

<http://blog.en.erste-am.com/2017/08/25/growth-picking-up-in-the-emerging-economies/>

## Growth picking up in the emerging economies

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Economic growth has increased significantly on a global scale and is broadly supported. According to our preliminary estimate, global GDP recorded a growth rate of 3.7% from Q1 to Q2 (annualised). While the developed economies have presumably grown by 2.7%, the emerging economies posted a growth rate of 5.2%. In this article, we would like to take a closer look at the emerging markets on the basis of classic economic indicators.

### Strong growth

Estimated real economic growth in the emerging markets for 2017 is 4.6% after 4.3% in 2016. 2017 will therefore be the first year after 2010 where economic growth will have exceeded that of the previous year. Of course, the data are heterogeneous with regard to the individual countries. At +6.8% in China and +7.2% in India, economic growth is high in these two countries. While growth in the two important commodity producers, Brazil (+0.7%) and Russia (+1.7), is comparatively low, both countries seem to have overcome recession. The negative examples are mainly South Africa (+0.5%) and Saudi Arabia (+0.4%), which are stagnating.

### Falling inflation

Inflation has seen two important developments. First, inflation has been down on aggregate. In the emerging markets, consumer prices fell from 3.9% to 2.5% y/y from Q4 2015 to Q2 2017. Inflation is down particularly in important countries with a previously elevated level of inflation, such as Brazil, India, Russia, and South Africa. Second, China has overcome the deflation pressure it had been exposed to. In China, it is less the constant, low increase in consumer prices that is important and more so that increasing tendency of producer prices. They had been falling for numerous years until the middle of 2016. That is also why deflation was a substantial risk to the global economy until very recently. In the meantime, producer prices in China are picking up again (July: 5.5% p.a.). Negative: the increased inflation in Turkey (9.8% in July) and the rising inflation in Mexico (6.4% p.a. in July).

### Interest rate cuts

The diverging development of inflation has made an impact on central bank policies. Overall, key-lending rates are falling in the emerging economies. More specifically, the average key-lending rate has fallen from 5.60% a year ago to 5.00%. Also, key-lending rates increased in China from September 2016 to June 2017. This tightening of the monetary environment was accompanied by a more stringent regulatory environment in the financial sector. Investors are currently waiting for two main questions to be answered. First, how big is the dampening effect on growth caused by the tightening measures in China? And second, what effect will the foreseeable reduction of central bank liquidity in the developed economies and the rate hikes in the USA have on the emerging markets? Our working hypothesis is that the central banks will remain cautious in their actions. This is supported by speeches given by central bank members that are used to prepare the market participants for marginal changes (“forward guidance”).

### **Only slightly elevated budget deficits**

The annual public deficits are, on average, slightly too high (average budget deficit 2017: 4.4%). Therefore, government debt has been on an upward trend (2007: 36% in terms of GDP; 2017: 49%). That being said, the level of debt is still comparatively low (developed economies: 106%). Countries that are under closer scrutiny due to the elevated budget deficits are Brazil (9.1%), India (6.4%), Argentina (6.1%), and Saudi Arabia (9.4%).

### **Slowdown of credit growth has come to an end**

There are three main reasons for the weakening economic growth in the emerging markets from 2010 (7.4%) to 2016 (4.1%) and for the subsequent acceleration, which of course are linked to each other. We have already addressed the first reason, i.e. the fall in producer price inflation in China in the years 2011 to 2016. In addition, commodity prices were falling significantly from 2011 to the beginning of 2016. The following stabilisation helped the commodity-producing countries, i.e. Brazil and Russia in particular, to make it out of recession. Finally, credit growth in the emerging markets (China excluded) has already decreased from about 20% per year in 2011 to currently 7%. This year, the signs of stabilisation have become more plentiful, which puts paid to a crucial growth damper.

The focus of the development from here on in should be on China: the International Monetary Fund has warned against the continuation of strong credit growth in a recent report. Total credit volume (government, corporate sector, and households) amounted to 242% of GDP last year and could rise to almost 300% by 2022. In fact, the risk of a hard landing in China constitutes an important structural risk for the global economy.

### **Favourable financial environment**

The financial environment is favourable: interest rates, spreads (government and corporate bonds), and volatility are low, and share prices are rising. On average, the emerging markets currencies have followed the development of the commodity price performance. The weakening vis-à-vis the US dollar from 2011 to the beginning of 2016 was followed by stabilisation and a rebound. This is another reason why the credit risk of bonds denominated in US dollar has fallen. N.B. the investors are already long, i.e. their positioning is geared towards a favourable environment.

### **Higher degree of competitiveness**

The real exchange rate (or real effective exchange rate; REER) is an important indicator of the competitiveness of a country. It has two important components. The nominal effective exchange rate relates a specific currency to a trade-weighted basket of other currencies before adjusting the effective exchange rate for differences in inflation. A rising REER in a country therefore means a decline in external competitiveness, because said country is going through an appreciating currency or a higher increase in inflation in comparison with the countries represented in the currency basket. The products of this country become more expensive. That is exactly what happened on average in the emerging economies from 2004 to 2015. While at the beginning this was absorbed by rising commodity prices, the decline in commodity prices (first wave: 2008; second wave: 2011) set in prior to the decline of the real effective exchange rates (beginning of 2015). This situation exerted pressure on economic growth. In the meantime, both commodity prices and REER have stabilised. More specifically, the nominal effective exchange rate is currently 7% below the high of 2015, the real effective exchange rate a still significant 5%. In a nutshell: the competitiveness of the emerging markets has increased. As for the outlook, one of the risk scenarios includes another decrease in commodity prices.

### **External imbalances have declined**

During the phase of weakening economic growth and declining commodity prices, the countries with external imbalances (high current account surplus in China, Russia, and Saudi Arabia, elevated current account deficits in Brazil, India, and Turkey) were undergoing an adjustment. Both surpluses and deficits have decreased significantly. However, at minus 4.7% (2017

estimate) of GDP, the current account deficit in Turkey is still elevated.

## Improvements with a few flaws

The analysis of the emerging markets on the basis of the eight indicators, inflation, key-lending rates, fiscal policy, credit growth, financial environment, competitiveness, and external imbalances suggests a clear improvement in some parts. However, risks remain in place. Every single one of the eight indicators comes with flaws. Also, countries that we have not discussed here have problems, too (for example Venezuela). In addition, there are more than just the eight indicators as described above (e.g. possible trade conflicts, geopolitical conflicts).

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