A recovery without trust is fragile and costly

Emerging Markets Outlook 2022

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The COVID crisis caused a fearsome economic slump and now we are in the rebound, but the outlook for emerging markets remains highly uncertain. Given the socio-economic consequences of the pandemic, people's views on solidarity and fairness are now taking centre stage. And with these views the perception of trust - are the promises well intended and effective and will they be kept. In several emerging countries, the lack of trust is already manifesting itself in the form of social unrest, investments being delayed, the cost of capital increasing and political tensions rising.

This is not unusual because during a crisis the fault lines or sources of distrust - that lie beneath the surface become more evident. If these fault lines are not addressed, trust will remain evasive, making the recovery more challenging. In such an environment, trust and collaboration between governments, institutions, investors, and households are essential.

A recovery without trust is fragile and costly

In our Emerging Markets Outlook for 2022, we explore how trust and other factors may influence economic and social decisions in the coming time. Divergence across countries remains our base scenario. We expect emerging markets and developing countries to reach their pre-pandemic GDP levels by 2024 (excluding China), while advanced economies will likely resume their GDP pre-pandemic levels by 2022. This divergence is explained by uneven vaccination rollouts, weak health systems and the withdrawal of the large fiscal and monetary impulse, as well as by the increasing social and political fragmentation within and across countries.

As impact investor, intermediating between investors and investees in emerging markets, trust is essential to maximise impact, returns and risk management. A lack of trust, particularly in a setting with a weak government and weak institutions, means that it will be more difficult and costly to allocate resources to where they are most needed. As a result, we observe that where trust is lowest, GDP per capita is also low (see figure 1).

