Building on inclusive trade for a sustainable recovery

Emerging Markets Outlook Q4 2021

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The virus is still with us and it will likely continue to be with us for a long time. Booster shots are now being planned in some countries, but there is still a shocking imbalance in the distribution of vaccines. Nonetheless, the rebound in the global economy continues, albeit at a slightly slower pace, still lifting consumption and trade in many emerging and developing countries. Global trade has been playing a critical role in mitigating the impact of the pandemic by ensuring the supply of food, supporting government policies to provide medical instruments and vaccines.

Given the fiscal constraints that countries are facing, it seems likely that trade will continue to be a driver of economic activity. But for trade to be sustainable, it needs to be rebuilt reintegrating critical issues more consistently, such as poverty reduction, labour rights and climate change on the back of increasing global cooperation, instead of further fragmenting through disperse trade blocs or strategies limited to competition through low wages. In this quarterly outlook, we present a few examples where trade makes or could make a difference.

Building on inclusive trade for a sustainable recovery

Global trade has been playing a critical role in mitigating the impact of the pandemic by ensuring the supply of food, supporting government policies to provide medical instruments and vaccines. Of course, some bilateral trade agreements regarding vaccination distribution could have been more equitable, particularly in the case of low-income countries. The global programme COVAX providing vaccines to the poor will fall short by 30% of its 2 billion shots this year, which was already a modest target.

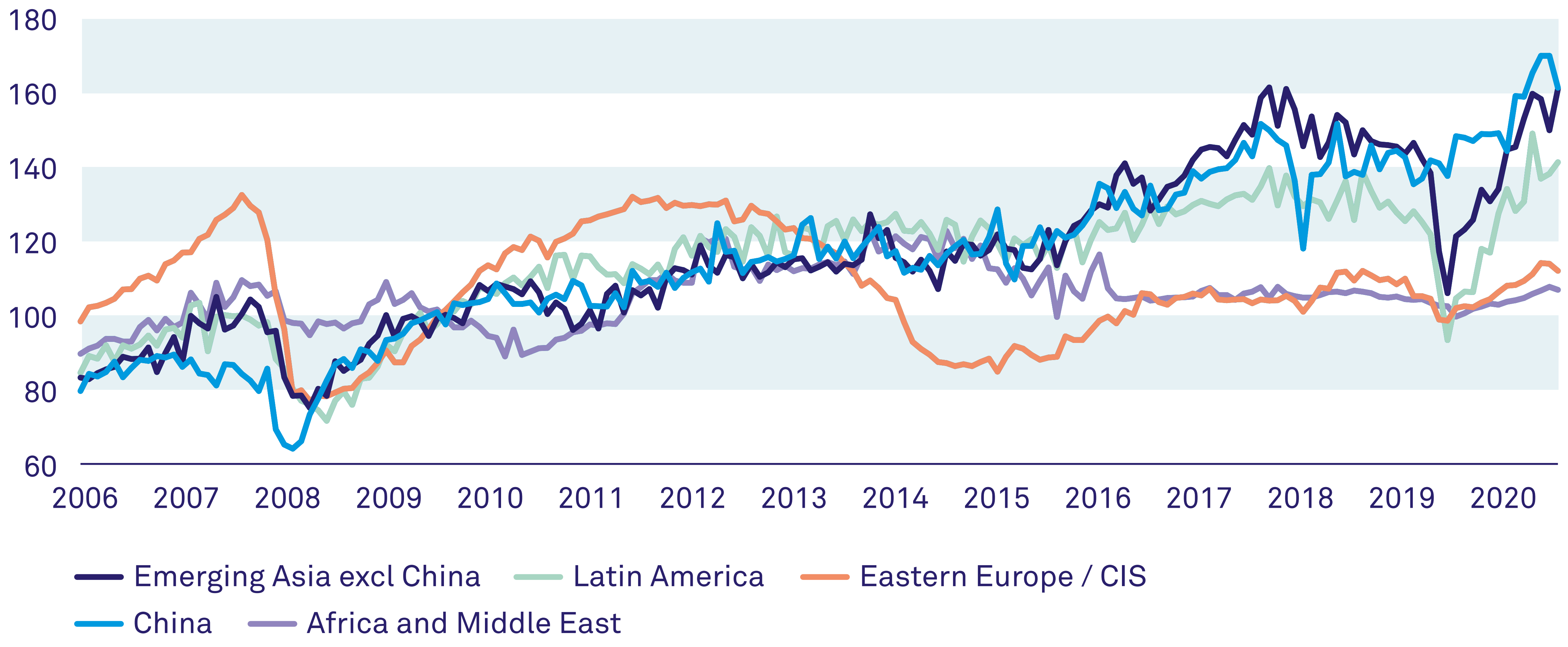
In general, the fallout in trade turned out to be less than initially feared and exports of goods, including commodities, have helped compensate the sluggishness of the most affected sectors: tourism and transport. Although several supply chain constraints surfaced since the outbreak of the pandemic, including semiconductor shortages and container ship bottlenecks, some countries have been uniquely placed to ramp up production using existing supply chains. This way, South Korea managed to export millions of test kits to the world, while COVID-vaccines were made in some cases with raw materials coming from 19 different countries.

