation a threat for building resilience

The COVID pandemic was exemplary in illustrating the costs at the health and at the supply chain levels of failing to address global problems with a collective and coordinated response. And now, since the war in Ukraine, geopolitical fragmentation has increased, as tensions between Russia and the West gain ground. Countries with similar economic interests are taking sides and moving supply chains to countries with similar (economic) values, in what has been coined as '**friendshoring**'. India and China, see more benefits for their countries if trade continues with Russia instead of joining a boycott. Additionally, the decoupling of the US and China, which has been ongoing for some time, has gained momentum recently as both countries are focusing more on their own security and economic interests.

For emerging markets trade fragmentation only increases their vulnerability. The reason is that emerging markets and developing countries have become increasingly integrated in the global trade system. They offer the benefits of trade diversification by creating redundancies in supply chains to mitigate over-concentration of risks. Emerging Asia, for example, **accounts for 50% of global demand in commodities** - supplied by different regions - including those needed for the renewable energy transition. Moreover, there is no doubt that complete autarky is very inefficient and ultimately reduces wellbeing.

Furthermore, trade fragmentation is being followed by the fragmentation of global banking and investment flows. Financial fragmentation affects mostly small and medium-sized enterprises access to finance as firms encounter credit rationing. This will likely spill over to labour markets. **The IMF** has estimated that average employment losses would be as high as 7% in Asia in a scenario of trade fragmentation.

Near-term outlook: three scenarios

In our *baseline scenario*, emerging markets growth in 2023 is expected to cool down to 3% from 3.5% in 2022, on the back of a mild recession in the US and the eurozone (see our Advanced Economies Outlook for more details) and ongoing high market volatility. Commodity exporters will slow because of lower commodity demand and higher risk premiums. Inflation in emerging markets is expected to peak in the second quarter of 2023 and despite being above their targets, central banks will be on hold. Some countries, particularly in Emerging Europe and Latin America, will continue to wrestle with high inflation levels because their currencies will continue to weaken until the Fed decides to pause. The US dollar will not give up its strength easily, because of the volatile environment, but there will be less pressure on currencies with stronger fundamentals, as the Fed moves to the end of its rate hike cycle.

Stimulus for the economy will remain limited. During COVID, governments have already stretched their finances, while central banks are in a tightening mode and unable to do 'whatever it takes' to support economies. The wealthier governments and multilaterals will be left to support the more vulnerable countries, ensuring food and energy security by working on ways to reduce sovereign debt risks. Without this support the recovery will be delayed and the costs of social fallout large. Improving resilience will become more difficult, because of weak buffers and limited global coordination on the transformations needed, leaving countries still vulnerable to disruptions.

In our *worst-case scenario*, a global recession and a sharp slowdown in emerging markets is likely to play out if global fragmentation takes the upper hand. This would mean a harder blow to trade, further increasing the prices of food and energy. And the longer it takes to put an end to the war in Ukraine, with increasing uncertainty, the higher the downside risks. As such, we would be seeing renewed export restrictions and higher costs of raw materials, including fertilizer prices – reflecting the reduced availability of fertilizer produced in Belarus and Russia. Inflation pressures would continue across the globe, central banks in Advanced Economies would continue hiking and the US dollar would strengthen further, putting even more pressure on emerging markets debt sustainability. Emerging countries will become only more vulnerable under this scenario, with the global economy becoming highly sensitive to shocks.

But if there would be positive surprises in China (more support for the property market and the zero COVID policy being lifted), the war in Ukraine not escalate further, and central banks would be successful in taming inflation, the outlook would be more *positive*. Because low-income countries will remain vulnerable to climate change, food insecurity and poverty, improved global conditions will not be enough to trigger growth and build buffers for more resilient economies.