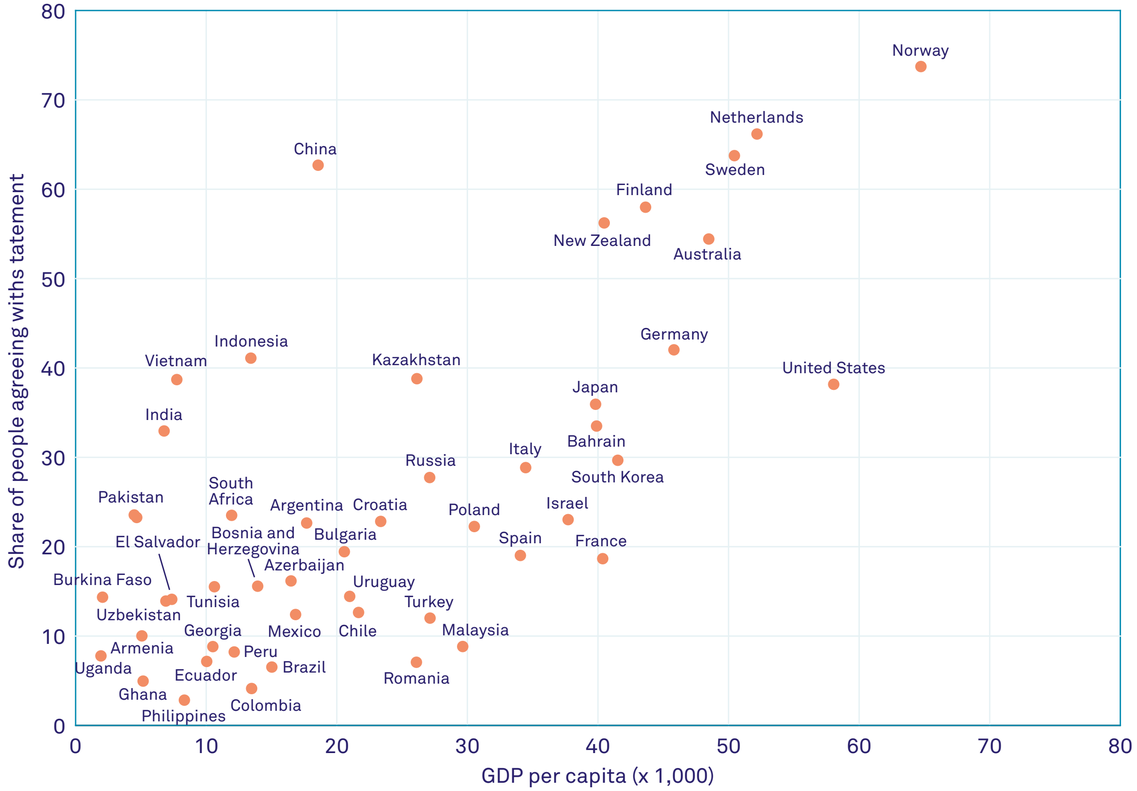
The year ends with uncertainty

As it stands, global economic activity is improving, but the pace of GDP growth is slowing. Emerging economies are getting back on track, albeit with some divergences. Fiscal and monetary support and a country's sectoral composition are playing an important role in shaping the economic outcomes, as well as how countries are dealing with the virus. Sectors reliant on contact-intensive activities are having more difficulty recovering where vaccination rates are low, while manufacturing has generally recovered to pre-pandemic levels, and IT and commodity-related activities are making a strong contribution to GDP growth. But the pandemic is not over and there is still the scarring. Indeed, although the recession was synchronised, the rebound was not. Vaccination rollouts and firm inflation prints have been weighing on economic activity. Some developing economies are being left behind and at least three fault lines are resurfacing, which are hurting trust: 1) international cooperation, 2) policymaking and stimulus, and 3) the choices of investors regarding capital allocation and how inequality and the environment are dealt with in this process.

Trust in international cooperation

The global nature of the pandemic calls for international cooperation. However, precisely the lack of international cooperation has deteriorated the trust in international decision-making bodies and in the leadership of the largest economies. Vaccines were not available for all countries from the start of the crisis

Figure 1 **Trust (before pandemic) vs GDP per capita. As share of people agreeing with the statement "most people can be trusted". For each country latest available data.**



Source: IHS and World Value Survey

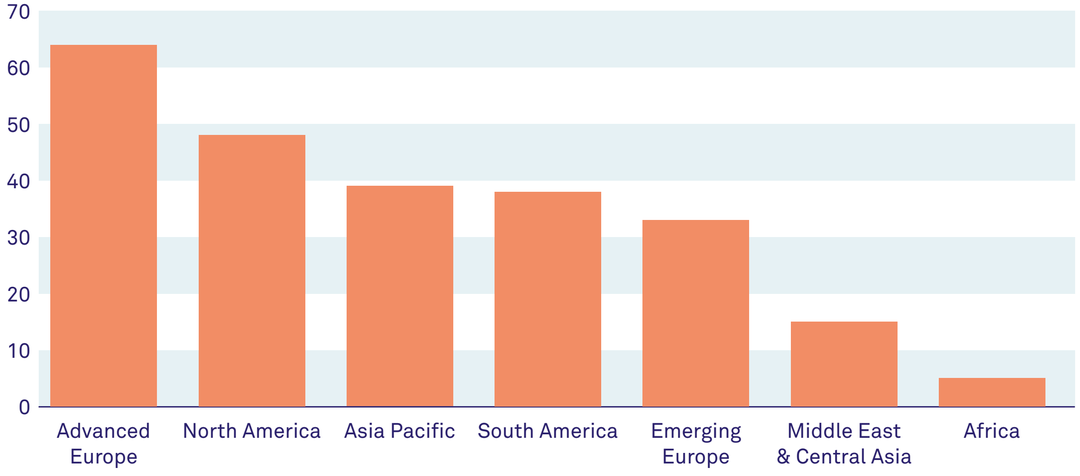
and are still largely unavailable in several low-income countries, mainly because of the limited disposition of the international community to coordinate the production and distribution of vaccines.

Additionally, the divergent recovery has led to a surge in global demand triggered by a surge in consumption, particularly in advanced economies. At the same time, supplies were largely constrained in many emerging countries unable to reopen their economies at the same speed. For instance, Indonesia's extended shutdown led to shortages in key components for the manufacturing industry, hurting particularly the auto industry. These supply constraints contributed to the build-up of global inflation pressures. Moreover, geopolitical tensions continue hampering the cooperation between the critical players, including the US and China, as well as Russia and the Ukraine, leading to cost inefficiencies in crucial areas, particularly in international trade.

