

Third quarter 2021

Key messages

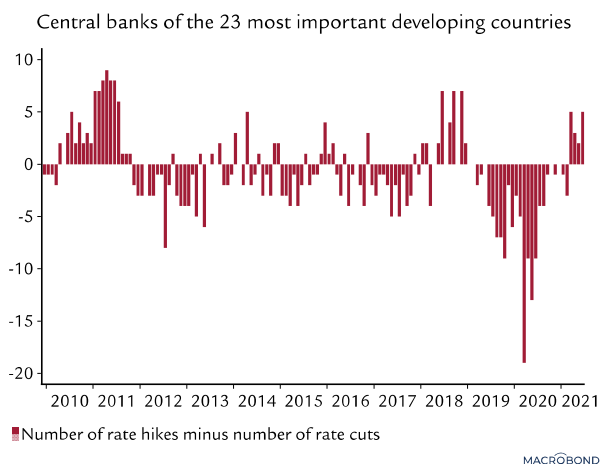
- The onset of winter causes renewed COVID-19 outbreaks in many places despite a faster pace of vaccination
- Monetary policy in developing countries reacts to positive inflation surprises with higher interest rates
- China: Shift in global consumer demand from goods to services as a potential risk

Number in focus

22
million

On 26 June 2021 alone, 22.1 million doses of vaccine were administered in China, i.e. 1.5% of the Chinese received one vaccination on that day. At the current rate, the population of London and Paris could be vaccinated twice a day. By comparison, at peak times the USA, Switzerland and Germany have been vaccinating around 1% of the population daily, the UK 0.9% and France 0.8%. However, with renewed COVID-19 outbreaks in China, Mongolia, the Seychelles, Chile, and Bahrain – all countries that rely on Chinese vaccines – doubts about the effectiveness of these vaccinations are growing.

Chart in focus

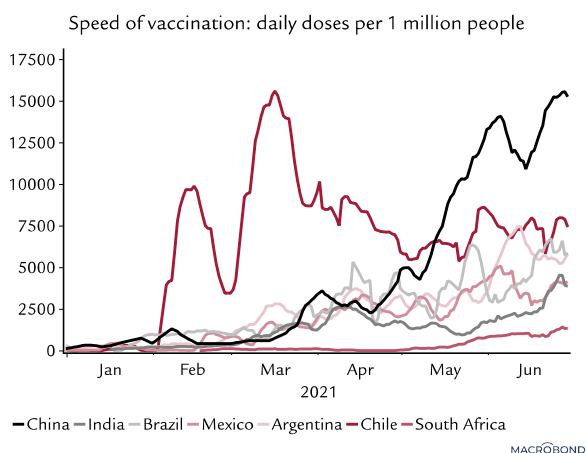


Compared to developed economies, where central banks continue to avoid the discussion about interest rate increases, many central banks in developing countries have returned to a tightening cycle since March 2021. Interest rate hikes over the past four months were 3.7 percentage points by the Slovenian central bank, 2 by the Turkish central bank, 1.5 by the Ukrainian and Brazilian central banks, 1.25 by the Russian central bank and 0.25 by the Mexican central bank. Further positive inflation surprises in May have put other central banks under pressure to react with an interest rate hike. For example, Chile's central bank has announced that interest rates will be higher in July.

The pandemic is not over yet

Through the first half of the year too, Asia led the economic recovery in the developing countries. China's GDP in the first quarter of 2021 was 6.9% above the Q4 2019 level, while Taiwan's GDP was as high as 7.9%. Following renewed local COVID-19 outbreaks, vaccination progress now seems to be a higher priority in China as well. The country has significantly accelerated its vaccination campaign in recent months (see figure of the month). China's vaccine portfolio, however, is largely composed of vaccines with rather low efficacy. Thus, herd immunity is likely to be reached only when a higher proportion of the population are vaccinated than in countries that rely on mRNA vaccines. In India, too, the pace of vaccination is accelerating after the devastating COVID-19 wave in April and May. Economic losses are expected to be smaller in the second quarter compared to the slump in 2020. In Latin America, the economic recovery has so far presented a mixed picture. For example, Mexico's GDP was still around 4% below pre-crisis levels after the first quarter, while Brazil and Colombia fell just short of pre-crisis levels, whereas Chile's GDP was already 3% higher than before the crisis. The onset of winter significantly worsened the already precarious pandemic situation in Brazil despite an accelerating rate of vaccination. Even Chile had to put its capital under quarantine again despite the very rapid vaccination progress. The fact that the pandemic will preoccupy many developing countries for even longer is also demonstrated by the renewed wave in South Africa, where vaccination is proceeding very slowly.

