Perspectives
Emerging Markets

Second quarter 2018

Key messages

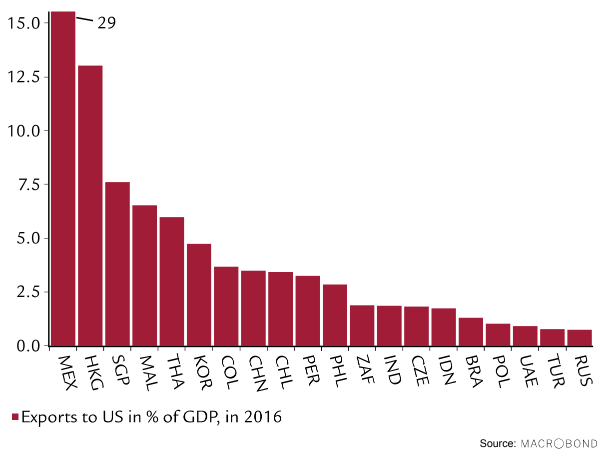
- GDP growth of emerging markets has recovered – from here it is more difficult to climb up further
- Fundamentals are solid – in 2018, pressure does not come from inside but from outside (e.g. US)
- In China, President Xi's new era and financial stability are the top policy priorities

Number in focus

35

35 days ago Cyril Ramaphosa became President of South Africa. The country had a number of economic and political problems under the presidency of Jacob Zuma, who is accused of corruption. The hope is that Ramaphosa can bring South Africa back on track. We think that growth, confidence and public finances will improve. Yet, we do not turn overly optimistic. It will take time to alleviate these serious problems. Moreover, Ramaphosa was a close ally of Zuma. This recalls memories of the recent change of power in Brazil.

Chart in focus



Emerging markets are vulnerable to protectionist US trade policy. It is not primarily the tariffs on steel and aluminium that are a concern but the final outcome to which these initial tariffs can lead via tit-for-tat trade measures. The path towards a trade war with numerous rounds of retaliation is unlikely as it is in no country's interest. Moreover, China's reaction has so far been measured. Yet, the risk of a trade war has risen. In such a scenario, emerging markets would not only suffer from fewer exports to the US but also from a disruption of world trade and global value chains.

Growth to remain solid

GDP growth of emerging markets has recovered from the weakness in 2015 and 2016. In the fourth quarter of 2017 it stabilised at around 5.5% (see chart 1). Commodity exporters were the main drivers of the recovery. We expect overall economic dynamics to remain solid in 2018. For example, the purchasing managers' index for emerging markets stands at 52 points and is well in the expansionary territory. Yet, as growth rates have mostly recovered, it is more difficult to climb up from current levels. We only see limited upside potential for growth in 2018. Latin America is the exception. In Brazil in particular, there is more room to go. In contrast, the air is thin when it comes to the overall growth in Asia and EMEA.

Pressure from outside

Fundamentals of emerging market economies are solid. Not only GDP growth has recovered but many countries have also lowered their imbalances, such as current account deficits. In 2018, the pressure does not come from inside but from outside. The year has started with a rapid rise of long-term US interest rates. This typically channels some capital away from emerging markets and towards the US. Financing costs of emerging economies have therefore tightened. Emerging markets have weathered this interest rate rise well. Investors did not lose confidence as these economies have comparably few imbalances. In March, a new risk has emerged: protectionist US trade policy. In our view, the tariffs on steel and aluminium that have been announced will only have a minor impact on emerging markets export activity. Yet, they have increased the risk of a wave of protectionist measures around the globe. As outlined on the previous page, such an escalation of retaliation measures is a risk scenario for us and not our base case as it would be very harmful for all the involved economies. In addition to the imposition of the above mentioned tariffs applied to all trading partners (with some exemptions), the US is currently investigating China's intellectual property practices. If the US concludes that the Middle Kingdom violates intellectual property rights, they could impose tariffs on Chinese goods. If tariffs are imposed not only on a few selected products but on a broad range, this could have a substantial impact on China. Moreover, the risk of a wave of retaliation measures would rise significantly. A disruption of trade between the US and China would hit emerging countries also indirectly: In particular, Asian economies would suffer from a disruption of global value chains and all export-oriented countries from a general softening of the world economy and international trade flows.

Xi's new era is the guiding theme

In China, the National People's Congress took place in March and has set the policy priorities for the next months or even years. The first main topic was the new era under Xi Jinping. President Xi who heralds and defines this new era has further strengthened his power. He has much more influence than most of the previous

Chart 1: Given the recent growth recovery, we do not see much further upside potential