But there are opportunities to regain trust. There is more attention from governments and investors for international cooperation in the field of climate. Despite the considerable differences between the US and China on many fronts, both countries have made some progress in their joint commitments within the context of COP26 to control carbon emissions. There is much more to be done in each country though, but this is a first step in collaboration.

Another area is climate financing. Asset managers, banks and insurers worldwide have pledged to cut emissions in their lending and investing to net zero. As such, Triodos Bank became one of the first banks to join the Net-Zero Banking Alliance (NZBA) convened by the UN aiming to cut emissions by 2050 or sooner. And there are the promises of wealthier nations committed to mobilising USD 100 billion twelve years ago to help poor countries cut their emissions and manage the consequences of climate change. This pledge is again on the table and although much more is needed for mitigation and adaptation, meeting it will already be an accomplishment, breaking from past unmet promises. Overall, we are cautious and expect no major shift in international cooperation going forward.

Figure 2 **Vaccination rate across regions** (%)



Source: Refinitiv

Trust in policymakers

Although vaccine availability was more skewed to advanced economies, health experts and governments have become leading actors in determining how to control and mitigate the impact of COVID-19. However, some governments may have gone a bit too far. Freedom House is monitoring and reporting cases where governments have taken the opportunity to undermine institutions and accountability. This leads us to another fault line: the effectiveness and credibility of government and central bank policies in supporting the recovery. The shock was labelled as temporary, and policy makers have been withdrawing or intend to withdraw their stimulus, while the virus is still among us. This is not unexpected since the policy space has shrunk, because of higher fiscal deficits and large debts, and the prospects of higher interest rates. Trust or distrust in policy makers will reduce the blow or ignite social instability.

The 2021 Edelman Trust Barometer shows that globally trust in governments/policymakers to do what is right is deteriorating, while trust in business is improving. In emerging markets, China, India, and Mexico saw a drop in the trust in governments. Without trust policy makers will have an even more difficult time solving their numerous dilemmas.

One of the dilemmas for policymakers is how to deal with inflation pressures, which have been mounting in advanced and emerging economies alike. A policy mistake will be more costly for emerging markets though, because the tradeoff between helping growth and fighting inflation can be quite painful. Higher

inflation can depress economic activity, undermine the trust in the value of money and lead to food insecurity in many emerging countries. But letting interest rates rise too far can supress the economy. In the 1970s, surges in oil prices were followed by recessions, leading to the new phenomenon of stagflation – a period of inflation combined with low growth and high unemployment. We expect trust in governments to be closely linked to vaccination and booster rollouts, and therefore to remain practically unchanged compared to 2021.

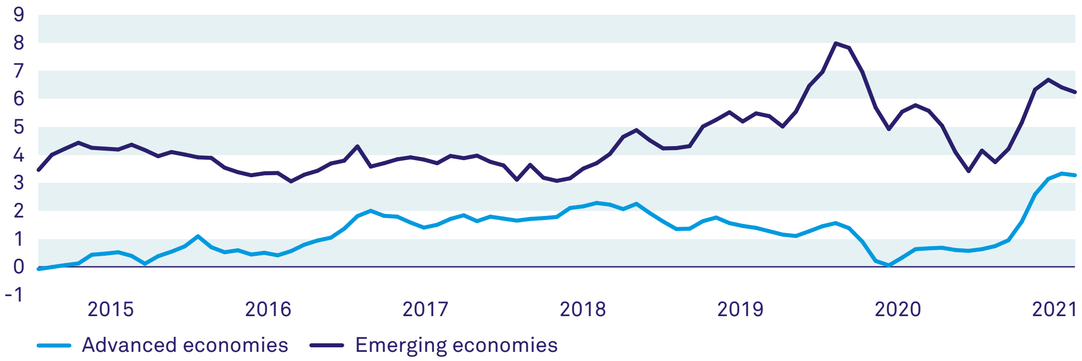
Several emerging market central banks have missed their inflation targets and have already started hiking rates. This is also driven by the fear that global tightening will trigger capital outflows from countries with weaker fundamentals. Latin America has been leading the rate hike cycle. Emerging Europe followed, while emerging Asia has relatively lower inflation levels compared to the targets set. Yet inflation fears are rising, and markets are pricing in more rate hikes by end-2022.