Near-term 2023	Base case scenario declining inflation and slowing growth		Negative stagflation scenario high inflation, low growth		High growth scenario low inflation and divergence growth	
	Developing	Low-income	Developing	Low-income	Developing	Low-income
Resilience	🟡	🟠	🔴	🔴	🟡	🟡
Growth	🟡	🟠	🔴	🔴	🟢	🟡
Inflation	🟡	🟠	🔴	🔴	🟢	🟡
Savings gap (S-I)	🟡	🟠	🔴	🔴	🟢	🟡

🟢 Improvement 🟡 Modest deterioration/unchanged 🟠 Moderate deterioration 🔴 Significant deterioration

Long-term outlook - building buffers in search of resilience

Since global crises are no longer unusual, this means we need to prepare better for the future. There is no doubt that emerging markets that had invested ahead in education, health, food systems, safety nets and digitalisation have been more resilient to the recent crises (Indonesia and Mexico). And they were able to provide more support to weather the shocks.

At the same time the most vulnerable countries (Pakistan and Sri Lanka) that have been living on the edge, with large fiscal and current account deficits, had limited means to mitigate the impact and support their communities. These countries have no financial capacity or the so-called *ecosystem redundancy* to withstand shocks or to make policy mistakes (see our long-term outlook 'Resilience in times of polycrisis'). And after two shocks these same countries are now even more vulnerable to shocks, facing high risk premiums which only complicate their path towards resilience.

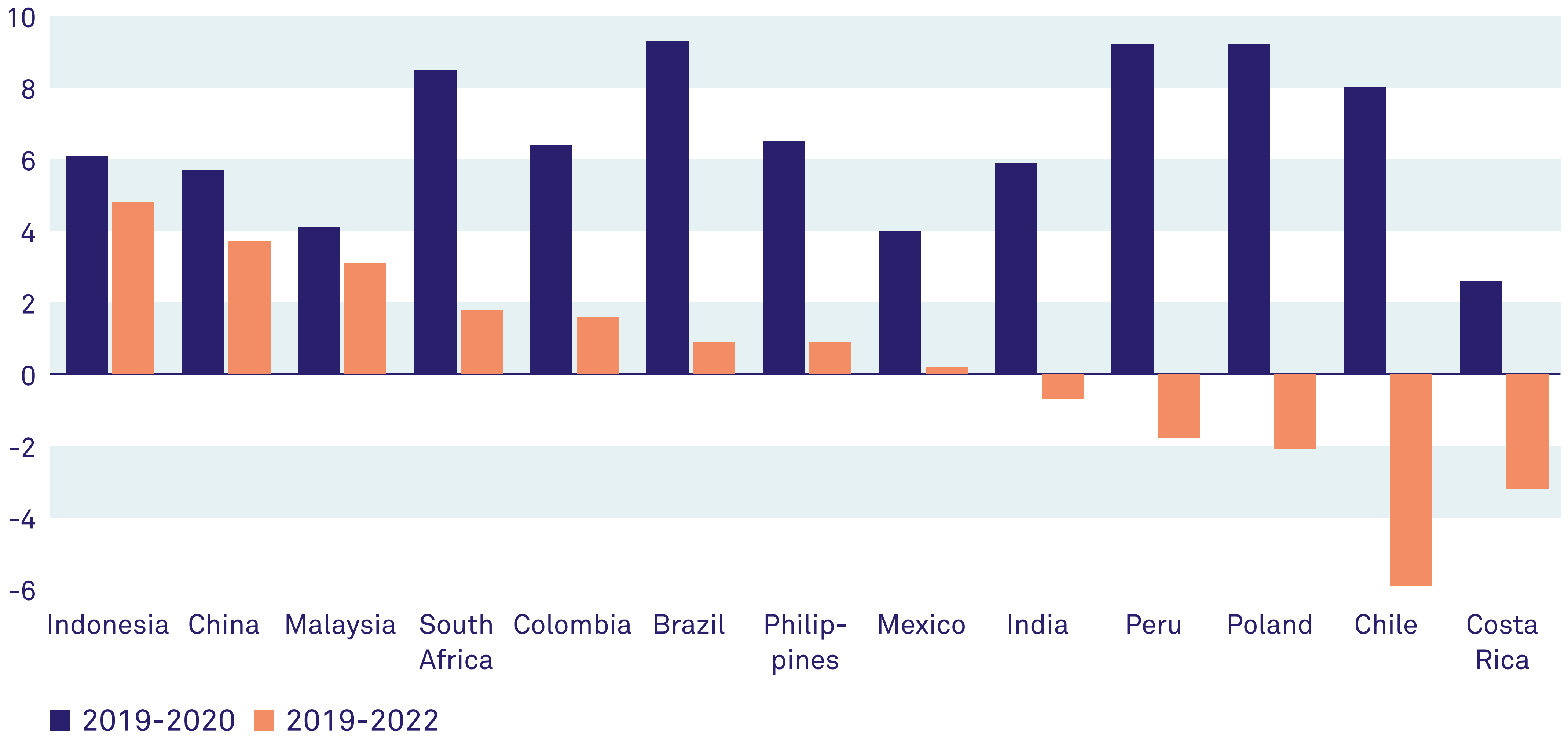
Indeed, when looking in more detail at the recent crises, buffers or private savings are a key factor separating the economic resilient from the most vulnerable countries. On average private savings in emerging markets show large dispersions, with China owning a large part of these savings. And private savings increased in 2020 during lockdowns, but the savings gap (savings minus investments) has strongly declined in 2022, particularly in Chile, Poland and Peru, even below the 2019 level (see graph 4).

