Riding China's recovery wave

Emerging markets outlook 2021

Investment Outlook

Triodos Investment Management

Our emerging and developing markets outlook for 2021 is one of a cautious and uneven recovery, with risks tilted to the downside. After almost a year of global crises – both health and economic – and unprecedented stimulus, support will be nearing an end for most countries. Yet uncertainty about the further course of the pandemic will continue, especially regarding the widespread availability of a COVID-19 vaccine. Meanwhile, governments will be picking up the bill of the pandemic and re-prioritising expenditure, with the accompanying social tensions. Countries that can attract capital to meet their financing needs will have more spending power. As for low-income countries that were the hardest hit by the pandemic, they will be trying to avoid more people falling into extreme poverty.

Emerging Markets Outlook 2021

Beyond the pandemic: Riding China's recovery wave

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There is one swing factor that could help some countries to offset the impact of the pandemic to some extent in the coming year: China's recovery. As the second largest economy in the world, making up slightly more than 16% of global GDP, China is positioned as a fundamental player in terms of commodity demand, a foreign credit provider and a high value-added producer in the technology race. Although this has brought about challenges to the established geopolitical order, it has also resulted in stronger trade and financial ties with many emerging and developing economies.

Near-term outlook

Our **baseline projections** for emerging and developing markets assume that the worst of the crisis is over in terms of economic contraction, with the largest impact having taken place in the first half of 2020. However, the coronavirus pandemic will not end abruptly. It is likely to fade away slowly, and this process may go on beyond 2021. Our assumption is that an effective COVID-19 vaccine will be available to the public in the first half of 2021, but it will take longer for some emerging markets to get hold of it. Once available, the vaccine will require storage and distribution facilities that will have to be built in some places. There will also need to be a clear policy on who will be vaccinated first.

The distribution of the vaccine worldwide will take time, and this uncertainty will likely delay consumption and investment growth for a large part of the coming year. On top of this, disposable income is expected to drop on the back of declining government support. There is room for optimism though. Foreign trade has been picking up at a fast pace since the third quarter 2020, a trend that is likely to continue in 2021. This can be partly explained by the relatively rapid recovery of the goods producing sector, where social distancing was easier to follow and as a result of the increase in health-related imports. Whether the recovery of trade will be sustainable in the medium term depends on the demand of the largest economies, including China, and on geopolitical developments. Additionally, risk sentiment could improve with the vaccine, favouring emerging markets and the search for yield. But the cost is often onerous debt burdens, so governments and companies will have to be mindful and focus on borrowing that leads to sustainable growth.

Continuing into 2021, most emerging and developing economies will still be operating below their full potential or long-term trend growth. There was already a considerable amount of slack in most emerging countries prior to the pandemic. And unemployment is now on the rise. Workers who have lost their jobs because of the pandemic will find it more difficult to return to the labour market in the hardest hit sectors. These are the sectors with contact-intensive jobs such as hospitality and food, which employ mainly young women. In Latin America and sub-Saharan Africa, the largest number of lay-offs, according to the IMF, were among young women working in contact-intensive sectors.

Below-potential growth means less inflationary pressures in the near term for most emerging and developing countries. But where the pandemic has had a larger impact on supply chains, inflation pressures have been increasing. Some countries are reporting double digit inflation, including Nigeria, India and Turkey, which leads to further deterioration of the purchasing power for households. Russia and Kazakhstan have below double-digit inflation, but it has been increasing in the past months. Currencies in emerging markets are expected to have a mixed performance, related to the strength of their macroeconomic fundamentals and geopolitical tensions. Turkey's and Russia's currencies are feeling the pressure of the prospect of a tougher US stance, while China and South Korea will continue to see a favourable performance of their currencies on account of their solid recovery.

