
# Stagflation fears are a new setback for sustainability

## Emerging Markets Outlook Q3 2022

Maritza Cabezas Ludena

Triodos Investment Management

The past couple of years have been a test for the global economy. A double shock, triggered by COVID-19 and followed by the war in Ukraine, has created an energy squeeze and exacerbated the surge in global food prices. In turn, this has led to worldwide fear for stagflation – a painful mix of persistent high inflation and low economic growth. In response, central banks all around the world are hiking rates to tame inflation. And the challenge for central banks is large, since there will be undesired costs if the rate hikes lead to a recession.

Although the import bans on Russian energy were initially expected to accelerate th energy transition, they are actually threatening to delay the sustainable developmen pledges. The global economy is under rising social and political pressures, leading decision-makers to opt for the quickest fix. The result is that it is becoming more difficult to achieve sustainable development and better living standards.

Only if we continue following our sustainable agenda will we be able to reduce the enormous costs we pay every day, and reverse the increasing inequality, food insecurity, and climate threats. In this outlook we focus on some of the dilemmas surrounding sustainability, particularly when stagflation fears are on the rise.

# Emerging markets GDP growth marked down

The global economy is expected to decelerate in 2022 after the rebound that got underway the previous year, as figure 1 shows. Emerging markets' growth will likely halve, compared to 2021, reaching around 3.4% in 2022. The adverse effects of the war in Ukraine, the acute inflationary pressures, and the faster-than-expected pace of rate hikes in the US are all pushing down global growth. Our base scenario for emerging markets, which became cautious after the outbreak of the war, **is practically unchanged**, with slowing growth and rising inflation throughout the year. Commodity importers will be hit harder than commodity exporters. But even if our negative scenario has become slightly more probable lately, we still believe that there are ways to avoid a sharp slowdown in emerging markets if the right decisions are made.

Where households' purchasing power is rapidly deteriorating, governments are pushed to mitigate the impact of higher energy prices by increasing subsidies on fossil-fuel related products and even reconsider their decision to phase out coal. To quickly cap food prices, price controls, food subsidies, and export restrictions are being considered. This may keep voters satisfied, but such measures will create price distortions. At the same time, capital flows to emerging markets have become more volatile on the back of the Fed rate hikes and the search for higher yields, just when they should be more predictable to support long-term growth.

## Some regions continue to do well

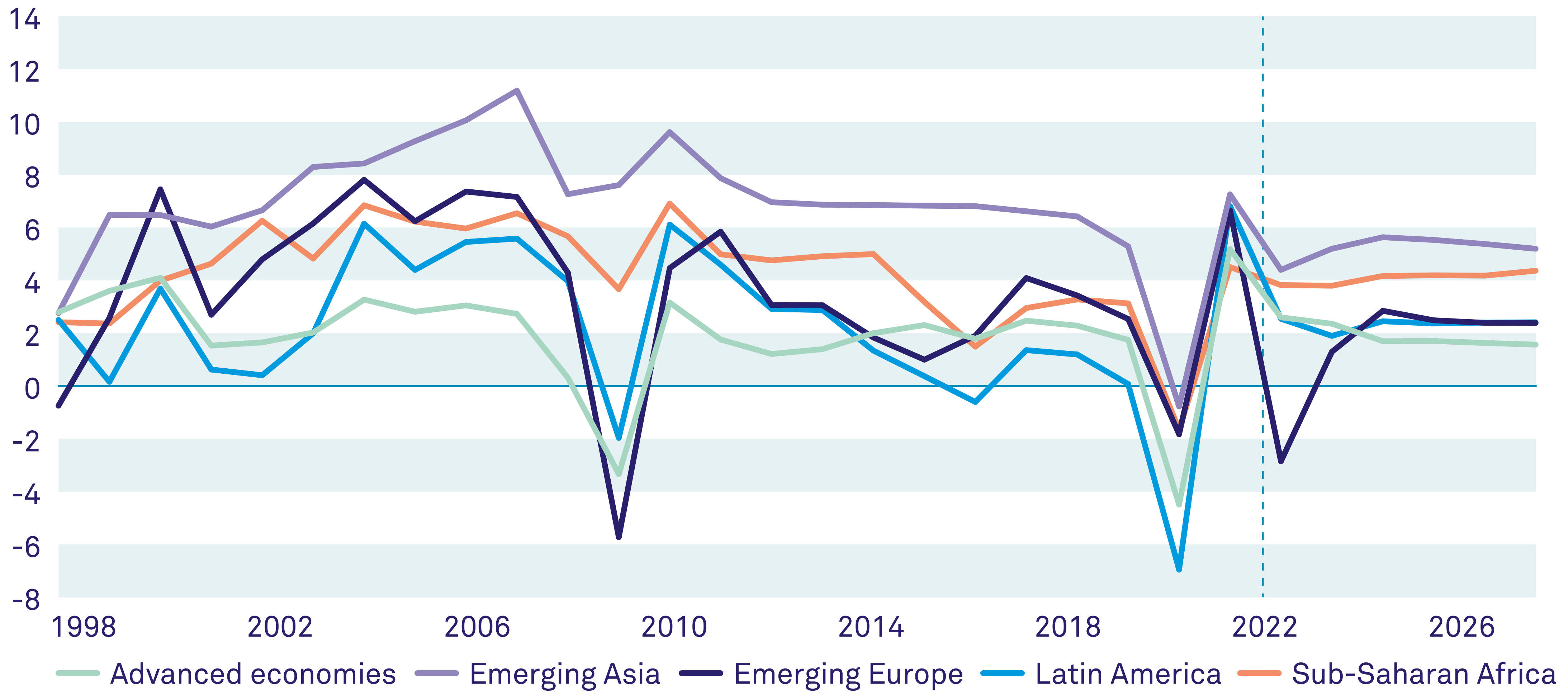
The Middle East is expected to grow at the fastest pace in a decade, mainly on the back of higher oil prices. Latin America is also benefitting, and growth will stay on track in several commodity exporting countries, including Colombia, Chile, and Peru. However, the region is already feeling the impact of faster-than-expected rate hikes in the US and social pressure from an overdue improvement in living standards of a large segment of the population, as the recent protests in Ecuador and Peru show.

