Perspectives
Emerging Markets

SwissLife
Asset Managers

Second quarter 2021

Key messages

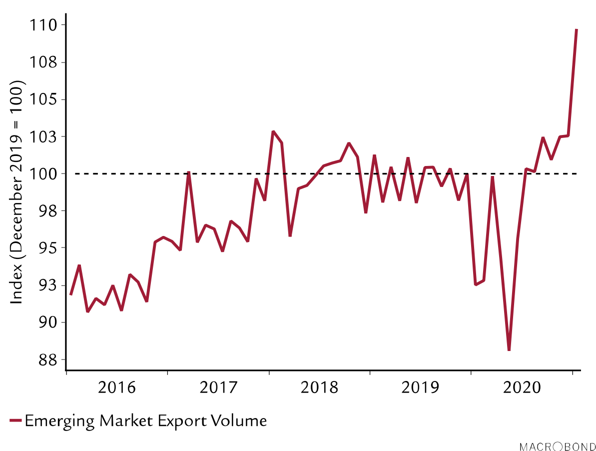
- Emerging markets boosted by global economic recovery, but higher interest rates pose a challenge
- ESG considerations are valuable when assessing a country's long-term economic stability
- China: focus shifting towards quality growth, innovation and self-reliance, as external risks are growing

Number in focus

5

After less than five months in office, Turkey's market-friendly central bank governor Naci Agbal has been ousted. While he aggressively raised the policy rate by 875 bps, which strengthened the lira considerably, the appointment of his successor Sahap Kavcioglu – a critic of interest rate increases – led to a plunge in the lira by more than 15% against the US dollar. Turkey's economic fundamentals deteriorated over 2020, with a tremendous sell-off of foreign exchange reserves and a pile-up in short-term foreign debt. A shift towards an unorthodox monetary policy regime increases the risk of a renewed balance of payments crisis in the country.

Chart in focus



Emerging market exports had already surpassed pre-pandemic levels by the end of 2020 and they experienced a real boom in January this year. The expected ongoing global progress in vaccinations as well as an economic rebound in the US, supported by a large fiscal stimulus package, will likely boost demand for goods produced in emerging countries and support their economic recovery. Nevertheless, as vaccine progress in major developing countries remains slow, social distancing measures will continue to weigh on the services sector.

Higher interest rates challenge emerging markets

Brighter economic prospects as well as expectations of higher inflation pushed US Treasury yields up. Higher interest rates in the US, in turn, are dampening investors' appetite for riskier emerging market assets, as reflected in a sell-off of emerging market currencies that have depreciated across the board against the dollar so far this year. Weaker currencies combined with higher commodity prices will likely push inflation higher, inducing central banks to tighten their monetary policy stance. Brazil, Russia and Turkey have already raised policy rates, while other emerging countries have refrained from cutting interest rates further. Tightening financial conditions pose a challenge, particularly for economies with a high debt burden. Over the course of 2020, government debt in 15 major emerging markets jumped from 52% of GDP in 2019 to 63% in 2020, and IMF projections point to a continued increase in the public debt burden. The debt pile should remain manageable for the majority of the emerging markets, as higher economic growth and fiscal consolidation efforts in the future should help them to gradually grow out of the debt burden. In Brazil and South Africa however, fiscal vulnerabilities are elevated. Both countries report some of the highest public debt as a percentage of GDP. Already before the pandemic-induced recession, debt in these countries had been on the upswing for a number of years. At the same time, growth rates have been lacklustre over the last five to ten years and are not expected to pick up significantly any time soon – so that revenue generation to pay off the debt mountains remains limited. A further significant increase in interest rates could therefore complicate these countries' ability to pay off their debt.

Stronger external positions make EM less prone to USD risks

Besides higher interest rates, a higher US dollar that has strengthened amid the brighter economic prospects for the US economy, also poses a challenge for emerging countries with external financing needs. On the positive side, external positions among the vast majority of developing countries have strengthened over the past ten years. Emerging countries have built up their foreign exchange reserves, while their current account deficits have decreased, making them more resilient to a higher US dollar. One major exception to this positive development is Turkey, that used up a significant amount of its foreign exchange reserves to defend a depreciating currency, while short-term external debt has risen significantly, and the current account balance has plunged deeper into negative territory. The country's vulnerable fundamentals combined with heightened political uncertainty as well as a potential shift towards an unorthodox monetary policy stance have significantly increased the risk of a renewed balance of payments crisis in Turkey (see number of the month). Such an event could have negative repercussions on other vulnerable emerging countries.