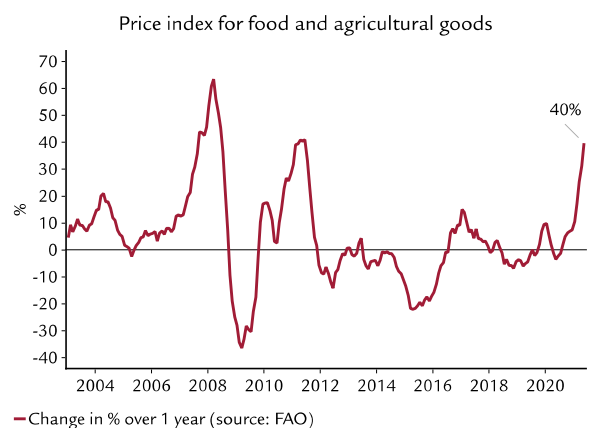
Fig 1: Mixed vaccination progress



Inflation and emerging markets

Prices of agricultural goods are rising by 40% in an annual comparison, according to an index of the UN's Food and Agriculture Organization (FAO). In many emerging economies, this development brings back memories of events ten years ago: food prices rose at a similar rate in the first half of 2011. At the same time, protests and uprisings broke out in the Arab world, likely a result of the rise in the cost of living. However, compounded by the slow management of the pandemic, rising costs of living hold the potential for increasing social dissatisfaction in the most affected countries. In Brazil, next year's elections could be an occasion for a reckoning with President Bolsonaro. In contrast to developed countries, food has a high weighting in the consumer price index basket in many emerging markets. Higher food prices therefore act like a tax for many consumers in these countries: disposable income available for other goods and services is shrinking while the suppliers' price-setting clout remains limited. The less generous unemployment benefits for employees will further weaken domestic demand in emerging markets this year. Unlike in the aftermath of the great financial crisis, the emerging markets are now not assuming the role of growth drivers for the global economy. They should therefore rather have a dampening impact on global inflation risks.

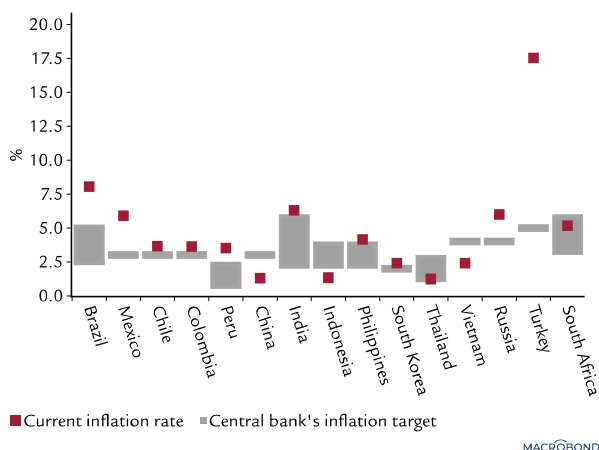
Fig 2: Sharp rise in food prices



Tighter monetary policy?

However, a glance at the current figures shows that higher inflation in emerging markets will certainly have consequences. Apart from Argentina with its almost notoriously high inflation rates, Turkey (16.6%), Brazil (8.1%) and India (6.3%) are currently also experiencing high rates. Inflation in these countries is thus above the respective central banks' inflation target. The same is true for Russia and Mexico, where headline inflation of 5.9% in May is well above the Banco de Mexico's 3% target. As Mexico's gross domestic product remains below pre-crisis levels, tightening monetary policy there would have a pro-cyclical drag on the domestic economy. As recently as February, Mexico's central bank cut its key interest rate to support the economy. Everywhere, the debate on inflation and the need for monetary policy action is similar to the debate in the largest developed countries. Most people are assuming that this inflation is largely a temporary phenomenon. Nonetheless, key interest rates in Brazil and Russia have already been raised several times during the current year. Monetary policy tightening is also imminent in Chile. Perhaps best known is the situation in Turkey, where the increase in the key interest rate to 19% in March led to a politically motivated change at the head of the central bank. China is considering other ways to avoid an inflationary spiral: price controls on important raw materials such as iron ore, copper, coal and corn are to be tightened.

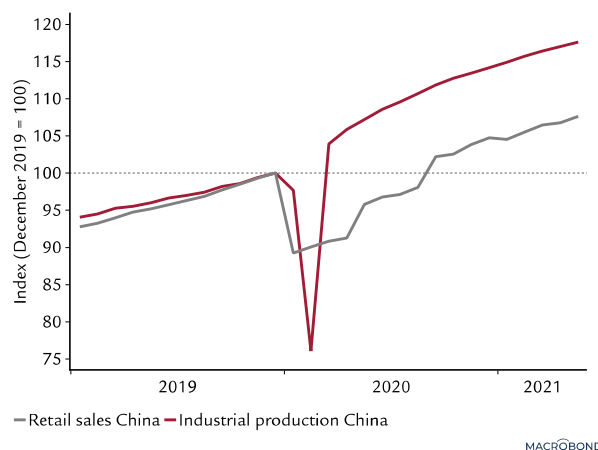
Fig 3: The inflation rate exceeds the central bank's inflation target in some places



China: export-driven growth

China continues to pursue a zero-tolerance strategy in the event of local COVID-19 outbreaks. Recently, some clusters have appeared in the economically strong area of the Pearl River Delta, with corresponding sharp reactions from the authorities and effects on the production and shipment of export goods. In this respect, the recent acceleration of the vaccination campaign (see page 1) is encouraging. The effectiveness of the Chinese vaccine against the rampant delta variant remains questionable, as does the issue of whether the authorities will adopt a less drastic containment strategy with the increasing immunisation of the population. A change of strategy would certainly be good news for domestic consumption, which has been disappointing as of late, mainly due to cautious monetary and fiscal policy. Meanwhile, the export economy is benefiting from strong global demand for consumer goods, though at present the higher prices and the weaker US dollar year-on-year somewhat overstate China's foreign trade growth figures, which are mostly expressed in USD. Ironically, the easing of restrictions in the developed world, which should result in a shift in demand away from consumer goods towards services in the second half of the year, constitute a certain risk for China's export-driven recovery. Overall, our 2021 GDP growth forecast for 2021 remains somewhat more prudent than the consensus forecast of 8.7%

Fig 4: The recovery of Chinese consumer spending is lagging industrial production



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