At the same time, emerging Asia is showing a mixed picture, with Sri Lanka contracting and the larger economies showing improvement. Malaysia, Vietnam, the Philippines, and Indonesia had a rebound in consumption and investment, while in Thailand tourism is recovering slowly.

When the global economy succumbed to COVID in 2020, the Chinese economy came away relatively unscathed. But in the second quarter of this year, Shanghai went into lockdown. It took time for China's 'zero-COVID' policy to work, and the economic costs are high, but the rebound in the coming quarters is likely to be strong. Given its size, the recovery of the Chinese economy will benefit other countries with close financial and trade ties with China. Moreover, the country has sufficient buffers to avoid a sharp slowdown and the government has made clear it will step up targeted support for investments if needed.

India will likely be the fastest growing large economy in the world. The country is benefitting from the fragmentation of global trade and is forging defense and technology links with the larger world powers. It continues to import commodities from Russia and is taking a leap in the IT-service industry. However, the biggest challenges for India are reducing the enormous inequality and avoiding high inflation. Inflation should remain manageable in the near term if India continues to import energy from Russia at discounted prices.

**Figure 1 A new slowdown after COVID** (GPD growth in %)




Source: IMF, IHS, Authors estimates

## Emerging Europe outlook remains uncertain

Meanwhile, emerging Europe is feeling the most pain. Russia and Belarus are in a deep recession, largely due to the sanctions. Because of their strong ties with Russia, the economies of Kyrgyz Republic and Tajikistan are expected to contract in 2022. The commodity exporters in the region, including Kazakhstan and Uzbekistan, will be able to offset somewhat the impact of the war, but the negative impact of their ties with Russia is expected to be large. This will result in a lower growth outlook than before the war.

