EDITORIAL

A FRAGILE RECOVERY

Emerging countries have continued to recover since the beginning of the year, although the recovery remains fragile. Household confidence indicators are lagging behind those of business sentiment, illustrating the constraints on domestic demand: the pandemic risk persists, inflation is accelerating, and governments are facing rising financing costs, which reduces their fiscal manoeuvring room. Despite buoyant foreign trade, the horizon is not clear enough yet for investment to rebound. Fortunately, the vast majority of central banks have been maintaining a proactive stance so far, despite inflationary pressures. But monetary policy is bound to tighten across the board.

Real GDP growth continued to slow in the 27 main emerging countries in Q1 2021, although it held strong at 1% q/q, down from 3.5% in Q4 and 7.7% in Q3. For half of these countries, real GDP growth returned to or exceeded Q4 2019 levels. In general, exports were still the main growth engine, notably in Asia (China, Taiwan and Vietnam). Companies are rebuilding inventory, which is generating pricing pressures on commodities and raising transport costs. Private domestic demand is also picking up, but in a more hesitant manner, including in China, even though it is more advanced in the cycle than the other countries. Confidence indicators reflect this lag: for the large majority of countries, the Markit indexes for the manufacturing sector have returned to or surpassed pre-crisis levels, but this is not yet the case for household confidence indicators.

THE RECOVERY CONTINUES, BUT THE RISKS ARE MORE ON THE DOWNSIDE THAN ON THE UPSIDE.

There is still a major pandemic risk. New waves of Covid-19 infections were reported in Asia and Latin America in Q2 2021. The virus is mutating into more contagious variants, and vaccination coverage rates are still too low to ensure herd immunity (less than 10% in India and Indonesia, and less than 15% in Brazil and Russia, to cite only the countries with the largest populations). The authorities in several countries have had to reinstate lockdowns, and as a result, economic activity is expected to slow or even contract in several Asian and Latin American countries.

The upsurge in inflation is now widespread (in May, the median increase in the inflation rate was already 1.8 points above the 2020 average). Oil and agricultural commodities are the main drivers of inflation, which strains household purchasing power, notably for the most vulnerable households. In its most recent June outlook, the World Bank, following the IMF, reiterated its alarming estimates of the number of people who slid into poverty last year (nearly 100 million people live off less than USD 1.9 a day, or 164 million using a broader definition that also takes into account the deterioration of healthcare and education). Even under a recovery scenario, per capita income in 2023 will still be lower than in 2019 in at least 40% of the emerging and developing countries. In comparison, four years after the 2008-2009 shock, this figure was only 15%.

The upsurge in inflation also poses a problem for the central banks, because it will exceed the inflation targets in more than half of the countries that have them. Yet tightening monetary policy at this point in the cycle risks disrupting the recovery of domestic demand, and investment in particular. Monetary tightening would only make sense if it is necessary to anchor inflation expectations. On the whole, the central banks are taking care to be proactive.

Since the beginning of the year, governments have been faced with higher financing costs, both domestically and externally. The rebound in portfolio investment as a share of local currency public debt in H2 2020 helped contain the increase in bond yields that could have been triggered by swelling deficits. Since the beginning of the year, however, portfolio investment has been returning to normal levels (they were cut in half in H1 2021 compared to H2 2020), notably due to expectations of a tapering of US monetary policy. The big increase in debt ratios in 2020, will magnify the impact of higher bond yields on the interest burden, reducing by as much the fiscal manoeuvring room in case of a relapse into recession.

Lastly, it is uncertain that foreign direct investment (FDI) will recover. According to the CNUCED, the number of greenfield projects in the manufacturing sector – which was already tending to decline in the 2010s – was slashed in half in 2020. Project financing also declined through Q1 2021, and inertia is very strong (following the 2008-2009 crisis, it took two years for projects to pick up again). These two categories of FDI will make a smaller contribution to growth than during the previous crisis exit phases, because governments have less borrowing capacity and because multinational companies are planning to relocate their business.

Yet the rebound in commodity prices could stimulate investment and help raise the growth potential of the countries concerned. This was the case in Latin American countries in the 2000s, when the upward phase of the commodity price cycle increased potential growth rates by nearly a percentage point. But the current situation is not comparable to the 2000s. At that time, China had maximum leverage with a growth rate of 10%, nearly double its current rate.

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