Perspectives
Emerging markets

Second quarter 2023

Key takeaways

- China's economic upswing boosts Asian economies
- Turbulence in the banking sector and an expected recession in the US are weighing on the emerging markets
- The interest rate hike cycle is coming to an end, no interest rate cuts in sight until later in the year

Number in focus

1

Apart from Turkey's central bank, which has been pursuing an unorthodox monetary policy for some time, Vietnam's central bank was the first of the major emerging markets to cut interest rates this month. However, it was also the only one. The vast majority of the central banks in the emerging markets are keeping interest rates at a very high level. The scope for reversing interest rate hikes remains limited for as long as the Federal Reserve continues to raise interest rates in order to combat inflation.

Chart in focus

The Covid restrictions have caused significant damage to China's economy and weighed particularly on the services sector, whose share of GDP has fallen sharply. Now that the restrictions have been lifted the economy is recovering, led by an upturn in the services sector, whose share of GDP growth is likely to return to pre-pandemic levels. Exporters of services to China are likely to benefit most from this upturn, i.e. mainly countries in Asia.

China's economic recovery continues

China's economy continues to recover. The first official economic indicators for January and February taken together show a significant improvement. The upswing has mainly taken place in consumption. Retail sales rose by 3.5% compared to the first two months of the previous year, as the catering sector posted strong growth following the lifting of the Covid restrictions. Developments in the real estate sector, which severely slowed economic activity last year, were also positive. Real estate sales picked up again, while property prices rose month-on-month for the first time in 18 months. In addition, the completion of unfinished real estate projects posted a growth rate of 8%. The latter development is also of great importance in the medium term, as the completion and delivery of pre-sold real estate projects are key factors in restoring public confidence and ensuring stabilisation in this economically important sector. This favourable development at the beginning of the year is in line with this year's growth target, which the Chinese government has set at around 5%. This year's growth target implies a significant recovery compared with last year, when the Chinese economy grew by only 3.0%. It is however also the lowest growth target ever set, but it is in line with our own growth forecast for this year. Indeed, there are a number of obstacles. Firstly, the external economic environment is unfavourable as we expect a slight recession in the US and demand from Europe is also likely to remain weak. Secondly, it will take some time for consumer sentiment to return to pre-pandemic levels, which means that a full recovery of major purchases will be delayed. And thirdly, the moderate growth target reflects the fact that Beijing does not intend to implement a strong infrastructure or real estate stimulus programme.

China's upswing boosts emerging Asian economies

Unlike previous episodes in which the Chinese government brought about strong growth through a hefty infrastructure boost, this time the Chinese economy's recovery is being mainly driven by a recovery in the services sector. This also means that the positive spillover effect for the rest of the world will be less pronounced. The countries that will benefit most from the Chinese upturn are service exporters to China, mainly Asian economies such as Hong Kong, Singapore, Taiwan, Malaysia or Thailand (see Chart 2). Accordingly, the growth outlook for Asia remains quite constructive, thanks to the tailwind from the Chinese recovery and despite the gloomy global outlook, especially given the expectation of a mild recession in the US. In other emerging markets, however, we anticipate a more significant slowdown in economic growth. In Latin America, the region with the strongest and very early interest rate hikes, domestic demand is slowing down due to the high level of interest rates. For European emerging markets growth prospects are also bleak, given the lack of growth impetus geopolitical uncertainty and

Chart 1: China's real estate sector shows initial signs of stabilisation

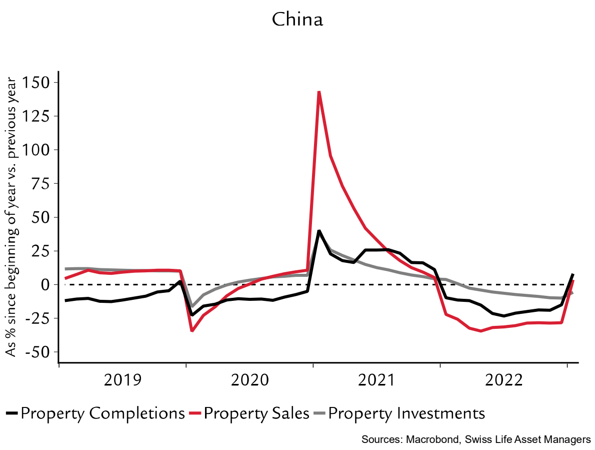
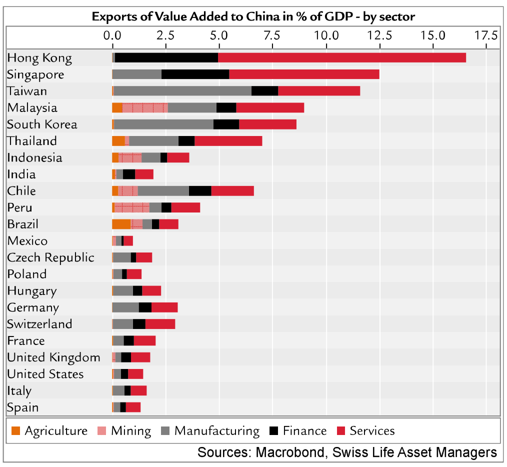


Chart 2: Service exporters in Asia benefit most from China's economic upturn



persistently high inflation, which is still at double-digit levels in Hungary, the Czech Republic and Poland, for example.