But for trade to be inclusive, just more trade and adjusting slightly supply chains is not enough. As emerging economies look for paths towards a sustainable recovery from COVID-19, lessons from past crises suggest that well-integrated countries that have distributed more evenly their gains from trade are more resilient. And there are countries scarcely benefitting from stronger global demand. In Africa and Eastern Europe, the impulse from the export of goods and services in the post-pandemic recovery has been more limited (see figure 1).

When Triodos IM selects companies, including those working with international trade, it is guided by principles including labour rights and the protection of biodiversity. We also provide trade finance to agricultural producers in Africa, Latin America, and Asia, who export products to international markets, selecting certified organic companies or those that follow these principles, ensuring a maximum benefit in social, environmental, and economic terms.

In this quarterly we focus on the near-term outlook and on building inclusive trade as a potent tool to improve welfare, socio-economic development, and nature in the long-term.

Figure 1 Emerging Asia leading in goods export rebound (index 2010 = 100)



Source: Centraal Plan Bureau

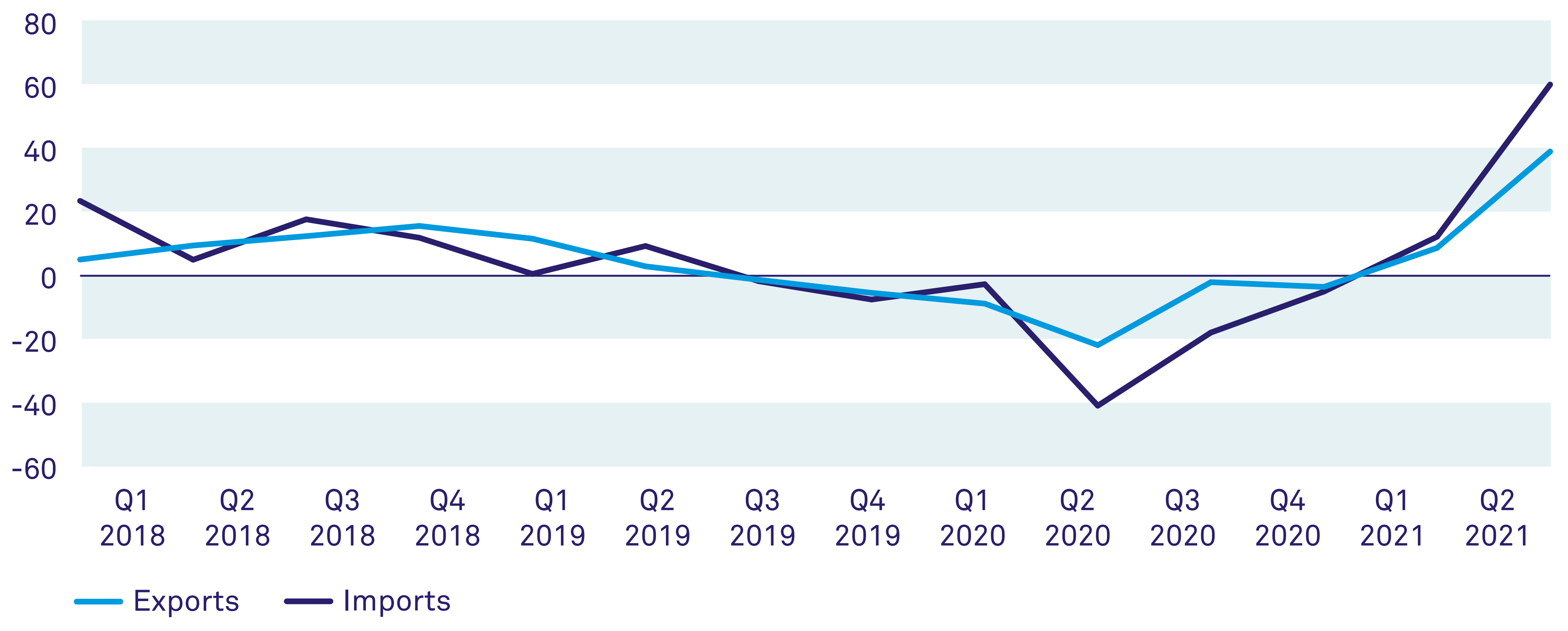
Developments in the second half of 2021

Another summer with the virus. The delta variant ignited a new wave of contagion in emerging markets, particularly in Asia, where certain countries experienced new contagion peaks in the third quarter. The low rate of vaccinations explains this surge. Indonesia, the Philippines, Bangladesh, and Vietnam, for instance were lagging considerably in vaccination rollouts and were severely hit in this new wave.

Meanwhile, the recent spread of the delta variant in **China** across a range of provinces and cities has resulted in a slowdown of economic activity in the third quarter. The impact of the virus outbreak, albeit modest, together with related individual mobility restriction measures, is restraining consumer spending and domestic tourism activity. A range of service sectors, including road, water, and air