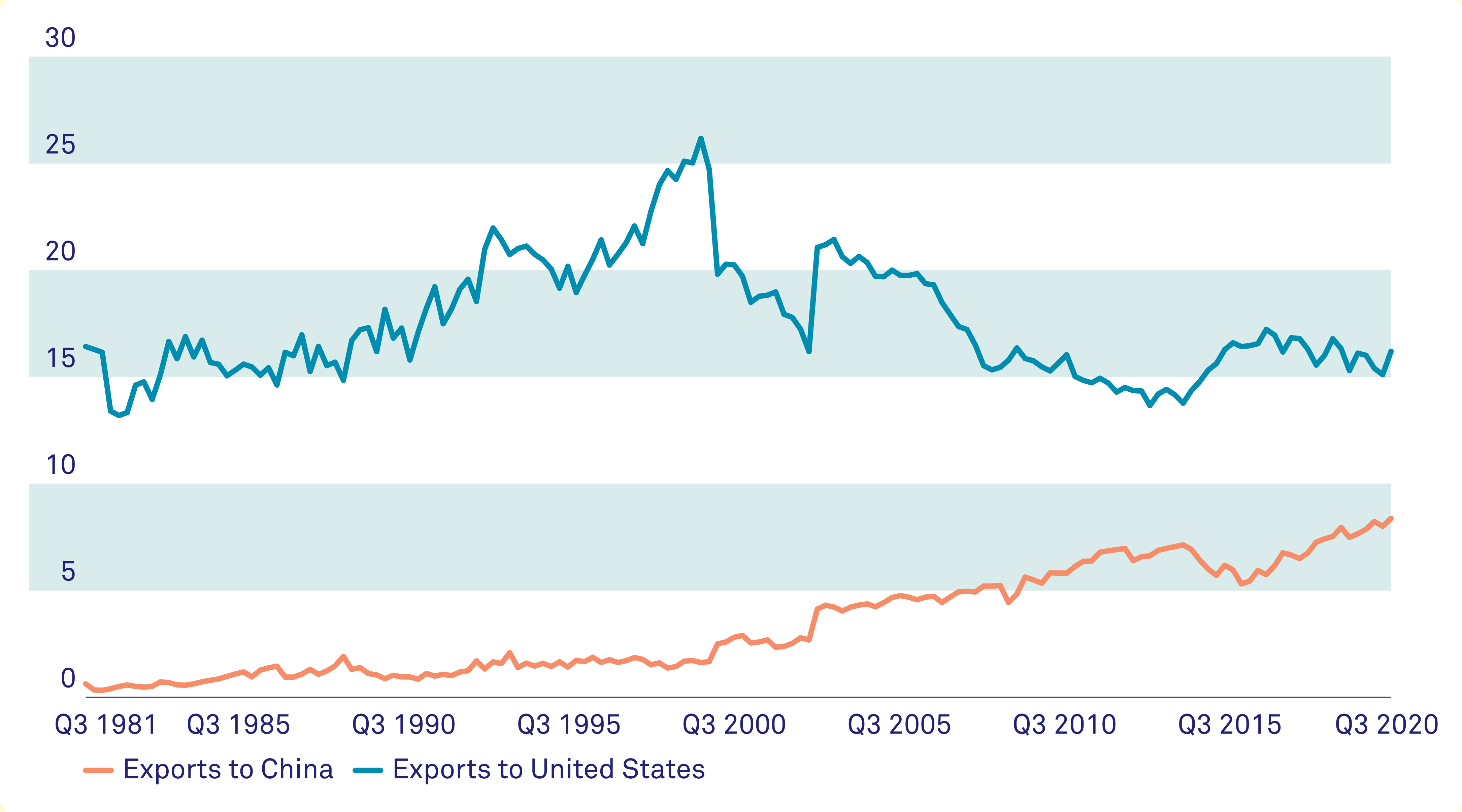
Poverty implications

The scarring from the pandemic has been large, depending on the state of health systems, fiscal space, the structure of economies and the degree of digitalisation of a country. Estimates from the World Bank suggest that poverty and income inequality will unavoidably increase. The deceleration of economic activity will hit the poorest hardest. The stronger effects will be felt in the more unequal societies. In 2021, an additional 110 to 150 million people will fall into extreme poverty and live below USD 1.90 a day. Almost two-thirds of the extremely poor live in South Asia and sub-Saharan Africa. Meanwhile, inequality will also increase because of job losses affecting those with lower levels of education, or those working in informal activities or in service-related activities, where social distancing is more difficult.

China's rise – an impulse for emerging markets

Although the outlook for emerging markets' recovery highly depends on the course of the pandemic, it is also conditioned by a rapid economic recovery from China. China has been increasing its trade integration and financial links with emerging markets for a while. China's economic performance in the near and medium term will be relevant for growth in emerging markets and the patterns of supply chains and capital flows.

