A LACKLUSTER SUMMER

The recovery in emerging countries remains fragile. Several economies in Asia and Latin America went through an air-pocket in Q2 2021. The emergence of Covid-19 variants has triggered new waves of the pandemic resulting in production stoppages, which have been temporary so far but which are eroding business confidence. Companies are also struggling with supply-side constraints, including supply-chain bottlenecks and energy shortages, which are contributing to fueling inflation and indirectly straining household confidence. Lastly, the Chinese economy is a source of concern with its sluggish household consumption and with the construction and real estate sectors in great distress. Still, to end on a positive note, according to IIF estimates, the rise in non-financial private debt has been moderate so far when compared with public debt.

A CHAOTIC RECOVERY

The recovery in emerging economies is proving to be bumpy. In Q2 2021, real GDP plummeted again for one third of the twenty- seven countries in our selection. The only countries that reported stronger growth were the member states of the European Union, thanks notably to the rebound in the Eurozone. It was primarily the Asian economies that went through air pockets, mainly due to the reintroduction of lockdown measures following new waves of the pandemic caused by Covid-19 variants (notably in India and Malaysia). And yet exports were still dynamic through June, even in Asia, and accelerated in other regions. Africa and the Middle East are the only regions where exports are still below the pre-pandemic level of 2019, which can be attributed to the oil production quotas that were maintained by OPEC+.

Summer trends do not provide much room for optimism. Granted, vaccination campaigns are being rolled out at an accelerated pace. But the business climate is deteriorating (except in Central Europe). Surging inflation is straining household confidence and driving more central banks to raise their policy rates. So far central banks have increased their policy rate cautiously (even the central banks of Brazil and Russia, which have been very reactive, remained behind the curve). This cautious approach is justified by 1) the usual inertia of core inflation relative to headline inflation (especially in Asia), and 2) the results of business surveys showing that the ratio between the output price diffusion index and the input prices one is generally less than 1.

The expected tapering of US monetary policy has triggered an outflow of portfolio investment, and exchange rates continue to depreciate against the dollar. Above all, the Chinese economy is a source of concern with its sluggish household consumption and with the construction and real estate sectors in great distress. These fears have already been reflected in the downturn in metal prices since mid-September.

The threat of a stronger-than-expected Chinese economic slowdown in Q4 2021 and 2022 presents a new downside risk for growth in emerging countries. If the slowdown is limited to the construction and real estate sectors, then the impact on Chinese demand could be circumscribed. Indeed, higher infrastructure spending could partially offset the shock that is already being felt in residential construction. Yet the indirect impact conveyed via the commodity channel is likely to be much faster. The first in line are the Latin American countries, which are already struggling.

THE COVID SHOCK DID NOT LEAD TO EXCESSIVE PRIVATE DEBT

The latest update of the IIF's Global Debt Monitor provides a preliminary picture of the health crisis's impact on debt in the emerging countries. The median increase in the public debt ratio was about 10 points of GDP between December 2019 and June 2021. In comparison, in the aftermath of the Lehman Brothers shock of 2008, the public debt ratio increased by only 5 points. For the non-financial private sector, in contrast, the median increase was equivalent to about 3.5 points during the two episodes. More surprisingly, corporate debt does not seem to have increased significantly more than household debt, even though companies benefited from emergency credit lines. With little or no unemployment insurance, households may have had to resort to borrowing to offset the loss of jobs or revenues (South Africa, Brazil, Colombia, Malaysia and Thailand). On the whole, although the IIF regularly warns about the increasingly high level of global debt (both public and private), the rise in the non-financial private debt has been moderate so far, when compared with public debt. Two exceptions are worth pointing out: Saudi Arabia and Russia, where non-financial corporate debt rose by 14 points of GDP. Yet Russia's non-financial private sector is not in an excessive debt situation (the credit gap is less than 5 pp). However, both economies are vulnerable given the structural constraints arising from their lack of diversification, which is holding back their growth potential.

Another lesson that can be drawn from the IIF estimates is that the Covid-19 shock did not increase the external vulnerability of emerging countries. At the aggregate level, the increase in the foreign-currency debt of non-financial agents (governments, companies and households combined) was more than offset by the increase in official foreign reserves, despite the volatility of portfolio investment.

The ratio of foreign-currency debt to foreign reserves has diminished in the vast majority of countries, with the notable exception of Turkey, and to a lesser extent, Saudi Arabia and Colombia. Another positive point is that emerging countries have maintained their capacity to issue debt either on the international markets or on their domestic market. With a few exceptions (Turkey, Brazil, Colombia), CDS spreads on sovereign debt have hardly widened since March 2020 despite the rise in public borrowing requirements. Sovereign issuers have relied on domestic savings and also non-resident portfolio investors.

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