Perspectives
Emerging markets

Second quarter 2022

Key messages

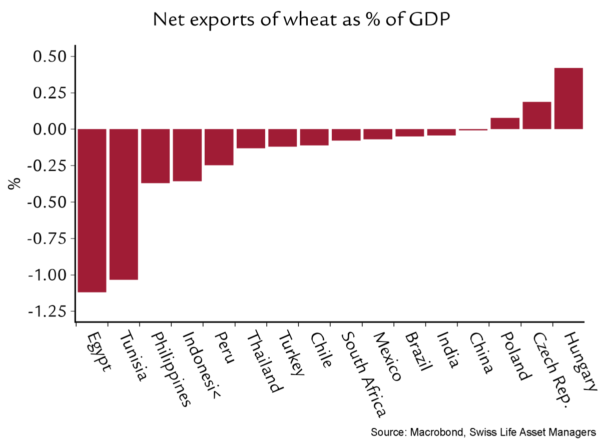
- Russia is falling into a deep recession due to its political and economic isolation
- The Ukraine war is hitting emerging markets in three ways: weaker trade with Russia, higher energy prices and higher food prices
- China: in addition to the uncertain geopolitical situation, the pandemic poses a further risk to the economy

Number in focus

9%

After the West imposed a series of sanctions to punish and isolate Moscow for its invasion of Ukraine, the rouble had depreciated significantly. This is already reflected in much higher inflation, which is significantly reducing the purchasing power of the Russian population. Inflation in Russia has risen to almost 9% so far this year. The median estimate of analysts in a Bloomberg survey for the annual inflation is currently at an astonishing 17.6%.

Chart in focus



Russia and Ukraine account for more than a quarter of global wheat exports. Disruptions to the supply of such essential foodstuffs can have catastrophic consequences for a number of emerging markets in which the population spends a considerable share of income on food. Countries in North Africa such as Tunisia and Egypt are particularly affected, and Asian economies such as the Philippines and Indonesia are also major wheat importers that are set to suffer from a shortage of wheat supplies and higher food prices.

Russia falling into a deep recession

The Russian economy is heading into a deep recession this year as the tough sanctions of a number of western countries are causing it significant damage. In addition to the sanctions against a range of politicians, officials and oligarchs, the key measures include the exclusion of certain Russian banks from the SWIFT international payment system and sanctions against the Russian central bank that are blocking a considerable share of foreign currency reserves. As a consequence, the Russian rouble has plummeted sharply, which is reflected in higher inflation. The rise in consumer prices since the start of the year has already reached 8.9% (see "Number in focus"). The mean estimate of the analysts in a Bloomberg survey for annual inflation currently lies at an astonishing 17.6% (Russia's inflation in 2021 amounted to 6.7%). The higher prices are reducing the purchasing power of the Russian population and accordingly exerting a negative impact on consumption. Furthermore, the Russian central bank has hiked its key interest rate from 9.5% to 20%. While this helped to prevent a run on the banks, the high interest rates will weigh on the domestic economy. The medium and long-term outlooks for the Russian economy are also gloomy, as the political and economic isolation are considerably reducing the country's growth potential. The most important anchors that Russia has are its oil and gas reserves that are finding their way onto the market and continuing to generate finance flows. This means that the economy will continue to function but with significantly lower standards of living than was the case a few weeks ago.

From pandemic to war in Ukraine

The next hurdle has arrived before the emerging markets have had time to recover from the economic damage caused by the pandemic. The war in Ukraine is affecting the emerging markets via three key channels: trade relations with Russia, higher energy prices and higher food prices. The negative effects are being felt most strongly in the Eastern European emerging markets such as Poland, Hungary and the Czech Republic, while Turkey is also severely affected. These economies have close trade relations with Russia, with exports to the latter accounting for more than 1% of their GDP (see Figure 2). They are simultaneously energy importers and suffering from the significant rise in energy prices. Higher energy prices are also weighing on the current accounts of many Asian economies such as India, Indonesia and the Philippines, while the major energy exporters in the Middle East are benefiting from the improved terms of trade. Alongside Russia's role as an important oil and gas supplier, its status as a major producer of agricultural commodities poses the risk of food bottlenecks that would exert a disproportionately negative impact on the emerging markets. Russia and Ukraine account for around 30% of global wheat exports. Disruption to exports of these important foodstuffs would have negative consequences for consumers in terms of availability and price (see "Chart in focus"). Egypt, for instance, a major wheat importer, procures 80% of its wheat from Russia and has already asked the IMF for support as it is facing increasing financial pressure due to the increased grain prices. On top of this, Russia is also an important exporter of var-

Figure 1: The Russian central bank is hiking interest rates while the rouble is falling