transportation, as well as leisure spending have clearly slowed down. At the same time, China's fiscal tightening and the implications for the property market, as well as recent changes of regulation in new sectors have added to investor uncertainty. However, China's authorities have room for fiscal and monetary support to stabilise the economy if needed.

India has seen a significant drop in contagion, after an unexpected surge in the second quarter of 2021. With vaccinations having ramped up in the past few months and activity normalising, GDP is already recovering. But rising inequality is one of the scars left by the virus and is also the result of weak safety nets. The impact of Covid-19 on the poorer and informal segments of the population and on SMEs is large, while larger firms have proven to be resilient. Household spending plummeted as credit dried up and consumption was severely hit. The silver lining was India's exports (see figure 2). Manufacturing exports in the second quarter were 25 ppts above pre-pandemic levels. Imports were also much stronger compared to pre-pandemic levels, driven by manufacturing imports, consistent with economic activity picking up. Stronger external demand is an opportunity for India since a large chunk of India's small and medium-sized companies are in this activity, but given the damage done by the pandemic there is much more to be done.

Figure 2 **India trades goods and services above pre-COVID levels** (% change y-o-y))



Source: Refinitiv

In **Latin America**, vaccination rollouts have been increasing and more stable growth is expected in the fourth quarter. In **Africa**, the picture is far less rosy. Vaccination rates remain low on average. The virus has contributed to social tensions in several countries, including South Africa where the current quarter is likely to take a substantial hit from the recent protests. In Peru, political uncertainty over the new administration's programs has weakened the currency and led to a spike in expected inflation. As for Afghanistan and Myanmar, countries in a severe economic and political crisis, the costs at every level will continue to rise since no solution is in sight.