Trust in the right capital allocation

Investors monitor financial markets to make informed investment decisions. Their views and choices are often seen as a gauge of the health of an economy. However, there is an increasing disconnect between real economic developments and the search for financial returns. Trust in investors' views on capital allocation is now being challenged. According to the IMF abundant liquidity is leading to equity price misalignments (relative to fundamentals-based values), which remain elevated in most markets. In the larger emerging economies, including India, where equity market performance has been less overwhelming than in advanced economies, performance has also been considerably strong, while credit remains scarce, and inequality has been increasing. The consequence is that the gap between those benefitting from wealth creation and those that have no savings is increasing. One of the claims is that stimulus has supported financial markets and that it has been unable to revive real activity and reduce inequality. Here the lack of trust in markets making the right capital allocations is expanding to the distrust in institutions and how they facilitate this allocation, including central banks' accountability.

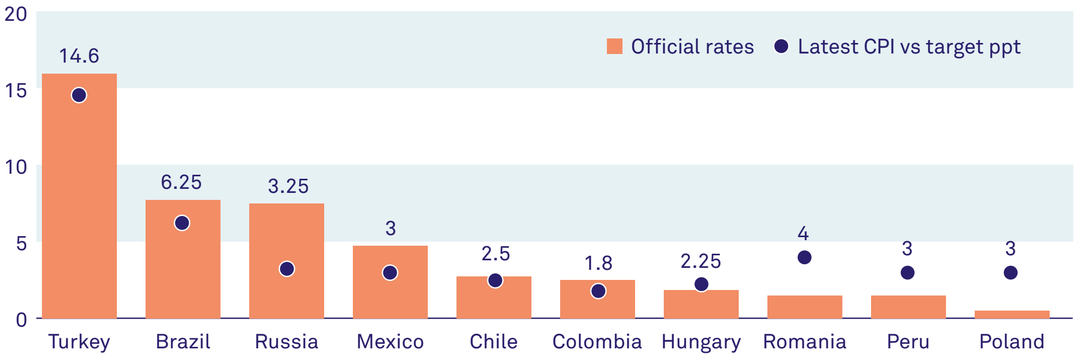
But trust can be regained with more responsible investments to help drive the transition to a more sustainable world, by embracing social inclusion, inequality, and climate. A successful transition demands a deep economic transformation, requiring the mobilisation of funds on a large scale. As impact investors, sustainability considerations have been for decades part of our investment values. Investing in high risk developing countries means an opportunity

Figure 3 Headline inflation (%, y-o-y)



Source: Refinitiv

Figure 4 Central bank official interest rates and inflation (%)



Source: Refinitiv

for improving the quality of economic activity and securing a steady flow of capital in the future, at lower costs. However, this will take time and markets will likely correct as they align with the real economy.

Implications for the economic outlook

This brings us to the macroeconomic projections for emerging markets. Economic uncertainty – measured by confidence – has broken many records since the pandemic and we need to keep in mind and consider how this will shape the economic landscape in the future. Trust in governments in many countries has deteriorated. This suggests that governments will encounter difficulties, not only in executing measures against the virus, but also in withdrawing fiscal stimulus, while central banks will have a harder time keeping inflation expectations anchored.

There are three scenarios that could play out for emerging markets in the near-term. These scenarios are essentially triggered by the trust that businesses and households have in the government and investors in dealing with the pandemic and the spillovers that this has on investments, consumption, and international trade.