To reduce the savings gap and improve the path towards resilience in emerging countries, particularly low-income countries, a wave of initiatives is being put forward. Now there is more acceptance that poor countries are often suffering the consequences of decisions taken elsewhere in the world and some multilaterals have been scaling up their concessional financing and seeking debt forgiveness for low-income countries.

In this context, the **IMF has created a new fund**, the Resilience and Sustainability Trust, to help countries build resilience and sustainability in the areas of climate change, pandemic preparedness and digitalisation. Costa Rica is the first country to obtain this type of financing, a country with a relatively low private savings gap, but showing increasing commitments to improve social conditions and the environment. Additionally, in the recent UN climate change summit, an agreement was reached to fund the losses and damages of particularly vulnerable countries to climate change, without stating how it is funded. But isolated efforts will not help in reaching the scale that countries need.

And as we have seen in the cases of China and India, although they have been fast to rebound on the back of their higher savings rates compared to the deficit countries, there are other concerns, including political divisions and security challenges which make them less resilient despite their buffers. A country's success in the search for resilience will depend on the willingness to go the extra mile to cement common values on how people and planet can prosper. And on the creation of capabilities to mitigate and adapt to shocks and manage transformations.

Figure 4 Emerging markets private savings - investments
% GDP



Source: Refinitiv

Forecast table- emerging markets selected countries

	GDP growth (% yoy)				**Inflation** (CPI, % yoy avg)				**Government debt/GDP** (%)				**Government balance/GDP** (%)				**Current account** (% GDP)			
	2020	Prelimi-nary 2021	Forecast 2022	Forecast 2023	2020	Prelimi-nary 2021	Forecast 2022	Forecast 2023	2020	Prelimi-nary 2021	Forecast 2022	Forecast 2023	2020	Prelimi-nary 2021	Forecast 2022	Forecast 2023	2020	Prelimi-nary 2021	Forecast 2022	Forecast 2023
Belarus	-0.7	2.3	-8.8	-1.6	5.5	9.5	16.4	12.4	38.6	33.7	46.4	52.7	-1.7	-1.3	-2.3	-2.5	-0.4	2.4	-9.8	-4.7
