

Fourth quarter 2022

## Key messages

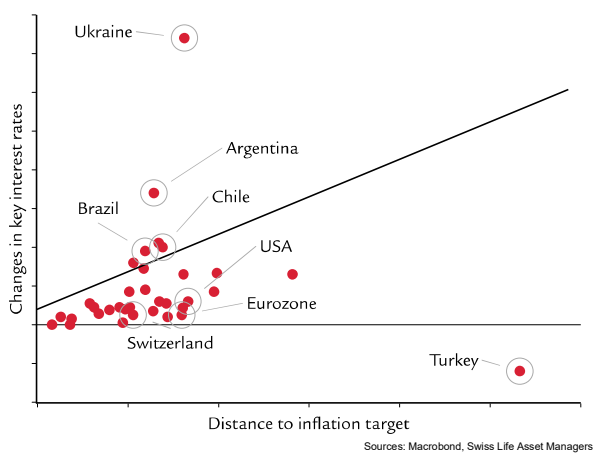
- The high interest rate environment is weighing on the emerging markets; medium-term prospects for Asia are constructive
- In addition to high inflation and high interest rates, political uncertainty is weighing on Latin America's prospects
- Uncertainties remain about China's growth prospects, although the obstacles differ from those of Japan

## Number in focus

20

The 20th Congress of the Communist Party of China will be held on 16 October. While Xi Jinping will be elected for a third term as the party's general secretary, attention will be focused on the potential successors of Premier Li Keqiang and economic tsar Liu He. Before this pivotal political event, China's priority has been and still is to ensure stability and, in particular, to avoid a nationwide Covid outbreak at all costs. After the congress, it will thus be important to watch for possible, if at best only gradual, adjustments to the strict zero-Covid strategy.

## Chart in focus

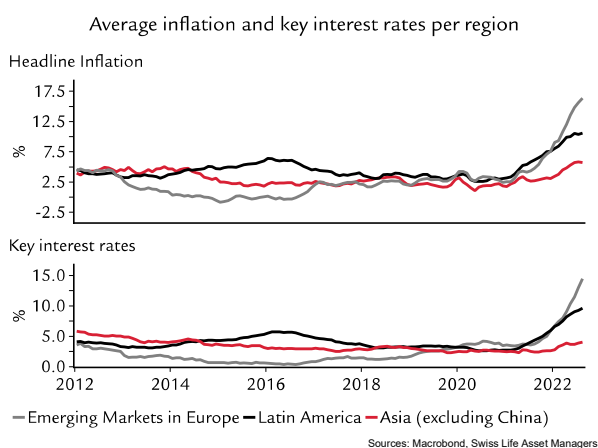


All over the world, inflation is shooting far beyond the inflation targets defined by the central banks. Accordingly, the central banks are raising their key interest rates in order to counteract rising inflationary pressure. Latin American countries such as Argentina, Brazil and Chile are among the leaders. Turkey, meanwhile, is dealing with a different situation. Despite the country's record-high inflation rate of over 80%, the central bank continues to lower interest rates, reflecting political pressure from President Erdogan, who is advocating lower interest rates in order to boost investment.

## Medium-term constructive growth prospects for Asia

Falling global demand is increasingly weighing on emerging markets. The Purchasing Managers' Index for emerging markets' export orders fell further below the 50-point threshold to 48.7 in August. This downward trend is expected to continue, especially as demand from Europe, hit by an energy crisis, continues to stagnate and higher interest rates in the US are likely to cool the overheated US economy. Export-dependent economies in North Asia in particular, such as South Korea, Taiwan and China, recorded a significant drop in their Purchasing Managers' Indices in August. Meanwhile, in China the slump is not only a result of slowing global demand, but also weak domestic momentum, as persistent Covid lockdowns weigh on consumer confidence and the real estate sector remains under pressure. South Asia, on the other hand, has so far remained quite resilient. South Asian economies continue to benefit from the momentum of the reopening since the peak of the pandemic. Moreover, inflation in Asia has so far remained at decidedly moderate levels compared to other regions, so that interest rate hikes were less severe and are therefore weighing less on domestic demand. If China shifts to a more flexible Covid containment strategy next year, the region could also benefit from the country's cyclical upswing. The medium-term prospects for Asia are thus relatively constructive. In the short term, however, the environment remains difficult for emerging markets globally, especially for as long as the US Fed continues to hike interest rates, which strengthens the US dollar and puts pressure on emerging market currencies.