Near-term economic outlook. We expect economic growth in emerging markets to pick up somewhat in the coming quarters, with the gradual increase in vaccinations, and economies dealing better with the virus. But the rebound will remain mixed. Vaccination rates in some low-income countries are still worrisome, below 3 percent in several African countries, including Uganda, Ethiopia, and Nigeria.

Investments are expected to recover in some middle-income countries that are planning to access capital markets in the coming months, including Chile and Colombia. Although growth in advanced economies may have peaked, the strength of the global economy suggests that external demand will be a meaningful tailwind for growth in emerging markets. Commodity exporting countries are already reaping the benefits. The slow recovery of the services sector suggests that there is still a long way to go to close the employment gap. The downside risks to this scenario are associated with new COVID-19 variants and a subsequent surge in contagion.

The Fed's call for monetary policy tightening and higher interest rates remains cautious, and we expect an announcement of tapering towards the end of this year (see Q4 Advanced Economies Outlook). Emerging markets are now more resilient to a new monetary tightening cycle in the US compared to 2013, when the previous tapering episode was announced. Central banks in emerging markets are vigilant and some have already raised rates to tackle inflation pressures in their home countries, including Russia, Brazil, Chile, and Peru. This determination to curve inflation is a positive sign, since food is a large part of the consumer basket in many developing countries. That economies fully open up on the back of vaccinations will also be positive for reducing inflation pressures associated with supply chain bottlenecks.

On a positive note, the IMF's recently approved USD 650bn allocation of special drawing rights (SDR) - of which around USD 250bn will help strengthen the external position of low-income countries - and provide them some breathing space. Low-income countries responded to the crisis by practically depleting their international reserves and these reserve assets will boost their short-term liquidity.