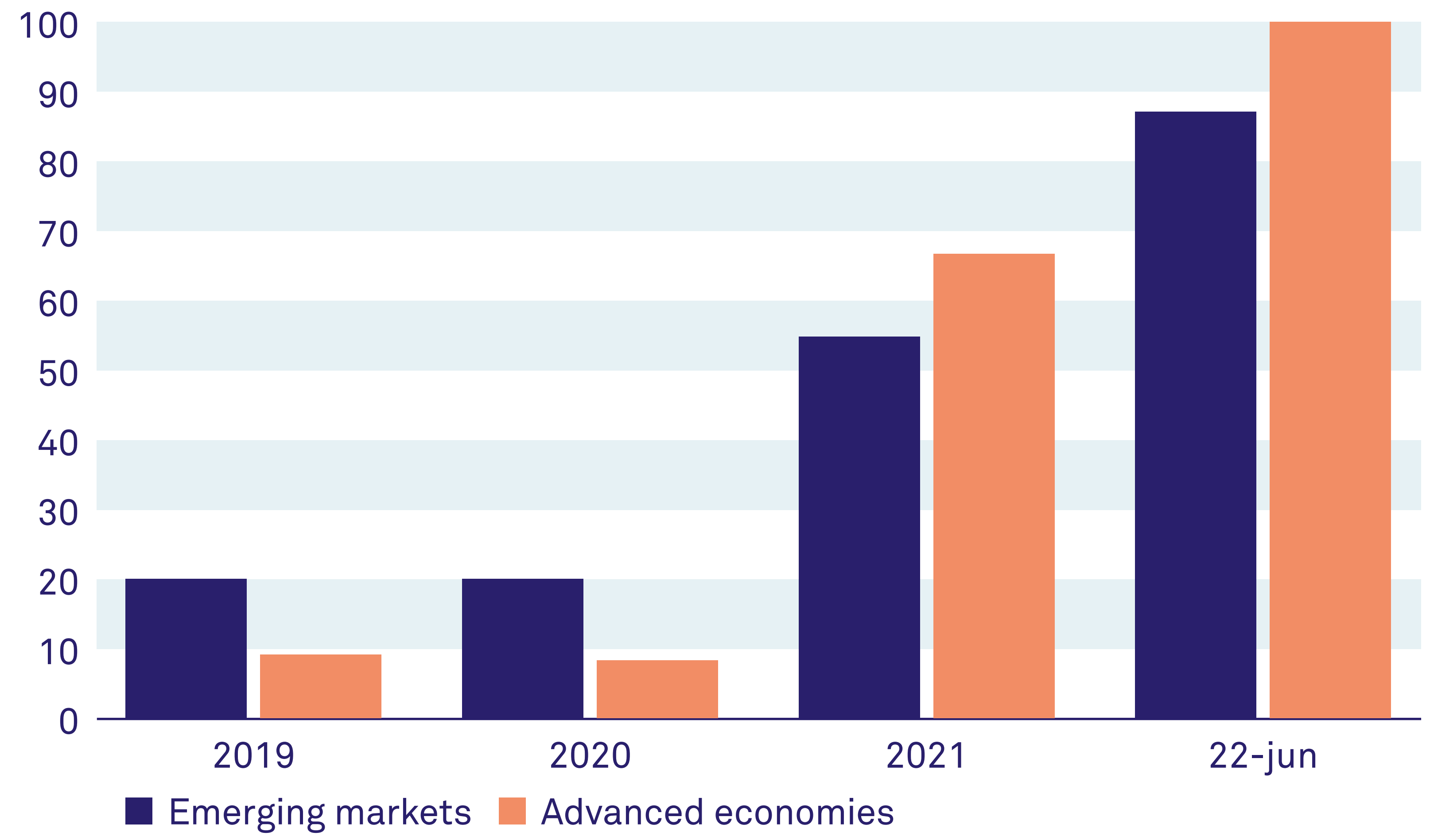
Overall, however, the slowdown in the region has been less pronounced than expected. Preliminary data on remittances from Russia show that flows to neighbouring countries are holding up well. Reducing inflation pressures will be a priority, although inflation is expected to remain high in the region in the coming quarters, due to the pass-through of higher energy prices.

## Emerging markets' inflation will take time to tame

Central bankers in advanced economies initially viewed inflation as temporary, but with hindsight they have come to realize that it is persistent and needs to be addressed with more aggressive monetary tightening. Meanwhile, emerging markets' central banks have been on a rate hike spree since 2021, already preparing for the Fed's monetary tightening. Nonetheless, inflation has hit new and nasty highs all around the world, increasing at a faster pace in advanced economies. According to the Bank of International Settlements, more than 80% of advanced economies have year-on-year inflation above 5%, more than three percentage points higher than typical inflation targets, while in emerging markets more than 65% of the countries have inflation above 5% (see figure 2).

In our base scenario, we expect inflation in emerging markets to remain above central banks' targets well into 2023. We think the war-driven supply shortages and export restrictions will not disappear in the near-term, although supply chain disruptions related to COVID lockdowns are already easing. In time, however, consumption growth will likely slowdown as emerging economies adjust to tighter monetary conditions, easing the inflation pressure.