Base scenario: Temporary higher inflation, GDP recovers slowly in the direction of its previous trajectory

- Emerging markets' and developing countries' GDP is expected to return to pre-pandemic levels by 2024 (excluding China), with advanced economies' GDP reaching pre-pandemic levels in 2022.
- The response to mitigating the impact of the virus moves slowly but in the right direction. The overall economic backdrop related to the virus is generally improving. Vaccination rates in low-income countries increase towards the minimum required levels of 30% by the end of 2022.
- The large fiscal and monetary impulse that led many emerging markets out of the crisis is gradually being withdrawn. Countries with improving fundamentals and access to capital markets will likely have more fiscal space to continue supporting their economies (i.e. Chile, Colombia, and Cameroon). Global trade will also pick up as supply chain bottlenecks fade away in the course of next year.
- Since most emerging and developing countries have exhausted their fiscal space, fiscal credibility through measures that are being taken to improve debt sustainability will be part of next year's agenda. This will result in lower government investment and weaker domestic consumption compared to 2021, slowing down GDP growth. Commodity exporters will fare better. We expect inequality will continue to increase, affecting mostly low-income countries.
- Additionally, the external environment will continue to be dominated by geopolitical risks regarding the US, China, and Russia, as well as uncertainty regarding the pace of monetary tightening by central banks in advanced economies. We expect the Fed to start hiking rates by the end of 2022.
- Central banks in emerging markets will continue hiking rates. This will likely temper inflation expectations, but the impact will vary per country. We expect inflation in emerging markets to return to more moderate levels by mid-2022.
- Emerging market currencies will go through some volatility as central banks move from loose to tighter monetary policies and start hiking rates. Countries with weak fundamentals may face sharper adjustments both in interest rates and currencies, including Brazil, Argentina, and Turkey.
- In this scenario, emerging markets' growth potential is scarcely lifted due to the more limited public and private investments in an uncertain year. We expect investments that favour a more rapid transition towards a greener economy to start picking up, but to remain below the size that is effectively needed for more meaningful change. Trust in policymakers is still evasive because of the duration of the pandemic, while many solutions to controlling the virus and reducing inequality will remain a topic of increasing debate.

Emerging from the pandemic – the outlook is mixed

China is likely to continue its economic transformation, which means lower but better-quality GDP growth in the coming years, including a tightening of its housing policy and a property market slowdown. Authorities have sufficient fiscal space to direct the economy. Fiscal policy was intentionally contractionary in 2021 and is expected to shift to a neutral stance in 2022, focusing more on green investments and social safety nets. Inflation is expected to remain low, allowing monetary policy to be accommodative. Implementation of China's 2030 carbon peaking and 2060 carbon neutrality goals has begun in all key ministries, as well as by local and central governments, setting the stage for more leadership in the greening the economy.

India's economic activity will continue to pick up modestly, mainly supported by government investments and global trade. The setback in poverty because of the pandemic needs to be addressed in the coming time through investments in infrastructure and education, while high debt levels require the economy to pick up rapidly to avoid debt sustainability risks. A new virus outbreak and inflation pressures from higher energy prices are the main downside risks to the outlook. India is one of the world's largest energy importers. Higher inflation could lead to food insecurity since food is a large percentage of the consumption basket. Private investments in the form of renewable energy and the recovery of credit to SMEs will play a key role in facilitating a green and inclusive recovery.

South Africa will have more difficulty consolidating growth. Public finances were severely stretched during the pandemic, the budget deficit and public debt having increased significantly. Trade, particularly buoyant mining receipts, have supported the recovery. While the space for social spending is limited, social unrest could easily ignite with the country's unemployment rate sitting at a record high of over 30 percent and social fissures widening by frayed basic services. South Africa is a clear example to illustrate the urgency of working together to avoid a further deterioration of the economy. Granting debt relief, investing in social capital, and at the same time investing in projects that matter, including the ongoing renewable energy projects that create employment, improve access to electricity, while reducing the impact of blackouts, are only some of the potential game changers.

Negative (stagflation) scenario: Prolonged higher inflation, and declining GDP growth

- Stagflation occurs when declining economic growth and its resultant high unemployment coincides with rising prices. The trigger is the inability to control the virus variants, resulting again in mobility restrictions and a slowdown in consumption and investments, driving lower GDP growth. Energy prices surge, supply chains are disrupted, and cost pressures increase, driving up inflation.
- Weaker GDP growth and higher fiscal deficits than in the base scenario will lead to currency depreciations, making FX-denominated debt more costly. The number of countries with debt sustainability issues increases.
- Central banks' independence and credibility is challenged in many countries, leaving them hand tied, and this will lead to an inflation spiral. Higher inflation means more uncertainty, and fewer investments and jobs.
- Given that many developing countries are net food importers, higher food prices result in food insecurity and social unrest.
- The fragmentation of the global economy is unprecedented. Trade growth slows down.
- Scientific research and innovation are left behind, whereas military investments are stepped up. There is no room for investments to counter climate change and natural disasters are more widespread and recurrent. Trust deteriorates at all levels.