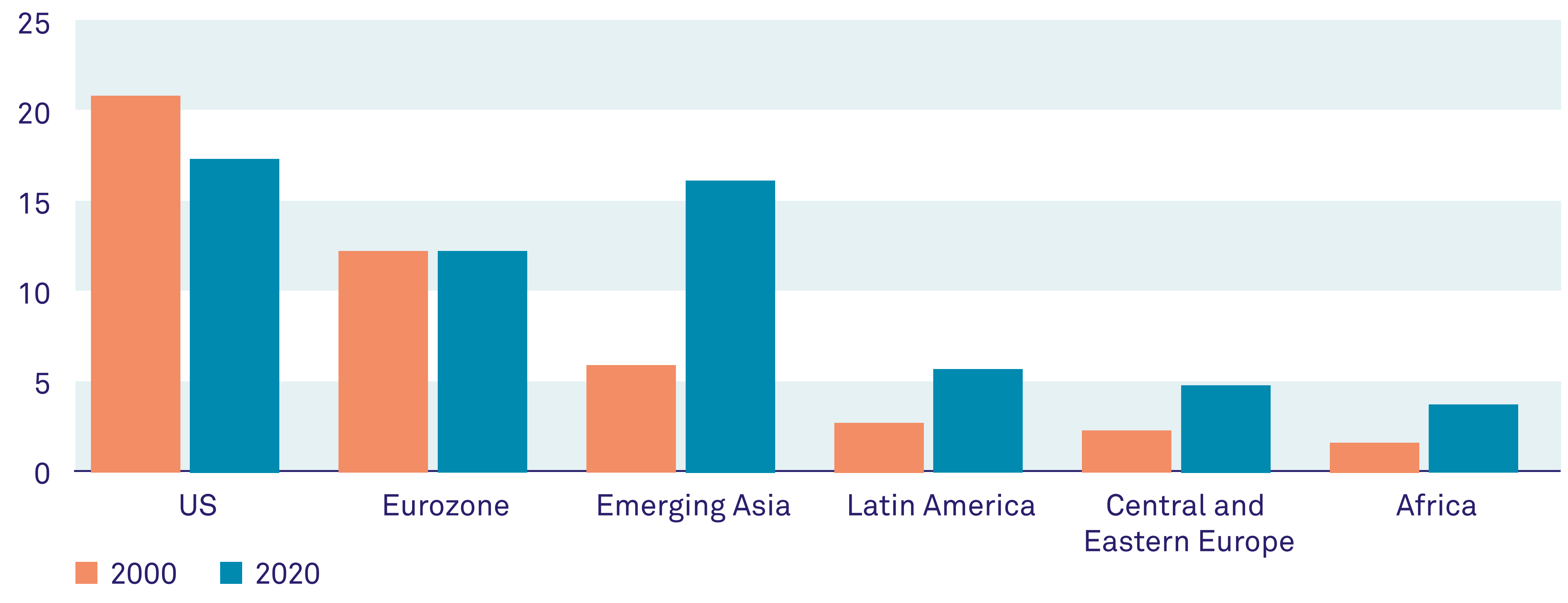
Emerging markets' role in trade

International trade has connected the world and emerging markets have consistently played an important role. The most famous trade routes brought commodities and spices, as well as the spread of religion, knowledge, and culture. Economies have integrated, and fortunes have been made through trade. Trade flows remain important drivers of growth until today, but there is a lot more to be done to make international trade a better contributor to income distribution and sustainability.

Market diversification. Over the past two decades, emerging markets and developing countries have become increasingly integrated in global trade, with trade across emerging countries creating a trade landscape. A major leap in this direction came when China joined the WTO and Eastern European partners joined the EU and the BRICS made their entrance as a potential leading economic group. China has become an important trading partner of other emerging and developing economies since then (see figure 3). China alone accounts for more than 14% of world exports and trade across emerging markets, excluding China has more than doubled in the past 20 years. These new trends in trade, together with technological progress, helped expand global markets, providing products at more attractive prices for consumers.

Another milestone of China's trade partnership with emerging markets has been the Belt and Road Initiative and the financing of mega projects across Asia and Africa, often creating new markets and trade routes for China's goods. By expanding infrastructure and logistics this project is already having positive effects on China's exports.

Figure 3 China's exports to emerging markets on the rise (%)