Turbulence in the banking sector is creating uncertainty

The banking sector has come into focus following the collapse of two regional banks in the US and Credit Suisse in Switzerland. In the emerging markets, the banking sector so far appears able to weather this volatile environment. After various crises in the past, the emerging markets have tightened their financial regulations to ensure good capitalisation in the financial sector. Moreover, the deposit base of banks in the emerging markets is seen as more stable and diversified, especially compared to the US. Nevertheless, an indirect risk could arise from tighter USD cash flows, which could affect banking systems that are more dependent on bank lending from developed countries, especially Turkey. Furthermore, the adverse events in the financial industry have confirmed our view that a recession is approaching in the US. Weaker global demand and financial market uncertainties are weighing on the emerging markets' economic prospects. At the same time, we do not expect the turbulence to deter the central banks in the US and the Eurozone from continuing to hike interest rates in order to dampen inflation – though perhaps to a more moderate extent. As a result, central banks in the emerging markets will also have limited opportunities to reduce interest rates, as they would otherwise risk a currency devaluation, which could fuel inflation again (see Number in focus).

Turkey: Erdogan faces difficult elections in May

Parliamentary and presidential elections will be held in Turkey on 14 May. According to recent polls, Erdogan is facing the toughest elections in his 20-year term of office, as he is well behind the opposition candidate Kemal Kilicdaroglu, who was nominated by the Nation Alliance, a six-party opposition bloc. Erdogan is being blamed for the ongoing inflation crisis with a rate of over 55% in February, and for the inadequate response to the devastating earthquake in the south of the country at the beginning of February. Although it is still very early to make any predictions, and things could therefore move in either direction, a possible regime change would have a positive impact on Turkey's economic outlook. A more credible monetary policy would be implemented with a tighter stance, which would reduce inflation. The new independent central bank would also attract capital inflows and strengthen the lira. On the other hand, if Erdogan remains in office, his influence on monetary and economic policy would remain intact. This means that interest rates would continue to be kept too low despite the high inflation, and the ongoing foreign exchange sales to stabilise the lira would further weaken the fundamental situation in the country.

Chart 3: No interest rate cuts for EM central banks in sight as long as the Fed keeps hiking

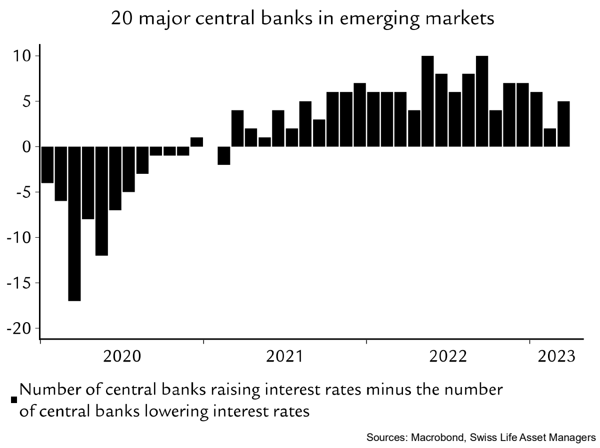
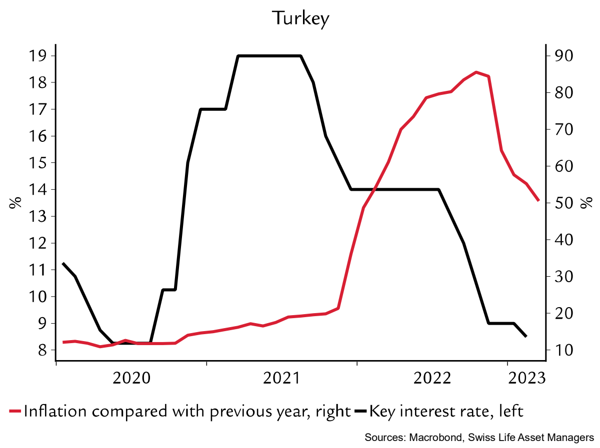


Chart 4: Under Erdogan, interest rates will be lowered further despite high inflation



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