Figure 1 Share developing countries exports to US and China (%)



Source: Refinitiv

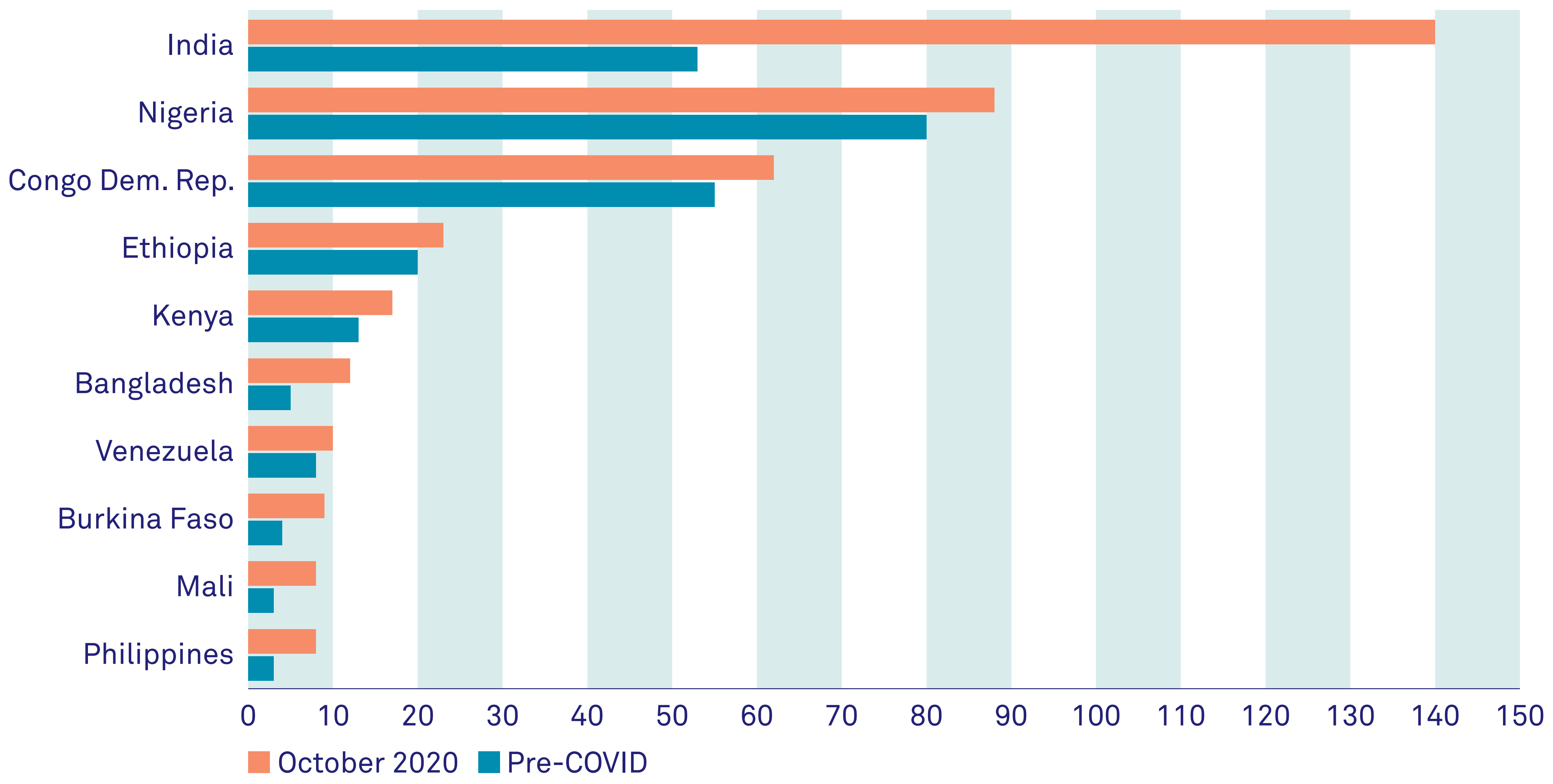
China's economy has been following a steady growth path after a strong contraction in the first quarter of 2020. This recovery is being led by strong import growth, with an increasing demand for hard commodities to support industrial production and construction, as well as greater demand for agricultural imports. The appreciation of China's currency has partly boosted this trend; a stronger currency makes imported goods cheaper. A more rapid shift to consumption would support the global recovery further, but China's household consumption is still modest, at around 39% of GDP compared to a global average of 63%. Improving safety nets in China would help to reduce precautionary savings and boost consumption, but this cannot be done overnight.