Source: Refinitiv

Includes selected export partners

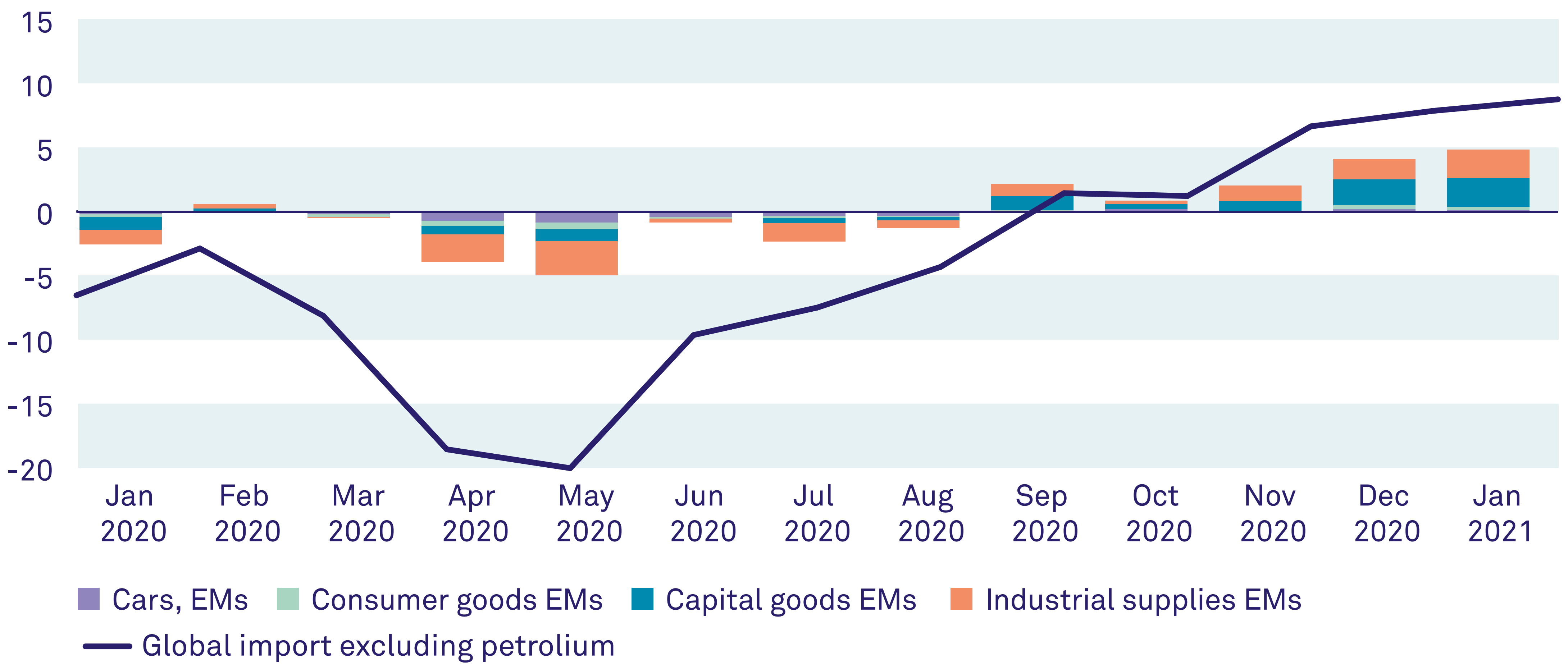
However, in the past years some doubt has arisen about the robustness of supply-chains involving emerging markets. During the trade war between the US and China, tariffs were raised unexpectedly on Chinese products including computer circuits, as well as car parts. In response, reshoring (bringing production back to a company's original country) became the talk of the day. More recently, the trade disruption witnessed in the months immediately following the pandemic outbreak, questioned the risks of supply chains in regions that were highly impacted - Asia-Pacific. Firms have been reprioritising goods that are being shipped, focusing more on supplying carmakers and producers of computers. Emerging markets are again importing industrial components critical for supply chains. The rapid resumption of trade in the second half of 2020 shows that supply chains in EMs proved to be more resilient than initially expected (see figure 4).

Concerns have not completely disappeared though. Transport costs have been rising rapidly on the back of logistic constraints often related to the COVID-19 outbreaks. Counterweighing this are some longer-lasting trends including the shifting of preferences for natural and degradable materials – instead of synthetic –, mostly produced in developing economies, which could make supply chains more robust in the future.

Product diversification. Emerging markets have also been shifting from essentially exporting primary products (oil, minerals, agricultural products), to exporting manufactured products and now to trade in (digital) services, including telecommunications, computer programmes and data. Trade has been central to creating new products, facilitating more balanced global growth across sectors, and scaling up resilience. We are now seeing that the digital transformation is leading to unprecedented reductions in the costs of engaging in international trade, changing both how and what is being traded and contributing to growing diversification since goods and services are now constantly connected. Some emerging countries, particularly China, India and Mexico are leading the race in trade in digital services.

This time, the recovery is not expected to lead to current account deficits, as so often in the past in emerging and developing countries, as the higher imports in the past few quarters were offset by the robust export growth.