Higher growth scenario: Temporary higher inflation (due to stronger demand), GDP growth picks up

- The positive scenario is based on improved global coordination leading to a faster distribution of vaccines, allowing economies to get back to business without further delay. Governments can focus on longer-term goals and investments.
- Consumption and investment growth resume as confidence radically improves. Global activity picks up and shortages gradually disappear as the COVID contagion is put behind and supply and demand are better aligned.
- The disinflationary forces that prevailed before the pandemic gain ground, mainly driven by technological progress and globalisation. Both allow for more efficient production processes. Currencies are generally more stable.
- Finance for innovation picks up, enabling more balanced growth with environmentally friendly policies.

Near-term	**Base case scenario** temporary high inflation and slowing growth		**Negative stagflation scenario** high inflation, low growth		**High growth scenario** low inflation and high growth	
	Developing	**Low-income**	**Developing**	**Low-income**	**Developing**	**Low-income**
Trust	🟡	🟠	🔴	🔴	🟢	🟡
Growth	🟡	🟡	🔴	🔴	🟢	🟡
Inflation	🟡	🟠	🔴	🔴	🟢	🟡
Fiscal balance	🟡	🟠	🔴	🔴	🟢	🟡

🟢 Improvement 🟡 Modest deterioration 🟠 Moderate deterioration 🔴 Significant deterioration

Call for cooperation

The post-pandemic economic rebound is set to continue in 2022. Although our base scenario shows emerging economies slowly recovering to pre-pandemic levels, there is no improvement in inequality in the near-term, while the energy transition still falls short of what is needed in emerging markets.

At the same time, the growth potential of emerging economies in the long-term had already been trending down before the pandemic due to deglobalisation, weaker productivity growth associated with lower investment growth, and a shrinking working age population, particularly in emerging Europe and China.

Because the pandemic has increased divergences across advanced and emerging economies and between emerging and developing countries, distrust can easily blow up, whether it is tensions arising between countries related to vaccination rollouts, migration, or food security.

In this challenging environment, trust and collaboration between governments, institutions, investors, and households are essential. Our impact investment funds in emerging and developing countries addressing financial inclusion and energy transition, give people an opportunity to satisfy their basic needs. Undoubtedly, investing in these countries is challenging. But next to appropriate due diligence, risk frameworks and the knowledge and experience of regional teams, we are building relationships with partners and clients that share similar values. This is giving us more ground to build trust and reap its benefits.