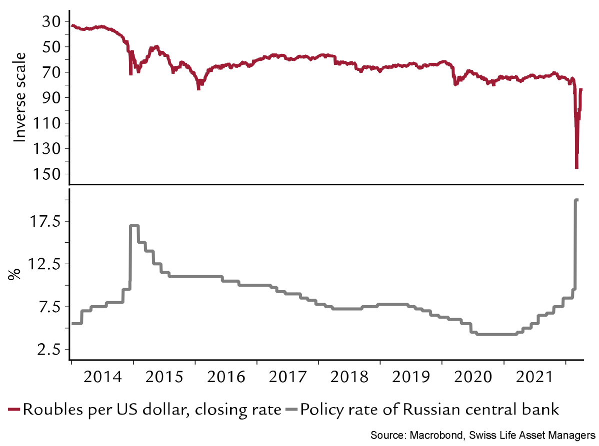
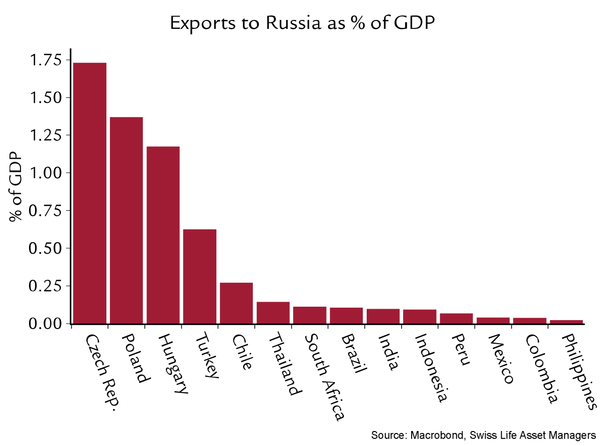


Figure 2: Eastern European emerging markets have the strongest trade relations with Russia



ious fertilisers, the supply of which has been suspended. The high fertiliser prices have already caused farmers to limit their use, which could impair food production in large parts of the world. Brazil, for instance, depends on imports for 85% of the fertilisers required for its cereal crop, with more than a fifth of these imports coming from Russia. Higher energy and food prices will ultimately drive inflation up further in the emerging markets, as food and energy account for more than 30% of the consumer price index in a number of these countries. While, particularly in Latin America, central banks have already significantly hiked interest rates over the last few months, real interest rates, i.e. interest rates adjusted for inflation, largely remain negative (see Figure 3). This means that the central banks of the emerging markets will be forced to hike key interest rates further despite the declining economic momentum.

China: diplomatic balancing act

In the midst of the war in Ukraine, China is trying to achieve a diplomatic balancing act. The ideal stance for China is to maintain relations with all parties. In other words, it is continuing to pursue political orientation towards Russia, while at the same time maintaining strong trade relations with the West. Russia is a major supplier of raw materials to China. China's demand for natural gas will increase significantly in future as the country pursues its long-term goal of reducing its carbon footprint. This means that it is extremely important for China still to be able to count in future on good conditions for commodity trading. At the same time, sound economic relations with the West are crucial, as its trade relations with the US and Europe are much more important than those with Russia. Chinese exports to the US and Europe each account for around 3% of Chinese gross domestic product, while supplies to Russia are ten times smaller (see Figure 4). As a result, China has so far strictly adhered to the Western sanctions framework. Both commercial and multilateral banks, such as the AIIB (Asian Infrastructure Investment Bank), based in Beijing, are ceasing to do business with Russia, while companies are cutting back their deliveries to Russia because they fear being affected by secondary sanctions. However, the war in Ukraine, which is placing the Chinese economy under pressure in view of potentially weaker foreign demand, is only one of the risks the country is currently exposed to. The number of Covid cases is rising sharply, and lockdown measures are being imposed in economically important cities. Following a one-week lockdown in the major technology centre Shenzhen, China's financial centre Shanghai is also being sealed off from the end of March. As long as the containment measures remain temporary, the economic impact and disruptions to global supply chains should remain manageable. However, there is a risk that the spread of Covid cases will get out of control and potentially more drastic measures will be taken, as China is continuing to stick to its zero-Covid approach. In view of the various economic risks, the political decision makers are focusing on economic stability and pushing for further monetary and fiscal stimulus. However, we do not think that this will suffice to achieve the country's ambitious economic target of 5.5% growth this year. We are sticking to our 5% growth forecast for 2022.

Figure 3: Central banks must hike interest rates further as real key interest rates are largely negative

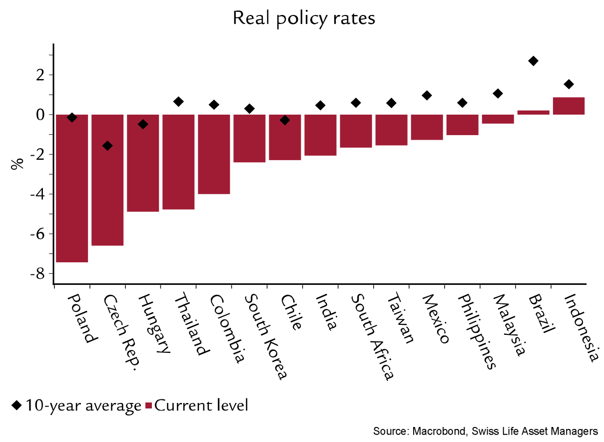


Figure 4: China's economic relations with the West are much more important than those with Russia

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