Trade with China is already making a difference, with some emerging and developing countries benefitting more than others. Over the past few years, China has accounted for a growing share in trade with developing countries (see graph), and it is becoming a major force in infrastructure and technology. Resource-rich countries are highly exposed to China's demand for commodities. Some African countries, like Angola, Eritrea and Gambia, export more than 50% of their total exports to China. The rebound in exports to China is even leading to upward revisions in the GDP growth of countries like **Chile, Brazil and Russia**.

But it's not only trade; **China** is also by far the most important investor in several developing countries, financing roads, ports, telecom networks and energy projects. China is the largest bilateral creditor for Africa and has surpassed the World Bank and the Paris Club in financing emerging markets and developing countries. The role of China as a major lender has gained force with the Belt and Road Initiative, a project between Asia, Europe and the Middle East introduced in 2013.

This role as a leading creditor for some low-income countries has been criticised by US politicians who see it as a strategy to increase China's global influence, while forcing excessive indebtedness of recipient countries. The **Center for Global Development** ranks donor countries across various dimensions in terms of policies contributing to development. China ranks last of 40 countries because of its opaque financing, small volumes of loans compared to its size and its non-concessional structure. On the positive side, since the pandemic China has participated in debt relief initiatives with other G20 creditors for payments due this year, showing that it can put aside its preference for bilateral agreements.

Figure 2 Countries with largest increase in extreme poverty headcounts in millions, 2020



Source: IMF/World Bank, Brookings

The number of people in extreme poverty could have been much higher though, had it not been for emergency aid programmes. According to the IMF, in Brazil these programmes managed to avoid the poverty increase doubling. In Pakistan, 12 million families benefitted from a cash transfer of USD 75.

The World Bank estimates that around 55 countries implemented electronic cash transfers, many of which managed to provide some relief to household consumption (Bangladesh, Ethiopia, Kenya and Nigeria).

Budget constraints to limit government support

The rebound in economic activity for some countries will depend on the availability of foreign financing. Sub-Saharan Africa and South Asia have large funding gaps and limited access to foreign lending and therefore will likely have the smallest expansions, followed by Latin America. Emerging markets with available fiscal space and affordable financing conditions will be able to consider additional fiscal stimulus in the coming year. Emerging Asia has been successfully tapping into capital markets in the past few months and more borrowing is expected next year. Other medium-income countries with high fiscal deficits are seeing borrowing costs rise and despite the higher borrowing costs are seeking market access. This is the case for commodity-exporting countries with high public expenditures.

Additionally, more than half of the low-income countries are at high risk of debt distress, according to the IMF. Spending on healthcare will remain a priority for these countries, and we expect cash transfers to continue where possible. The IMF is supporting efforts to step up debt relief for low-income countries as rapidly as possible. The faster governments agree on future debt restructuring for low income countries, the faster they can reallocate resources.

Risks to the near-term outlook tilted to the downside

Many of the risks to consider are global in nature. Upside risks to our baseline scenario refer to those positive risks that could speed up the global recovery. If a vaccine becomes available for broad distribution earlier than initially expected, this will likely boost confidence and have a positive effect on business activity and consumption. Positive data from vaccine trials have already raised hopes that a vaccine could be approved by regulators in December.

Another positive impulse would be that the US President-elect Biden takes a strong stance on mending international trade and reducing unilateral tariffs. Reverting the withdrawal of trade agreements like the Trans-Pacific Partnership would benefit several emerging countries.

In this positive scenario, advanced economies continue their fiscal stimulus and keep interest rates near zero until they are well-placed for a steady recovery. The

US dollar could weaken a bit on the back of lower safe-haven demand. The gains for emerging markets would come from more trade resulting from stronger growth in advanced economies, and stronger capital inflows searching for higher yields.

Risks that would lead to a more negative scenario include a longer-than-expected pandemic, as well as **fiscal imbalances and financing gaps** that constrain public expenditure and lead to more inequality. This is fertile ground for social unrest and a further deterioration of corporate balance sheets. Geopolitical tensions could resurface with more force – not only around trade, but also around migration, high debts and inequality – while governments debate policies and citizens seek better opportunities. **Studies of past pandemics** highlight that pre-existing divisions accentuate in the aftermath of a pandemic.

This more negative scenario plays out in higher market volatility and a stronger US dollar, benefitting from the flight to quality and the appeal as safe haven. In this scenario, low interest rates and stimulus in the US and eurozone are there for much longer. A further softening of inflation is expected. Divergence between China, the US and Europe increases geopolitical tensions between countries. Commodity prices fall. Currency wars dominate this scenario, delaying the global recovery.