**Figure 2 Countries with inflation above target** (% of countries)




Source: Bank of International Settlements

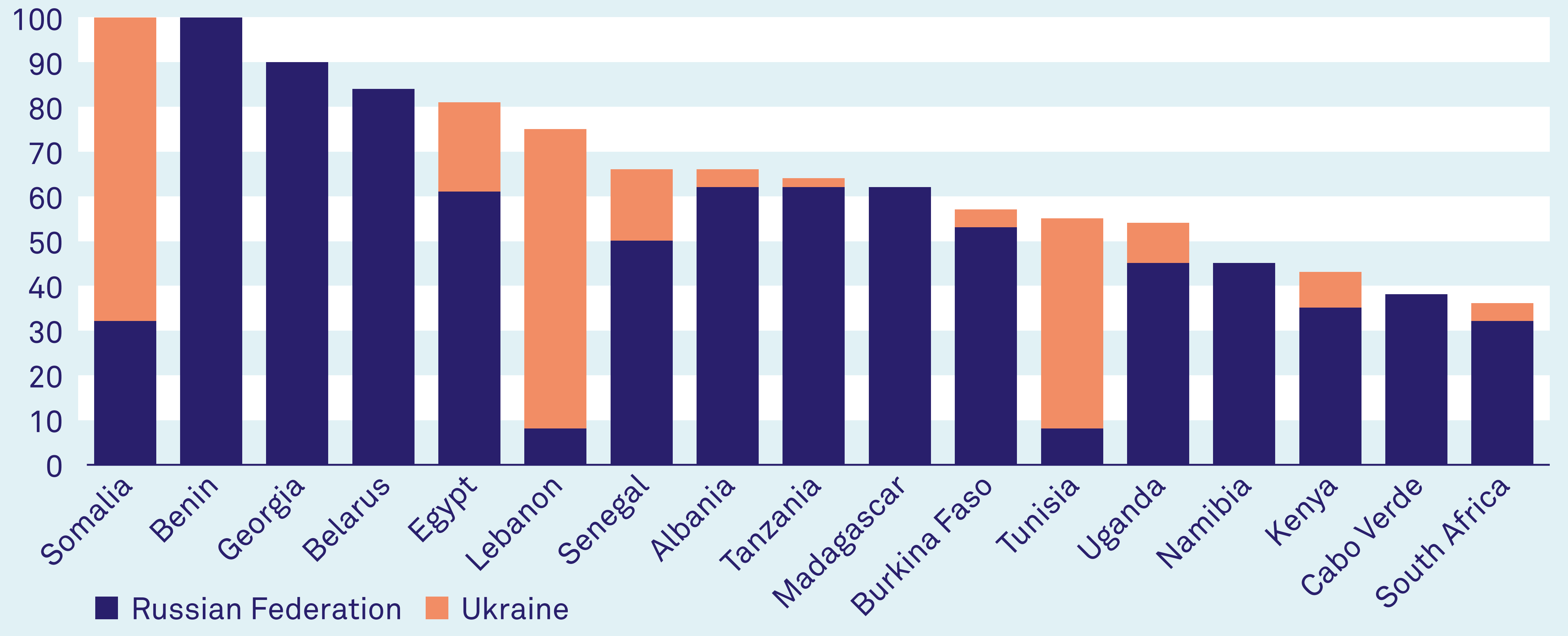
## Low-income countries and inflation

The COVID pandemic made evident that low-income countries have limited policy space to mitigate the impact of a global shock. With inadequate safety nets and low international reserves as buffers, they are much more vulnerable now to economic cycles. It did not help that low-income countries took longer to recover from the pandemic due to inadequate access to vaccinations. And now they have come under more pressure since the war in Ukraine, because in many cases the threats of food insecurity are increasing, particularly in countries that import almost all their wheat from Russia and Ukraine, including Benin, Somalia, and Egypt.

The COVID-19 crisis had already pushed **70 million** more people worldwide into extreme poverty in 2021, while the war in Ukraine will likely push over **40 million** more people into extreme poverty.