Figure 4 Contribution EM imports by type of goods (Contribution to y-o-y % change in ppts)



Source: IMF

The debate between trade pessimists and optimists

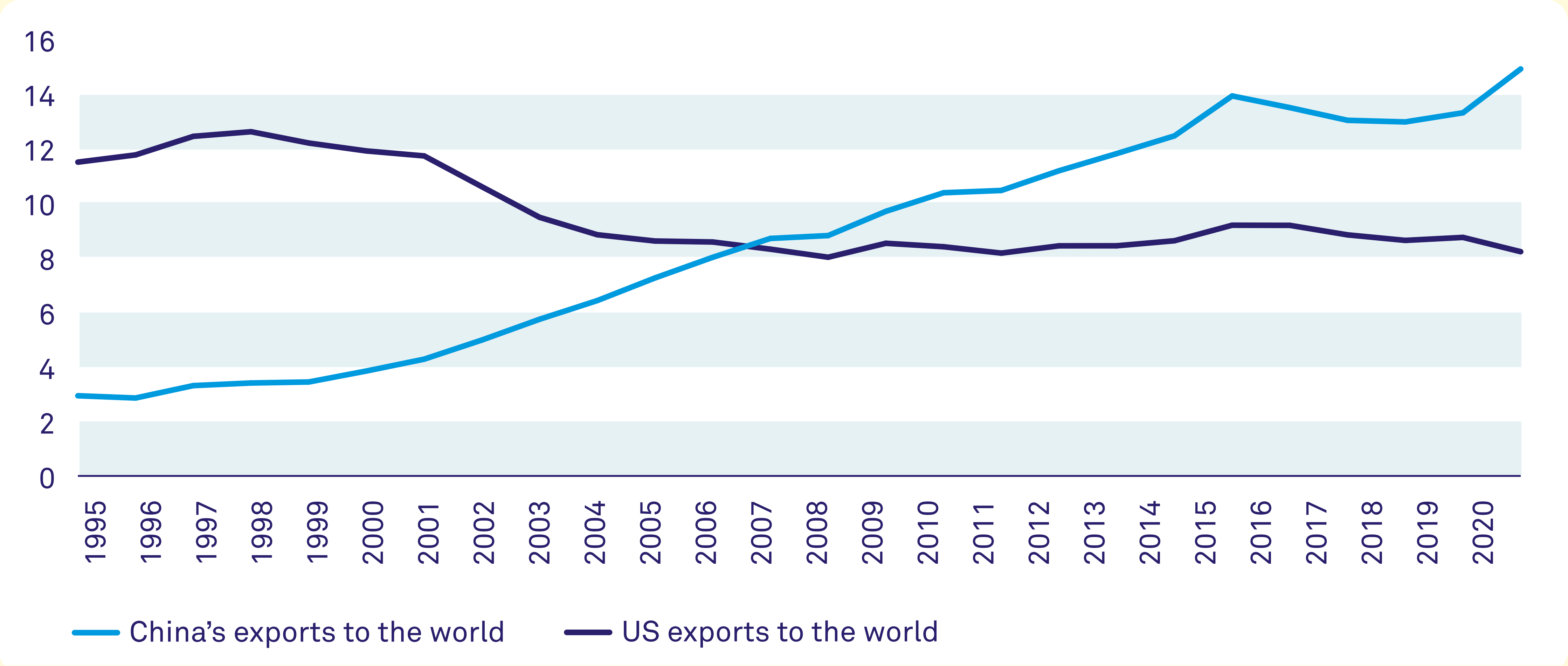
Trade optimists point to the benefits of trade and the efficient use of resources. South Korea, Malaysia and Vietnam are often used as examples of the benefits of export-led growth on the lives of the low-income segments of the population. Countries benefit if they export what they are good at, households benefit if they can choose from different markets and products, while firms benefit from competition and the transfer of knowledge and skills brought about by trade. Additionally, in the case of emerging and developing countries trade helps boosting capital flows, as trade often comes with foreign investments. Trade could also bring clean state of the art production techniques, particularly when there are higher standards in technological transfer.

The OECD has also estimated the share of jobs provided by trade for the largest emerging economies to be between 10-20% and trade related jobs are often important for small firms.