Long-term outlook

Severe economic contractions like this one will undoubtedly cast long-term effects on potential growth and income inequality. The loss of human capital, reduced investment and slower adoption of new technologies means that countries will not be able to grow at their full potential. At the same time, given that poorer countries and the most vulnerable workers within a country were the hardest hit, this will exacerbate inequality now and in the future, if the right actions are not taken.

Governments have acted as quickly as possible to provide stimulus, but deliberate and structural attempts to address lower growth potential and higher inequality will likely be topics of debate in the coming year. The pandemic has given us a forced time-out to think and assess those policies that are most effective in bringing about positive change. Countries that decided to support their population, with strong health systems, safety nets and digitalisation, fared better during the pandemic. But also, countries that provided cash transfers to the poor avoided more people falling into extreme poverty. How large-scale meaningful players and projects like China's Belt and Road Initiatives become examples of international collaboration is still to be seen. And as impact investors, we will have to do more, by allocating capital for change (see vison paper Investing in Radical Change). We are in this together and we will have to intensify our efforts to rebuild a global economy that is more resilient and fit for the future.

Growth projections 2020-2021

	GDP growth (% yoy)			Inflation (CPI, % yoy avg)			Government debt/GDP (%)			Government balance/GDP (%)		
	2019	Forecast 2020	2021	2019	Forecast 2020	2021	2019	Forecast 2020	2021	2019	Forecast 2020	2021
Argentina	-2.1	-12.2	4.2	54.0	42.9	48.6	90.0	98.2	95.5	-3.6	-10.9	-6.7
Brazil	1.0	-4.5	3.0	3.5	3.1	4.3	76.0	94.2	97.4	-6.0	-18.4	-8.8
Chile	1.0	-6.6	5.1	2.5	2.9	2.4	27.8	35.0	39.7	-2.9	-9.9	-6.9
China	6.1	2.1	7.9	2.9	2.7	2.0	16.9	20.4	19.8	-4.9	-6.6	-5.8
Colombia	3.3	-7.7	4.5	4.0	2.6	2.8	54.0	66.3	64.9	-3.3	-7.1	-6.9
Czech Rep	2.5	-6.4	4.6	2.8	3.2	2.3	30.5	39.0	42.0	0.3	-7.6	-6.6
Hungary	5.0	-6.9	4.3	3.5	3.5	3.4	68.0	75.0	73.0	-2.0	-7.5	-3.5
India	4.2	-10.8	9.2	3.7	6.4	5.2	47.0	56.0	58.0	-7.7	-10.1	-8.3
Indonesia	5.0	-3.4	3.4	2.8	1.9	2.9	29.9	38.8	42.9	-2.5	-1.0	-5.9
Malaysia	4.3	-6.0	5.8	0.7	-1.0	2.1	52.5	59.3	59.7	-3.4	-6.0	-5.4
Mexico	-0.5	-10.0	4.3	3.5	3.4	3.4	44.8	56.2	53.0	-2.0	-6.0	-4.1
Peru	2.2	-12.5	8.7	2.0	1.7	2.3	26.8	35.4	33.3	-1.3	-10.2	-10.2
Philippines	6.0	-8.4	7.8	2.5	2.5	2.9	39.6	52.8	56.1	-3.3	-10.0	-8.6
Poland	4.0	-4.5	3.8	2.5	3.6	2.6	46.0	55.3	55.5	-0.7	-8.1	-8.1
Russia	1.5	-3.5	2.7	4.5	3.3	3.9	12.3	19.0	20.2	1.8	-4.4	-2.2
South Africa	0.2	-9.5	2.7	4.0	3.3	4.4	62.2	82.0	85.5	-4.0	-14.9	-14.9
South Korea	2.0	-2.0	4.8	0.5	0.7	1.4	36.7	41.8	44.0	-0.6	-4.1	-2.1
Taiwan	2.7	-1.4	3.6	0.6	0.2	2.0	33.4	33.3	32.3	-0.1	-1.1	0.0
Thailand	2.5	-7.6	4.0	0.7	-0.8	1.1	41.2	53.5	59.6	-2.7	-6.4	-6.4
Turkey	0.7	-6.1	4.5	15.2	12.0	12.4	32.5	41.0	40.4	-2.9	-6.5	-5.5

Source: IMF and IHS

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Investing in positive change

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