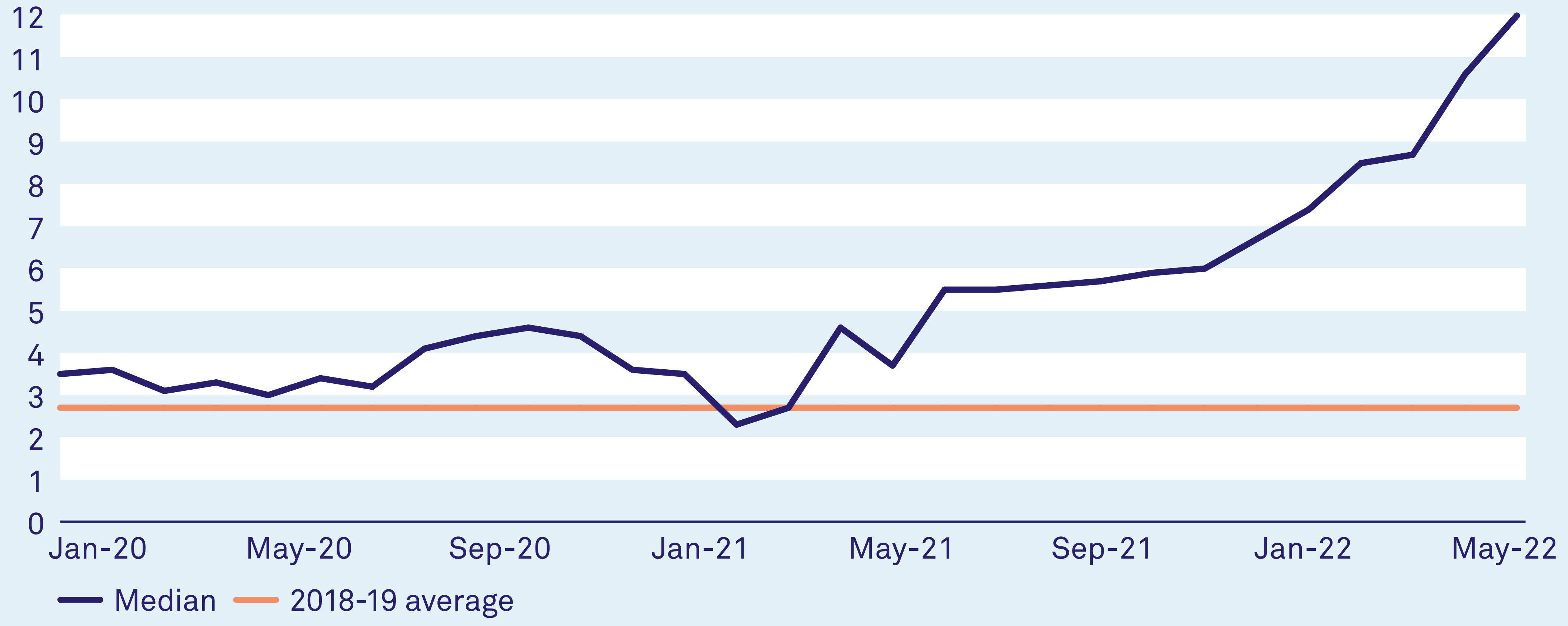
Countries in Sub-Saharan Africa are the most vulnerable to food insecurity, but the impact will be large across many low-income countries the longer the war lasts. These countries are more prone to higher inflation because food consumption amounts to between 45-60% of total household expenditures and staple foods are an important part of diets. As a result, social unrest is increasing, and political instability is large. In Sri Lanka, the government has been overthrown. The country has fallen into default and is facing a food security crisis and energy consumption is being rationed. But because of the limited resources, price controls are the only available policy to mitigate inflationary pressures and a negative spiral has been activated with a plunging currency. Inflation is now above 50% yoy moving into the territory of hyperinflation.

**Figure 3 Wheat dependency of selected emerging and developing countries** (%)




Source: UN Comtrade

**Figure 4 Inflation in low-income countries** (%)




Source: World Bank

## Stagflation fears increasing

Until recently we viewed the negative stagflation scenario to have a very low probability. However, we recognize that fears of longer lasting high global inflation and a sharp slowdown of global growth have been increasing. This is understandable as the war in Ukraine drags on, still more sanctions against Russia are being taken, and COVID continues to erupt every now and then.

At the same time, there is a risk that the slowdown in global growth could be compounded by a faster-than-expected tightening of financial conditions in advanced economies, triggering considerably higher borrowing costs for emerging markets and financial stress for countries with large financing needs. And it cannot be ruled out that if Russia responds to the additional sanctions by introducing new restrictions on energy exports, this could result in higher oil prices and an outright energy shock that would derail global inflation expectations. We are aware that with so many moving targets, the stakes are high.

