Emerging Markets Quarterly – 2017/3

It has been a relatively quiet summer for emerging markets. The fundamentals kept improving, there were no major political disruptions and capital flows into the emerging world continued. The benign external environment – low US interest rates, a weakening Dollar and stabilising commodity prices – was certainly a help. In September, the US Fed made it clear that it intends to start to reduce its balance sheet in October and to continue its gradual rate hiking cycle. Moreover, monetary policy in the Eurozone should also become less accommodative. How big of a risk pose central bank policies of the developed world for emerging markets?

US monetary policy – A threat?

If the gradual tightening of the Fed unfolds as smoothly as expected, emerging markets are well positioned to cope with it. First, the tightening is gradual and anticipated. According to the Fed's communication, the pace of the hiking cycle remains slow and the balance sheet will be reduced step by step. In our view, this will translate into a gradual rise of US long-term interest rate. We do not see a sharp rise of neither US rates nor the Dollar. Nevertheless, the balance sheet reduction implies that at the margin liquidity becomes less abundant. Yet, as the reduction is gradual we do not see it as a disruption. Second, emerging markets have lowered their macroeconomic imbalances, such as current account deficits or inflation rates, in recent years. They can therefore better cope with a tighter global monetary policy environment.

Growth recovery – A baton change

The gradual growth recovery, that we have discussed many times in this paper, is unfolding. GDP growth of emerging markets has increased from 4.5% to 5% over the last 12 months. This uptick was driven by the recovery of commodity exporters. The heavy weights Brazil and Russia got out of recession as the shocks of commodity prices and politics were fading out. The overall growth rate of commodity exporters has risen from -0.1% at the end of 2015 to 2.4% in mid-2017. Growth has already surpassed the level of mid-2014 when commodity prices started to fall. In our view, the revival of commodity dependent countries is almost over. We do not see much further upside for the group as a whole when it comes to annual growth rates. Going forward, we expect non-commodity exporters to be the driver for higher emerging markets growth. They have experienced a growth weakness in recent quarters. It was mainly caused by India and Turkey. In our view, India's economy will recover (see below) and support dynamics of non-commodity exporters. All in all, we see some more upside potential for overall emerging markets growth. Yet the air is getting thinner. Not least because China's growth has peaked in mid-2017.

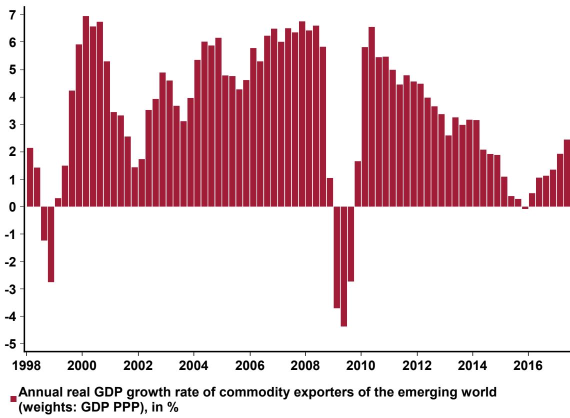
China – More of the same after the Party Congress

The seminal Party Congress opens on 18 October. It is highly awaited as important personnel changes will take place. President Xi Jinping can further consolidate his power for his second term. Moreover, the political report will unveil the priorities of the top leadership for the next five years. We believe that growth will remain a top priority for the government as it wants to achieve its goal of doubling GDP and income by 2020 from 2010 levels. This objective is crucial as it is linked to the centenary of the Chinese Communist Party, a major event falling into the second term of Xi Jinping. In order to attain the target, the Middle Kingdom needs to grow at roughly 6.5% in the next few years. Therefore, we only expect moderate economic reforms in coming years. While we think that there will be more emphasis on containment of financial risk and some efforts with regards to zombie firms, we do not expect rigorous reforms of state owned enterprises. Thus, the structural problems of the large unproductive state sector and high debt levels will continue to weigh on growth. A revival of the real estate sector and fiscal stimulus are likely candidates to boost growth if needed.

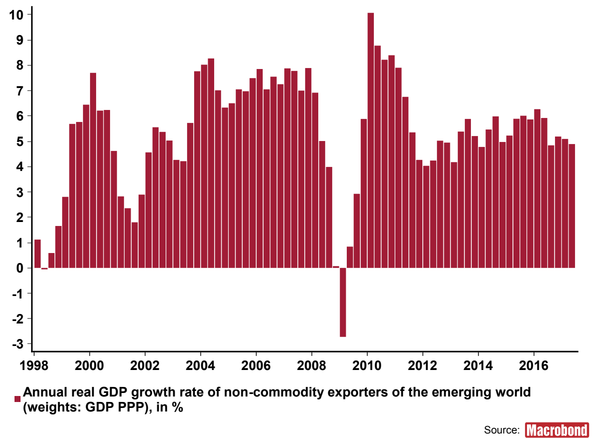
India – The growth slump is temporary not structural