Figure 1: Asia is least affected by high inflation and interest rates



## Latin America shaken by political uncertainties

In addition to record high inflation and interest rates, Latin America's prospects are clouded by political uncertainties. In Chile, the people overwhelmingly rejected the newly drafted constitution, which aimed to alleviate the rampant inequality in the country's society. While the new proposal included some very welcome environmental and social rights, the associated need to increase public spending would have called the country's fiscal stance into question, while environmental considerations cast doubt on the future potential of the mining sector – on which the country's economy remains heavily dependent. Thus, while the rejection creates the potential for a constitution with a more moderate text, it also represents a further period of political uncertainty until a new proposal is presented. Meanwhile, Brazil is in the middle of an election campaign. Up until now, former President Lula da Silva has been way ahead in most opinion polls. Although the left-wing candidate is widely expected to follow a moderate political course, he has said that he would abandon the rules limiting public spending – an anchor for fiscal policy credibility. Moreover, it remains unclear whether President Bolsonaro would accept defeat, or whether he would incite his supporters to protest.

Figure 2: Polls predict Lula da Silva as new Brazilian president



## Is China following Japan's slow growth path?

In many ways, China's current situation is similar to that of Japan in the late 1980s, when the real estate bubble burst, followed by more than 30 years of sluggish economic growth. Firstly, China, like Japan in the 1980s, has experienced huge house price inflation and faces the risk of a substantial real estate bubble, which is gradually deflating. Secondly, both countries are facing an increasingly ageing population – with rapidly ageing societies and a shrinking workforce placing a significant strain on economic growth potential. Despite these common challenges, there are significant differences between the two countries, three of which deserve special mention. Firstly, the countries differ in their respective political systems. In China, the government dominates the economic agenda and also has close control of the real estate market, whether in terms of buying, selling or pricing. Thus, while real estate price growth in Japan fell sharply into negative territory in the 1990s and remained there for an extended period, property prices in China have remained relatively stable even in times of declining construction activity – although they are coming under pressure in the current downturn. Secondly, China has strict capital controls that limit investment opportunities abroad. Hence, while the Japanese have been able to rid themselves of weak domestic assets, accelerating the downward pressure on corresponding asset prices, the Chinese have very little room for manoeuvre in

comparison. Thirdly, China is at a different stage of development compared with 1980s Japan. Even in the 1980s, Japan was a very advanced economy, with no large income disparities between regions, a consistently highly developed infrastructure, sound institutions and a large proportion of private companies. In China, on the other hand, there are huge disparities between the big, flourishing cities such as Shanghai, Beijing and Shenzhen and much of the rest of the country. In addition, a great deal of labour and capital is still not being used efficiently. A better allocation of these factors to productive companies could lead to rapid productivity gains – even without any major innovation progress. Finally, the positive prospects of sustained high productivity growth may compensate to some extent for the negative effects of a shrinking workforce. Therefore, the common challenges that China shares with Japan are unlikely to lead to the same gloomy growth path that Japan has found itself on. Instead, China faces challenges of its own regarding its future growth potential. On the one hand, the centralisation of Xi Jinping's power and increasing state intervention in the private sector could slow down innovation processes. Moreover, the widening gap between China and the West and the ongoing decoupling from the US may have far-reaching implications for long-term growth prospects – as China remains heavily dependent on foreign technology and global trade.

Figure 3: China's population is barely growing, which poses an obstacle to its growth potential

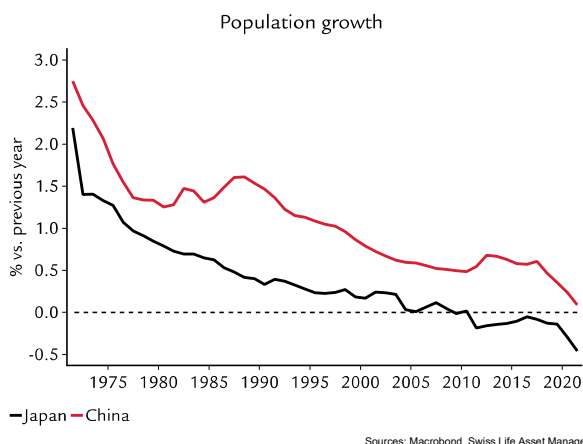


Figure 4: China's high productivity growth supports the economy



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