To avoid falling in a stagflation trap, more perspective on the long-term horizon is needed. There is urgency to continue with the UN Sustainable Development Goals (SDGs), basically anchoring inflation expectations by working collectively on topics that affect long-term growth. Some SDGs were already becoming more mainstream in emerging markets, in part because of pandemic-related financing needs, such as healthcare, as well as Latin America's surge in climate-related borrowing.

However, in general SDG progress has been lagging and one of the hurdles has been getting access to finance and reducing or even cutting financing of activities that conflict with the SDGs. Getting the SDGs back on track through coordination of debt relief efforts in low-income countries would be a start to reduce the threats of surging inequality and increasing social discontent. Policymakers and investors need to show that global fragmentation across trade, finance and investments is not an option.

## Sustainability pausing

After consecutive disruptions, governments are more inclined to look inwards and prefer short-term mitigating actions, of which the results are immediately visible, thus choosing for price controls to reduce high food prices or delaying climate security in favour of energy security.

**Fixing food systems vs. short-term incentives**
Rising food insecurity is one of the increasing threats of the surge in food prices. Even before COVID, trade and financial fragmentation were putting pressure on food prices. The pandemic and the war in Ukraine have increased the risks of global fragmentation. Wheat prices are at a 14-year high. Fertiliser prices have risen more than 30% since the start of the year.

The solutions to mitigate higher food and input prices so far are making the problems worse in the long run. Commodity export restrictions, implemented so far by 23 countries, are leaving a large part of the global demand unattended increasing prices further. Meanwhile, price controls and general subsidies, as well as the re-shoring of production is creating price distortions and trade inefficiencies, sending the wrong signals to food producers, leading to lower investments in the sector and more risks of food insecurity. Additionally, from past experiences it is well known that controlled prices and subsidies are difficult to withdraw.

Fixing food systems is a long-term transformation. The right economic policies matter, including avoiding price distortions. The same goes for sustainable practices, including shifting food demand by discouraging the production of food that is harmful for nature and climate. Adjustments on the supply-side include processes that improve production yields and meet rising food demand, as well as government and private sector support to bring smallholders together and reap the benefits of scale.

**Climate security vs. energy security**
The growing concerns about energy security have already prompted governments to support self-sufficiency and to increase the production of fossil fuels, including coal and LNG. However, these choices can be costly, compared to polices where governments work together to reduce dependency on fossil fuels by expanding investments in renewable energy. If we do not maintain our commitment to climate security, droughts, floods, and wildfires will pressure food systems ever more and cause more poverty than we are already witnessing, particularly in Sub Saharan Africa. Climate security has now become even more relevant with the spreading of food insecurity in recent decades.

Ideally, the path to follow would be for countries to decarbonise the economy, while reducing inequality and not sacrificing too much growth. China is by some distance the world's largest producer and importer of coal. It has a carbon emission scheme, but without a cap, allowing consumers to compensate higher emissions. Overall, actions to reduce the use of coal remain patchy in China with the pressure to sustain growth since the COVID-19 outbreak. At the same time, the country is focusing on solar and wind capacity to meet the target of carbon neutrality before 2060. It is also the leading producer for renewable energy inputs, including cobalt and lithium. The question is where the balance will tilt. Already this year there is political interest to show growth bordering the official target of 5.5%, which did not include the COVID-driven slowdown, before the Party Congress later in the year. This dilemma applies to most countries that need growth to reinforce their social contracts and maintain political continuity.

But it does help to keep sustainability high on the development agenda and meeting the SDGs remains an important commitment towards emerging markets. With many of them highly exposed to social inequality, climate hazards and already facing related transition challenges, private finance plays a crucial role in helping to develop a broader and more mature sustainable finance ecosystem. At the same time, countries around the world must refrain from fragmented trade, fiscal, and monetary policies that make the global economy worse off. We all must work together to avert another disaster.

