Perspectives
Emerging markets

Q4 2021

Key messages

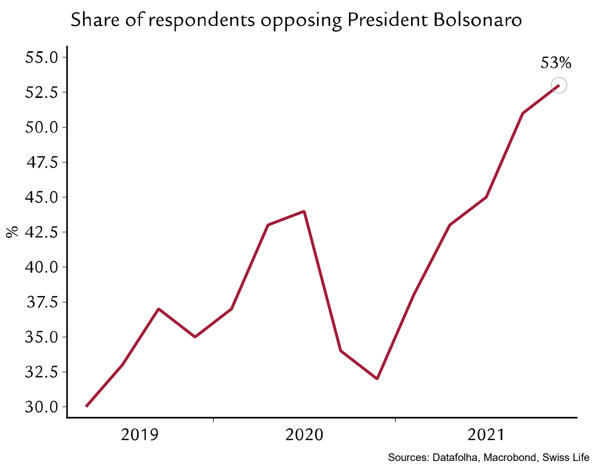
- Economic development remains heterogeneous, but the pandemic situation has improved in many places
- The turbulence on China's real estate market is a result of government regulation and is unlikely to become a conflagration as the authorities have far-reaching means to contain it
- However, activity in the real estate market is likely to weaken further and weigh on Chinese growth

Number in focus

15 000 billion

The debt of Chinese real estate developers and dependent companies amounts to more than USD 15 000 billion. The second-largest developer, Evergrande, now has serious payment difficulties with USD 300 billion of debt. This brings back memories of the 2008 financial crisis. However, compared to the Lehman bankruptcy, which triggered a global chain reaction, Evergrande is more of a domestic problem. Evergrande is also large, but according to observers it is not a systemic risk. There would only be greater domino effects in China if, contrary to expectations, the authorities failed to contain the problem.

Chart in focus



Brazil is currently in a difficult situation for several reasons. On the economic side, growth disappointed in the second quarter at -0.1%. At the same time, annual inflation rose to 9.7% in August, and low water reserves are likely to exert further upward pressure on energy prices. Political uncertainty is also high: President Bolsonaro's attacks on the Supreme Court triggered violent demonstrations, and the dispute over court-ordered payments, which could severely impair the state budget for 2022, continues. According to the latest Datafolha poll, 53% of respondents were dissatisfied with the President, 2% more than in July. The 2022 election year is set to be turbulent.

Review: heterogeneous development in the second quarter

A mixed picture persists in the emerging markets after the release of second quarter GDP figures. In China, growth slowed slightly more than expected to 7.9%, meaning that GDP is now 8.1% above the level of the fourth quarter of 2019. Other Asian economies are lagging behind the recovery. While GDP growth in Indonesia and Thailand surprised on the upside in the second quarter (3.3% and 0.4%, respectively), GDP has yet to reach pre-crisis levels in these economies. This gap even remains at 10% in India according to our seasonally adjusted series. Among Europe's emerging markets, GDP in Hungary reached pre-crisis levels in the second quarter, while in Poland and the Czech Republic it remained below by 2.8% and 4.8%, respectively. A heterogeneous recovery is also visible in Latin America. In the second quarter, Chilean GDP grew by 1.0%, putting it 4.3% above pre-crisis levels. In Colombia, however, GDP fell by 2.4% to 3% below the level of the fourth quarter of 2019. With 1.5% and -0.1% GDP growth, Mexico and Brazil are in between, putting them 2% below and exactly at their pre-crisis levels respectively.

Outlook: weak PMIs, improvement with the pandemic

According to the Purchasing Managers' Indices (PMI) for manufacturing, the growth picture remains very heterogeneous. In Mexico, Indonesia, Vietnam and Russia, the manufacturing PMI remains below the growth threshold. A slowdown is also visible in Brazil, India and South Korea, although still above the growth threshold. Taiwan (58.5) and the Czech Republic (61.0) currently have the highest scores. Supply bottlenecks remain an obstacle, although they have not exacerbated any further recently. As far as the pandemic is concerned, many emerging markets are entering the fourth quarter strengthened, with falling case numbers, higher vaccination rates and, following devastating pandemic waves, probably significantly higher natural immunity rates than in developed countries. The exception remains China, where the zero-tolerance policy is likely to continue to lead to a stop-and-go regime.

China: real estate market reaching its limits

For once, however, the focus in China is not on the pandemic, but on the real estate market, which has been a drag on growth since the start of the year. The weakness of the sector follows political tightening in the previous year and is therefore being consciously accepted by the authorities. The objective seems clear: to correct years of misallocation of capital to the bloated real estate sector and channel capital into more productive activities. The real estate boom since 2015 came at a time when rural exodus remained a major issue, but urban population growth also slowed significantly, from 3.3% in 2015 to 2.0% in 2020. The ratio of new-build residential projects versus population growth moved to unhealthy levels (Figure 2). Studies estimate that one in five homes in China is vacant. However, two fundamental drivers of the long-term boom have so far only been addressed half-heartedly. Firstly, the limited investment opportunities of private households, which are placing their money in real estate with partly speculative intentions. And secondly,