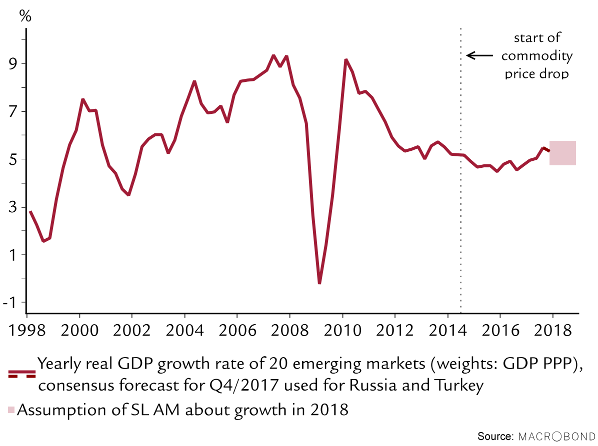
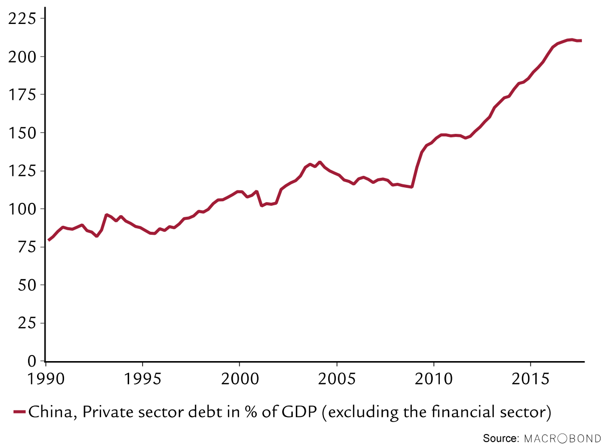


Chart 2: Chinese authorities no longer want to foster rapid debt build-up



leaders. The new era itself, addresses the need for a better life, e.g. reducing poverty and air pollution. Authorities have committed to shift their focus from the quantity to the quality of growth. The growth target for 2018 was set at "around 6.5%". This signals that there is a higher tolerance for slower growth. Yet, the fact that there is a growth target shows that China is still at the very beginning of this transition. The second main topic was financial stability. Authorities have changed their stance decisively in recent months. Over the last ten years, credit creation was an important growth pillar. Private debt has risen by 100% of GDP since the crisis in 2008 (see chart 2). In combination with a rapid expansion of shadow banking, this has worried many analysts, including ourselves, for a long time. Since last year, Chinese authorities seem to share these concerns and aim to contain financial leverage and to reduce complexity in the financial sector. They have emphasised at the above mentioned congress that the route of tightening financial regulation and prudent monetary policy will be continued. This will strengthen China's economic model. The main risk involved is an overtightening of financial regulation. We will watch closely whether any signs of stress arise in the financial sector to gauge if the transition towards less credit and shadow banking takes place smoothly.

Recovery in India

The long-awaited economic recovery in India is finally gaining steam. In late 2016 and early 2017, the economy suffered from the short-term costs induced by the implementation of reforms. These dampening effects are now fading and growth is picking up. GDP growth climbed to 7.2% in the fourth quarter of 2017 after having fallen to below 6% in the second quarter. Thereby India overtook China and became the world's fastest growing major economy. Also higher frequent data such as industrial production have picked up as illustrated in chart 3. While activity has improved, the macroeconomic situation has deteriorated on other fronts. Despite several announcements of fiscal consolidation plans, the budget deficit still remains at 4% of GDP. Government debt amounts to 70% of GDP which is high for an emerging economy. Moreover, inflation climbed up to roughly 4.5%.

Overheating in Eastern Europe?

In Eastern European countries, the air is getting thinner when it comes to GDP growth. In countries like Poland or Turkey, private and public consumption have risen rapidly in recent quarters. As a consequence, GDP growth has picked up substantially in 2017. As this pace is not sustainable and because other tailwinds such as the acceleration of the Eurozone economy are fading, we expect growth to moderate in 2018 and 2019 (see chart 4). In Russia, the situation is different: During the recession of 2015 and early 2016, private consumption was hit particularly hard because of high inflation and a weak social security system. In mid-2017, GDP growth climbed to a meagre 2%. As the economy is still overly dependent on oil and gas, we think that growth has reached a plateau at 2% also for 2018 and 2019.

Chart 3: In India, the recovery is gaining steam

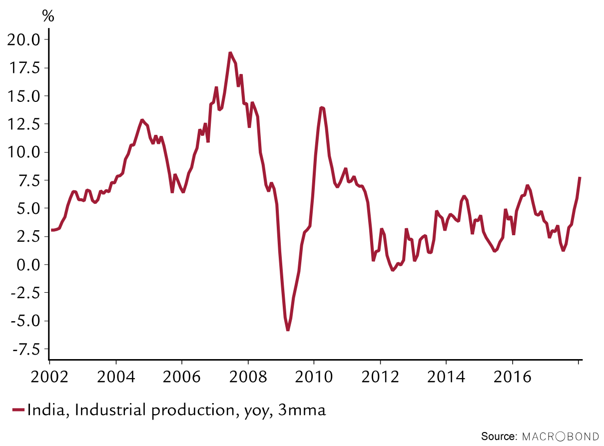
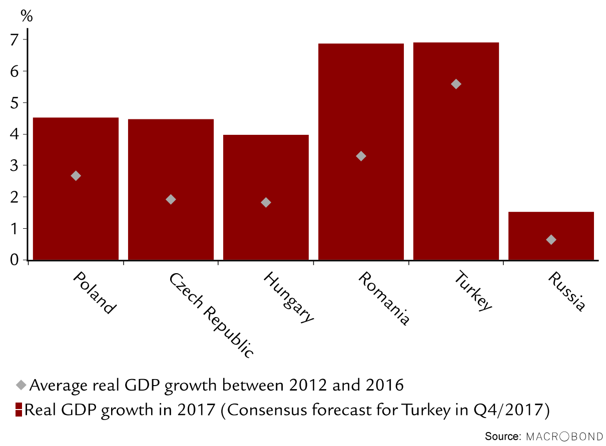


Chart 4: Growth rates do not seem sustainable in Eastern Europe



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