| | GDP growth (% yoy) | | | | Inflation (CPI, % yoy avg) | | | | Government debt/GDP (%) | | | | Government balance (% GDP) | | | | Current account (% GDP) | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2019 | 2020 | Prelimi-nary 2021 | Forecast 2022 | 2019 | 2020 | Prelimi-nary 2021 | Forecast 2022 | 2019 | 2020 | Prelimi-nary 2021 | Forecast 2022 | 2019 | 2020 | Prelimi-nary 2021 | Forecast 2022 | 2019 | 2020 | Prelimi-nary 2021 | Forecast 2022 |
| **Belarus** | 1.4 | -0.9 | 2.3 | -9.5 | 5.6 | 5.5 | 9.5 | 16.4 | 33.2 | 39.3 | 34.6 | 47.9 | 2.4 | -1.7 | -1.3 | -1.1 | -1.9 | -0.4 | -2.5 | -11.9 |
| **Bolivia** | 2.2 | -8.7 | 6.1 | 3.2 | 1.8 | 0.9 | 0.7 | 2.0 | 41.3 | 59.1 | 67.7 | 70.3 | -7.2 | -12.7 | -9.3 | -7.1 | -3.4 | -0.7 | 2.0 | 1.4 |
| **Brazil** | 1.2 | -4.2 | 4.9 | 1.5 | 3.7 | 3.2 | 8.3 | 10.6 | 75.1 | 89.4 | 81.0 | 84.1 | -5.8 | -13.6 | -4.4 | -5.4 | -3.5 | -1.7 | -1.7 | -1.2 |
| **Chile** | 0.7 | -6.2 | 11.9 | 1.3 | 2.6 | 3.0 | 4.5 | 10.9 | 28.3 | 32.5 | 30.2 | 30.9 | -2.9 | -7.3 | -7.7 | -4.3 | -5.2 | -1.7 | -6.5 | -12.8 |
| **China (mainland)** | 6.0 | 2.2 | 8.1 | 4.2 | 2.9 | 2.5 | 0.9 | 2.1 | 81.4 | 93.1 | 101.7 | 109.9 | -4.9 | -6.2 | -3.8 | -5.6 | 0.7 | 1.7 | 1.8 | 2.2 |
| **Colombia** | 3.2 | -7.0 | 10.7 | 5.5 | 3.5 | 2.5 | 3.5 | 8.6 | 45.6 | 59.0 | 49.1 | 40.3 | -1.9 | -8.2 | -3.8 | -5.3 | -4.6 | -3.4 | -5.7 | -4.3 |
| **Ecuador** | 0.0 | -7.8 | 4.2 | 2.9 | 0.3 | -0.3 | 0.1 | 3.0 | 53.0 | 63.6 | 58.4 | 50.9 | -2.5 | -5.5 | -3.7 | -1.9 | -0.4 | 0.2 | -1.5 | -1.6 |
| **India** | 3.8 | -6.6 | 8.7 | 6.8 | 3.7 | 6.6 | 5.1 | 6.9 | 42.3 | 50.4 | 50.1 | 55.9 | -4.5 | -6.1 | -6.0 | -8.0 | -1.0 | 1.2 | -1.1 | -2.6 |
| **Indonesia** | 5.0 | -2.1 | 3.7 | 5.0 | 2.8 | 2.0 | 1.6 | 4.1 | 30.7 | 39.9 | 41.3 | 44.2 | -2.2 | -6.2 | -4.6 | -4.5 | -2.7 | -0.4 | 0.3 | 0.7 |
| **Kazakhstan** | 4.5 | -2.5 | 4.1 | 1.9 | 5.2 | 6.8 | 8.4 | 14.2 | 18.5 | 23.6 | 22.8 | 47.0 | 1.9 | -3.9 | -1.8 | -4.2 | -4.0 | -3.8 | -3.0 | -3.9 |
| **Kenya** | 5.0 | -0.3 | 7.5 | 4.7 | 4.6 | 6.0 | 6.2 | 6.8 | 56.6 | 62.2 | 66.8 | 70.9 | -7.3 | -8.1 | -8.1 | -7.2 | -5.3 | -4.7 | -5.0 | -5.9 |
| **Mexico** | -0.2 | -8.3 | 5.0 | 1.5 | 3.6 | 3.4 | 5.7 | 8.0 | 36.1 | 40.4 | 38.7 | 37.5 | -1.7 | -2.8 | -2.9 | -3.4 | -0.3 | 2.4 | -0.4 | -1.1 |
| **Pakistan** | 1.1 | -0.9 | 4.7 | 4.0 | 10.6 | 9.7 | 9.5 | 13.9 | 100.7 | 105.2 | 103.7 | 104.8 | -8.9 | -8.2 | -7.5 | -7.1 | -3.4 | -0.3 | -4.3 | -4.5 |
| **Peru** | 2.2 | -11.0 | 13.4 | 2.5 | 2.1 | 1.8 | 4.0 | 6.9 | 26.1 | 33.9 | 35.3 | 33.8 | -1.4 | -8.3 | -2.6 | -2.3 | -0.7 | 1.2 | -2.3 | -3.4 |
| **Philippines** | 6.1 | -9.5 | 5.7 | 7.0 | 2.4 | 2.4 | 3.9 | 4.6 | 39.6 | 54.6 | 60.5 | 64.7 | -3.4 | -7.6 | -8.6 | -7.6 | -0.8 | 3.2 | -1.8 | -2.5 |
| **Poland** | 4.7 | -2.1 | 5.9 | 4.1 | 2.1 | 3.7 | 5.2 | 12.4 | 46.2 | 58.2 | 55.1 | 59.4 | -0.7 | -6.9 | -1.9 | -5.4 | 0.5 | 2.9 | -0.6 | -5.2 |
| **Russia** | 2.2 | -2.7 | 4.7 | -10.6 | 4.5 | 3.4 | 6.7 | 15.1 | 13.2 | 18.5 | 17.7 | 21.7 | 1.9 | -4.0 | 0.8 | 2.5 | 3.9 | 2.4 | 6.9 | 5.0 |
| **South Africa** | 0.3 | -6.3 | 4.9 | 2.0 | 4.1 | 3.3 | 4.6 | 6.2 | 55.6 | 68.5 | 67.9 | 73.4 | -4.3 | -9.1 | -4.8 | -6.4 | -2.6 | 2.0 | 3.7 | 1.2 |
| **South Korea** | 2.3 | -0.7 | 4.2 | 3.0 | 0.4 | 0.5 | 2.5 | 5.0 | 44.8 | 51.1 | 50.8 | 49.5 | -0.6 | -3.6 | -0.3 | -0.4 | 3.6 | 4.6 | 4.9 | 4.8 |
| **Thailand** | 2.2 | -6.2 | 1.5 | 3.0 | 0.7 | -0.8 | 1.2 | 4.8 | 34.0 | 45.0 | 52.8 | 52.7 | -1.5 | -5.6 | -4.9 | -4.3 | 7.0 | 4.2 | -2.1 | -1.5 |
| **Turkey** | 0.9 | 1.6 | 11.2 | 2.3 | 15.2 | 12.3 | 19.6 | 70.0 | 30.8 | 35.9 | 38.1 | 42.1 | -2.9 | -3.5 | -2.7 | -3.2 | 0.7 | -4.9 | -1.7 | -4.5 |
| **Uganda** | 7.7 | -0.8 | 4.4 | 5.3 | 2.1 | 2.8 | 2.2 | 5.1 | 37.7 | 45.6 | 53.9 | 56.3 | -4.6 | -7.3 | -9.1 | -10.9 | -6.2 | -9.0 | -9.7 | -10.7 |
| **Uzbekistan** | 5.7 | 1.7 | 7.4 | 2.8 | 14.5 | 12.9 | 10.8 | 12.2 | 29.6 | 38.0 | 36.8 | 40.4 | -3.8 | -4.3 | -6.2 | -3.8 | -5.6 | -5.0 | -6.9 | -8.2 |