Bolivia	-8.7	6.1	3.0	2.9	0.9	0.7	2.0	3.5	59.1	56.0	59.7	65.3	-12.7	-9.3	-7.4	-7.0	-0.7	2.0	2.1	-0.4
Brazil	-4.2	4.9	2.9	1.5	3.2	8.3	9.4	4.6	89.4	81.0	82.5	86.9	-13.6	-4.4	-5.4	-5.0	-1.7	-1.7	-2.9	-3.4
Chile	-6.2	11.9	1.8	-0.6	3.0	4.5	11.6	8.1	32.5	36.3	35.3	33.8	-7.3	-7.7	0.5	2.2	-1.7	-6.4	-11.0	-8.1
China (mainland)	2.2	8.1	3.0	4.4	2.5	0.9	2.0	2.0	93.1	101.7	109.9	116.5	-6.2	-3.8	-6.6	-6.5	1.7	1.8	2.3	1.6
Colombia	-7.0	10.7	7.0	0.8	2.5	3.5	10.0	8.0	59.0	49.0	38.8	35.9	-8.2	-3.8	-5.4	-5.1	-3.5	-5.6	-5.3	-4.1
Ecuador	-7.8	4.2	2.9	2.7	-0.3	0.1	3.5	2.7	63.6	58.1	50.6	46.0	-5.5	-3.7	-1.9	-1.1	0.2	-1.5	-1.6	-2.1
India	-6.7	8.8	7.1	5.3	6.6	5.1	6.9	5.3	50.5	49.9	55.2	54.2	-6.0	-6.2	-6.3	-6.1	1.2	-1.0	-3.6	-2.4
Indonesia	-2.1	3.7	5.2	4.5	2.0	1.6	4.3	4.3	39.9	41.3	39.2	39.1	-6.2	-4.6	-2.3	-2.8	-0.4	0.3	0.9	-0.2
Kazakhstan	-2.5	4.1	2.0	2.4	6.8	8.4	14.8	9.3	23.6	22.8	28.8	34.2	-3.9	-1.5	-3.9	-2.9	-4.4	-4.0	0.0	-0.1
Kenya	-0.3	7.5	5.0	4.0	6.0	6.2	7.8	7.3	62.5	63.6	69.6	69.1	-8.1	-8.2	-6.4	-5.6	-4.8	-5.2	-5.9	-5.9
Mexico	-8.2	5.0	2.6	1.2	3.4	5.7	8.0	5.9	40.3	38.6	37.4	37.3	-2.8	-2.9	-3.0	-3.2	2.5	-0.4	-1.7	-2.8
Pakistan	-1.3	6.0	4.5	0.3	9.7	9.5	20.5	11.3	92.0	85.9	84.1	84.7	-7.2	-6.3	-7.3	-6.1	-0.2	-3.6	-4.2	-2.9
Peru	-11.0	13.5	2.2	1.7	1.8	4.0	7.8	5.6	33.5	34.8	34.6	35.5	-8.3	-2.6	0.4	-2.7	1.2	-2.3	-3.4	-3.7
Philippines	-9.3	5.5	7.1	5.5	2.4	4.0	5.7	4.5	54.6	60.4	62.8	62.2	-7.6	-8.6	-7.3	-6.9	3.2	-1.5	-4.7	-3.0
Poland	-2.1	5.8	4.0	0.0	3.7	5.2	13.5	12.6	57.9	54.6	56.2	56.3	-6.9	-1.8	-3.6	-5.7	2.5	-1.4	-5.7	-4.7
Russia	-2.7	4.7	-5.4	-3.4	3.4	6.7	13.6	6.0	18.5	17.7	21.9	28.9	-4.0	0.8	-2.1	-4.0	2.4	6.9	8.2	2.5
South Africa	-6.3	4.9	1.8	1.5	3.3	4.6	6.8	5.5	68.0	67.4	70.5	70.3	-8.8	-4.7	-3.9	-4.8	2.0	3.7	0.1	-1.0
South Korea	-0.7	4.1	2.5	1.7	0.5	2.5	5.2	3.2	51.0	50.4	49.4	48.8	-3.7	-1.5	-1.2	-0.5	4.6	4.9	3.7	2.8
Thailand	-6.2	1.5	3.0	3.7	-0.8	1.2	6.0	2.4	45.0	52.8	52.6	51.4	-5.6	-4.9	-3.8	-2.8	4.2	-2.0	-1.6	2.8
Turkey	1.8	11.6	6.0	1.9	12.3	19.6	73.5	47.2	35.9	38.1	37.9	36.5	-3.5	-2.7	-1.8	-4.1	-5.0	-1.7	-5.8	-5.5
Uganda	-0.8	4.8	3.6	5.2	2.8	2.2	7.2	7.7	45.6	53.7	55.8	55.8	-7.3	-9.1	-10.9	-12.1	-9.2	-8.1	-8.6	-7.7
Uzbekistan	1.9	7.4	4.5	4.5	12.9	10.8	11.3	9.4	38.0	36.8	40.4	39.3	-4.3	-6.2	-3.8	-2.8	-5.0	-7.0	-7.2	-6.0

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