Figure 1: Mixed leading indicators

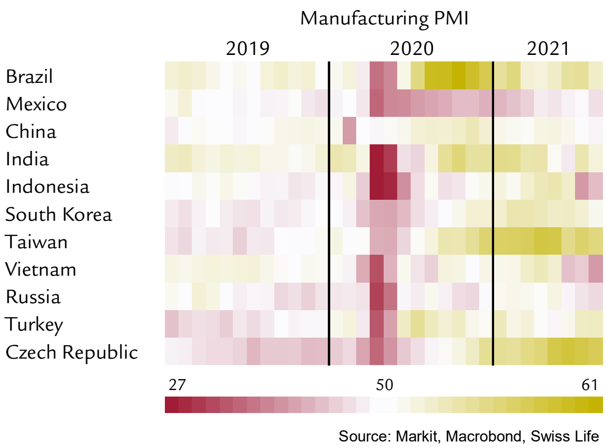
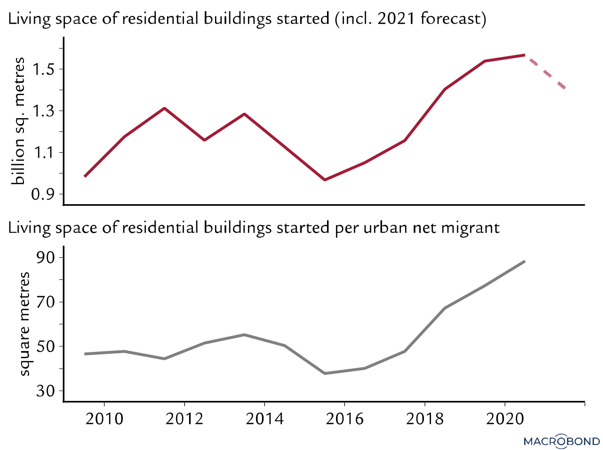


Figure 2: Construction boom since 2015 despite declining population growth in Chinese cities



the growing dependence of local governments on land sales, which account for 35% of fiscal revenues. As a result, construction activity is geared to the supply of land and too much is often built in the wrong place. With measures such as higher mortgage rates or the cancellation of land auctions, the government is tackling the symptoms here, while the fundamental drivers are likely to continue to generate interest in real estate investments as long as the prospect of rising or at least stable prices beckons. Despite the low affordability of housing in large cities, the government will try to avoid a price collapse at all costs in order to avert a chain reaction to private consumption and previously healthy property developers. As a result, we expect the regulatory focus to remain on the speculative behaviour and the high level of indebtedness of many real estate developers.

China: fewer real estate investments, but no price collapse

The interests of the authorities therefore seem to indicate the following approach: (1) maintain pressure on highly indebted real estate developers, (2) restructure companies in case of payment difficulties instead of liquidating them so that real estate prices do not come under pressure due to emergency sales, (3) spread costs among investors and lending banks while indemnifying real estate buyers as far as possible for the sake of social calm, (4) maintain the market signal of higher financing costs for certain real estate firms but if necessary respond with general monetary policy easing. The central bank has plenty of scope for manoeuvre in this regard, as consumer price inflation is not a problem in China at the moment. Because the commercial banks are largely state-owned, the authorities have free rein in crisis management. A financial crisis is therefore very unlikely and would result from a government error. However, a further slowdown in real estate activity is likely due to higher financing costs for developers and at least temporary buyer restraint, which will naturally have an impact on economic growth. The real estate and construction sector contributed 14.5% to gross value added in 2020 (2000: 9.6%, Figure 3). The significance goes beyond this, as other sectors, from steel producers to furniture stores, are directly or indirectly linked to the real estate sector. A much-cited study by Rogoff and Yang from last year estimates that after deducting the import share, the significance is as high as 24% of China's GDP, considerably higher than in the other countries examined. However, we expect only a moderate slowdown in economic growth as residential is just a part of the construction and real estate sector, freed up demand is likely to shift to other sectors and the government will certainly cushion a larger slump. During the last government-induced real estate crisis in 2015, when prices fell by as much as 6%, construction and real estate virtually ceased contributing to GDP growth (Figure 4), but the expanded services sector seemed immune and provided a solid "baseline contribution" of around 5.5 percentage points to nominal GDP growth. We are therefore upholding our growth forecasts of 8.3% (2021) and 5.4% (2022), which remain below consensus.

Figure 3: Construction and real estate accounts for just under 15% of China's economy

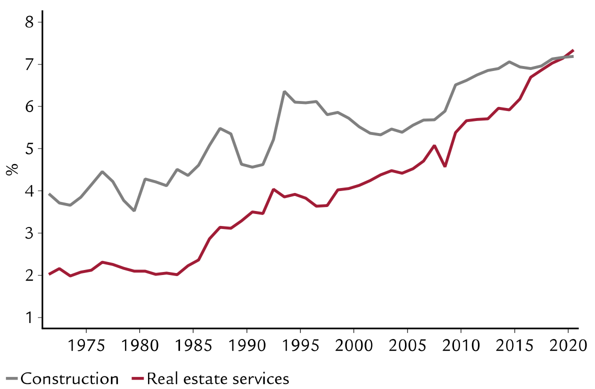
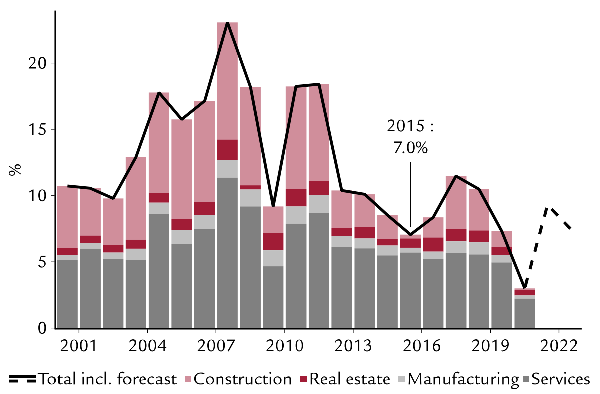


Figure 4: Services relatively immune to pronounced real estate cycle since 2012



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