ESG considerations as an indicator for long-term stability

Over the past years, awareness of the impact linked to environmental (E), social (S) and governance (G) issues – in short ESG – has risen markedly. Since ESG considerations focus on sustainable development, they are a valuable indicator of a country's long-term economic stability, and ideally complement the traditional

Chart 1: Emerging market government debt has been on the rise and jumped sharply in 2020

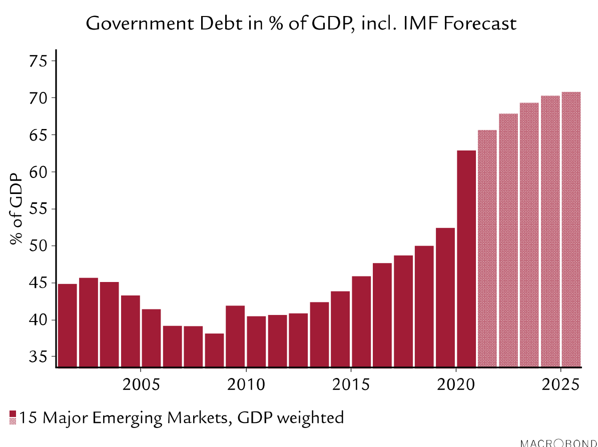
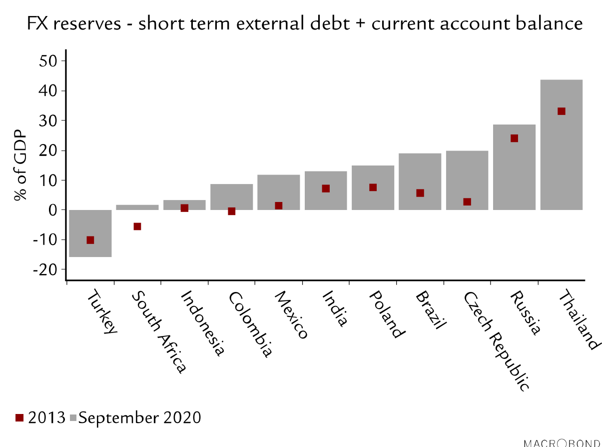


Chart 2: External positions improved compared to 2013, but not in Turkey



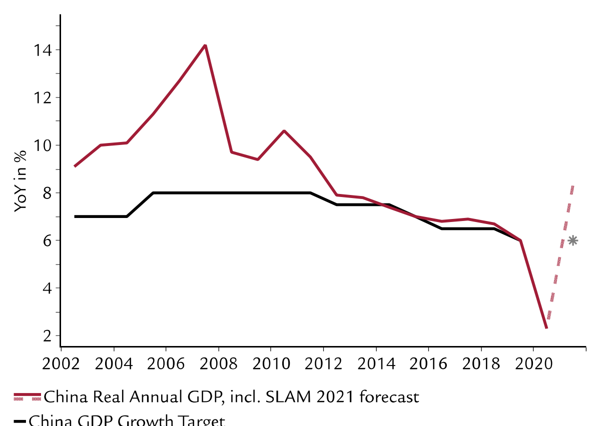
macroeconomic analysis, which focuses mainly on economic variables, such as government debt, budget deficits, current account balances and inflation. For instance, improving indicators on the social front, such as educational standards or the quality of healthcare systems, enhance living conditions and thus support economic growth in the long term. Moreover, various governance indicators are highly correlated with a country's credit profile. Stable and trustworthy institutions keep finances in check and guarantee an investor-friendly environment, while countries with poor performance on corruption indicators, for instance, are prone to misallocation of capital and therefore to a deterioration of their credit profile. For emerging markets, ESG considerations are of particular importance since this part of the world contains higher ESG-related vulnerabilities compared to developed countries. As more and more investors make the debt capacity and cost of debt of countries dependent on their ESG rating, emerging markets could be encouraged to adopt more sustainable policies. Meanwhile, ESG scores from leading data providers correlate only weakly, as they depend on the factors considered as well as their weightings. Furthermore, underlying drivers of changes in the scores are not always traceable. Our proprietary ESG model for developing countries is more transparent, allows deeper analysis and serves as a basis for our country selection of ESG-related investment products. It enables us to compare ESG ratings between the countries, and provides an insight into the ESG development of a country over time. In this respect, Turkey shows one of the deepest deteriorations of its ESG score among our universe of 71 emerging countries, particularly as its governance ratings deteriorated over the last six years – a development that has contributed to the country's economic vulnerabilities today. On the other hand, Ghana's ESG score has improved considerably, especially on aspects such as access to healthcare or educational standards – a positive development that has recently been recognised internationally, as Ghana was the first country provided with vaccines from the WHO's COVAX programme, since it has proven that it is able to establish a credible vaccine plan.

China: growth is not the only focus

In the first two months of this year, industrial activity kept expanding strongly, while consumption decelerated. Mobility restrictions during the Chinese Lunar New year supported industrial activity, as 75% of migrant workers remained in their working cities and production facilities kept working. At the same time, travel restrictions had a dampening effect on consumer spending. After a moderate start to 2021, China's economy is still expected to show solid expansion this year as consumption will recover further, while exports will be supported by the global economic recovery. However, Beijing's focus is shifting towards a more sustainable growth path. At the opening of China's National People's Congress, China announced a moderate GDP growth target for 2021 of "above 6%". While the "above 6%" target is open ended, it reflects the country's goal to shift back towards higher quality growth, giving policymakers more room for reforms. Moreover, Beijing stressed that R&D expenditure should grow at 7% over the next five years, reflecting the country's aim to strengthen innovation and enhance self-reliance as external risks grow, particularly with US-China tensions not abating.

Chart 3: Proprietary ESG model assesses the ESG risk of the emerging world

Chart 4: China's 2021 growth target well below expectations, as focus shifts to growth quality



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