Updated 7/12/2022, Source: IHS

# Disclaimer

- This document has been carefully prepared and is presented by Triodos Investment Management.
- It does not carry any right of publication or disclosure, in whole or in part, to any other party.
- This document is for discussion purposes only.
- The information and opinions in this document constitute the judgment of Triodos Investment Management at the time specified and may be subject to change without notice, they are not to be relied upon as authoritative or taken in substitution for the exercise of judgment by any recipient. Under no circumstances is it to be used or considered as an offer to sell, or solicitation of any offer to buy, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever or be taken as investment advice.
- The content of this document is based upon sources of information believed to be reliable, but no warranty or declaration, either explicit or implicit, is given as to their accuracy or completeness.
- This document is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.
- All copyrights patent s and other property in the information contained in this document is held by Triodos Investment Management and shall continue to belong to Triodos Investment Management. No rights whatsoever are licensed or assigned or shall otherwise pass.

## 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 6.4 billion as per 31 December 2021

## Investing in positive change

For more information about our impact investment strategies, please contact our Investor Relations team at:
+31 (0)30 694 2400
TriodosIM@triodos.com
www.triodos-im.com/impact-equities-and-bonds

**Published**
July 2022

**Text**
Maritza Cabezas
Triodos Investment Management

**Design and layout**
Via Bertha, Utrecht

**Cover photo**
Kyle Glenn