Economic forecasts

	GDP growth (% yoy)				**Inflation** (CPI, % yoy avg)				**Government debt/GDP** (%)				**Government balance/GDP** (%)				**Current account** (% GDP)			
	2019	2020	2021 forecast	2022 forecast	2019	2020	2021 forecast	2022 forecast	2019	2020	2021 forecast	2022 forecast	2019	2020	2021 forecast	2022 forecast	2019	2020	2021 forecast	2022 forecast
Argentina	-2.0	-9.9	7.1	2.2	52.8	40.5	47.7	48.4	88.2	97.8	92.4	84.4	-3.6	-8.3	-7.9	-10.9	-0.8	0.9	3.9	4.7
Brazil	1.4	-4.4	5.0	1.5	3.7	3.2	8.0	5.9	89.7	88.6	88.9	88.9	-5.9	-13.8	-5.7	-6.6	-3.5	-1.7	0.0	-0.4
Chile	0.9	-6.0	10.7	2.7	2.6	3.0	4.6	7.7	19.8	18.0	16.8	16.8	-2.8	-7.3	-5.8	-3.8	-3.8	1.3	-3.1	-1.3
China (mainland)	6.0	2.3	8.0	5.7	2.9	2.5	1.1	2.0	20.6	20.7	21.6	21.6	-4.9	-6.2	-3.8	-3.4	0.7	1.9	1.5	1.9
Colombia	3.3	-6.8	8.5	2.6	3.5	2.5	3.4	5.0	57.4	50.1	45.9	45.9	-1.9	-7.6	-6.9	-6.9	-4.6	-3.7	-5.2	-2.7
Hungary	4.6	-5.1	6.9	3.8	3.4	3.4	5.1	4.5	78.5	80.9	78.3	78.3	-2.0	-7.7	-5.3	-3.5	-0.7	-1.5	0.3	1.2
India	4.1	-7.5	7.9	6.5	3.7	6.6	5.6	6.0	50.5	54.8	56.9	56.9	-4.2	-6.4	-4.6	-5.0	-1.1	1.3	-0.7	-0.8
Indonesia	5.0	-2.0	3.2	5.2	2.8	2.0	1.6	3.3	39.9	44.3	49.4	49.4	-2.2	-6.1	-4.1	-4.9	-2.7	-0.5	-0.1	-0.5
Malaysia	4.4	-5.7	2.2	5.7	0.7	-1.1	2.6	3.5	63.2	65.4	65.7	65.7	-3.5	-3.8	-5.4	-4.7	3.5	4.2	3.0	1.8
Mexico	-0.2	-8.5	6.0	2.3	3.6	3.4	5.6	4.9	40.9	37.7	36.9	36.9	-1.7	-2.8	-2.8	-2.5	-0.4	2.5	0.5	-0.8
Peru	2.2	-11.1	12.8	3.3	2.1	1.8	4.0	4.8	33.9	38.5	39.6	39.6	-1.4	-7.7	-3.3	-3.1	-0.9	0.6	-1.4	-1.8
Philippines	6.1	-9.4	5.0	7.1	2.5	2.6	4.4	3.5	54.6	55.4	54.3	54.3	-3.3	-7.5	-8.5	-7.9	-0.8	3.1	0.1	-0.4
Poland	4.8	-2.5	5.0	4.7	2.1	3.7	5.1	5.3	58.2	61.3	61.2	61.2	-0.7	-7.1	-3.5	-4.7	0.5	2.9	0.1	-0.3
Russia	2.0	-2.9	4.4	3.3	4.5	3.4	6.6	4.9	18.6	16.7	23.5	23.5	2.1	-4.0	0.5	1.5	4.0	2.4	3.0	3.2
South Africa	0.1	-6.4	5.0	1.9	4.1	3.3	4.5	4.6	76.0	78.8	85.2	85.2	-4.1	-8.9	-6.7	-5.9	-2.6	2.1	3.8	-0.2
South Korea	2.2	-0.9	3.9	3.1	0.4	0.5	2.2	1.2	50.8	50.6	51.4	51.4	-0.6	-3.7	-0.5	0.6	3.6	4.5	5.7	5.5
Taiwan	3.0	3.1	6.0	3.2	0.6	-0.2	1.9	1.8	28.0	27.2	26.6	26.6	0.6	0.7	0.0	0.1	10.6	13.8	14.7	15.0
Thailand	2.3	-6.2	0.5	3.9	0.7	-0.8	1.3	1.9	44.9	47.6	46.9	46.9	-1.9	-5.9	-4.9	-5.6	7.0	3.9	1.4	1.8
Turkey	0.9	1.6	8.7	4.3	15.2	12.3	18.0	16.4	36.1	33.3	31.9	31.9	-2.9	-3.5	-2.4	-3.9	0.7	-4.8	-2.7	-4.5

Source: IHS

Disclaimer

About Triodos Investment Management

With over 25 years of experience as a globally active impact investor, and as a wholly owned subsidiary of Triodos Bank, Triodos Investment Management has developed deep sector-specific insights across Energy & Climate, Inclusive Finance, Sustainable Food & Agriculture, and Impact Equities and Bonds. Offering impact solutions through private equity, debt, and listed equities and bonds, our assets under management amounted to EUR 6.1 billion as per 30 June 2021.

Investing in positive change

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