India's annual GDP growth rate has fallen from 9.1% in early 2016 to 5.7% in mid-2017. Despite the doubts about the measurement of Indian GDP it is clear that the economy has slowed significantly in recent quarters. In our view, the slump was caused by temporary impacts of recent reforms. Both the demonetisation and national goods and services tax (GST) weigh on growth in the short-term. Yet, as households and firms adapt and uncertainty wanes the effect should neutralise. The positive impacts of these reforms will unfold only over the medium-term. Since we do not view the recent slump as a structural downtrend but as a temporary dent, we expect growth to recover soon. We do not rule out a fiscal stimulus by the government to support the economy temporarily. This would once again delay fiscal consolidation. Public finances remain the weak spot of India's macroeconomic stability.

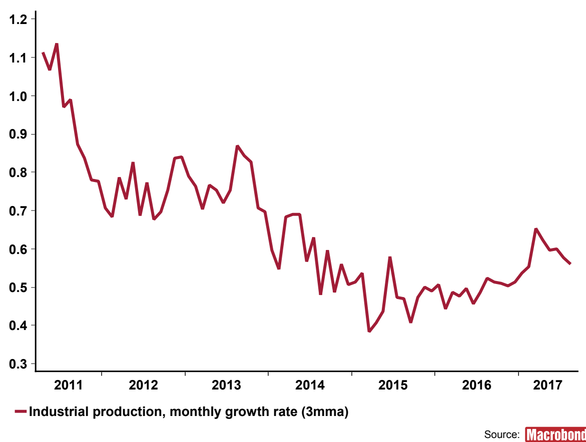
Growth – Commodity exporters have recovered, there is not much further upside



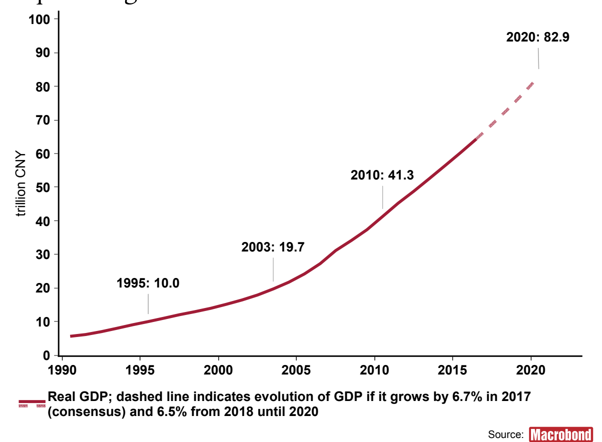
Growth – Room to the upside for non-commodity exporters



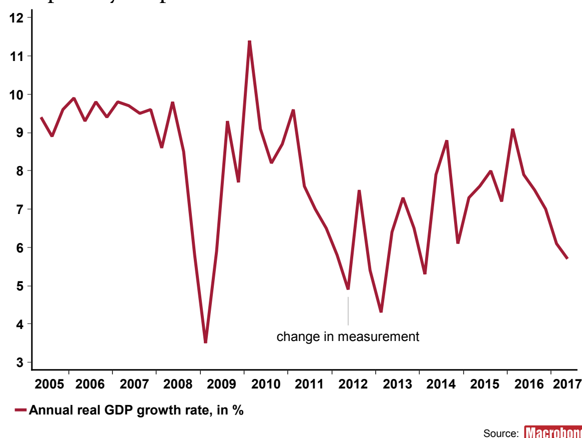
China – Activity has peaked in the first half of 2017



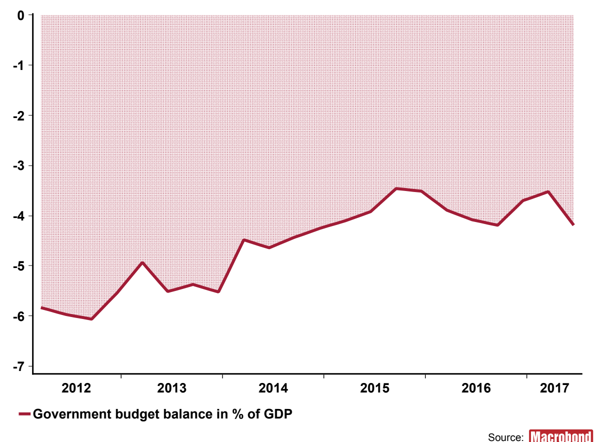
China – Doubling of GDP from 2010 until 2020 requires a growth rate of around 6.5%



India – Sharp deceleration of growth due to temporary impacts of reforms



India – Fiscal consolidation is very slow



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