Trade pessimists question the benefits of trade for domestic markets, pointing at the increasing inequality and even poverty brought about by trade. Think of supressed wages to stay competitive or social dumping and the impact of the displacement of activities to countries with cheaper production costs to increase market share, as well as the impact of free trade on nascent industries. Pollution from trade-related transport activities and production processes in countries that are less regulated is also an argument used against trade, particularly from distant countries.

Lately, the balance has been favouring trade pessimists, with protectionist policies taking the upper hand. Geopolitical tensions have been adding to the arguments against trade. China has overtaken the US as the world's largest trading partner (see figure 5), and this has been one of the triggers for the US-China trade war. There is more awareness of production process and their impact on the environment and trade often occurs at every stage of a product's lifecycle. And then came COVID-19, showing us how easily global trade can be disrupted through shocks from both the supply and demand sides. Nonetheless, the global economy continues searching for a better path. Trade can be a tool for development in emerging markets, but certainly more global coordination is needed.

Figure 5 China has overtaken the US as the world's trading partner (%)



Source: Retinitiv

Building better trade

Trade has been crucial in driving the post-pandemic rebound and given the fiscal constraints that countries are facing, it seems likely that trade will continue to be a driver of economic activity. But for trade to be sustainable, it needs to be rebuilt reintegrating critical issues more consistently, such as poverty reduction, labour rights and climate change on the back of increasing global cooperation, instead of further fragmenting through disperse trade blocs or strategies limited to competition through low wages. Below are a few examples of areas where trade is making or could make more of a difference.

Reducing poverty. The impact of trade in development hinges on many aspects. One of them is using trade to create positive spill-overs. Emerging countries that take advantage of trade to learn about markets and technology can move a step forward in development. But these spill-overs are rare specially in Africa, while in developing Asia they are much stronger. For instance, many multinational companies in Africa ship in their inputs and export what they produce benefitting from cheap labour. No additional added value is created, and no knowledge is transferred, which does not spur development. Fostering trade that is inclusive means enabling countries to learn, for instance by engaging multinationals that export to provide funds and share expertise by hiring more local workers at all levels.

Another aspect is the income distribution related to trade. When the gains form trade are not equally distributed, certain industries and workers can be left worse-off. A recent World Bank report points to the importance of a favourable business environment for exporting. If weak institutions, infrastructure, and logistics increase costs, lower wages are then often used as the means to become more competitive. Although there may be an increasing trend of trade agreements that include social clauses, including acceptable wages, their enforcement is still weak.

The right trade policies. Floppy trade policies going from protectionism to bilateralism, regional approaches and multilateralism, the shifting of strategies is constant and sustainability considerations are absent, often resulting in sub-optimal trade conditions for consumers, producers and for the global economy. For instance, the African Growth and Opportunity Act with the US, a preferential trade agreement that grants duty-free access to thousands of products in the region, will apparently be replaced by bilateral trade agreements, with Kenya now in discussion. At the same time, China has been busy with the Belt and Road Initiative, but this year announced a strategy aimed at protecting the country from outside pressure, likely referring to its intent to decouple its companies from Western capital markets. The question is how this will impact supply chains and efforts to work together as a region. Another issue is that trade agreements also have a limited scope in terms of sustainability and enforcement, for example regarding human rights and recycling standards since they do not include any sanction means.

Green trade. There are important linkages between a green recovery and trade. If we consider trade from a holistic and global perspective, by creating standards for sourcing, production and the use of products, trade can turn more environmentally friendly. For instance, choosing the appropriate technology to help the efficient use of resources or by digitising different components of the supply chain, businesses can better manage their inventories, as well as choosing manufacturing processes that are more resource efficient. These initiatives could be embedded in multilateral trade agreements. Cooperation on trade could control, for example, the use of certain ‘toxic’ products like plastic. Individual companies are giving more attention to these topics, but through global trade cooperation and policies the impact could be much larger.

For investors who are looking for reasons to be optimistic, trade has been a silver lining in this rebound and it offers potential to be optimistic for longer. Indeed, trade could be the linking pin that allows to jointly uphold social and environmental pledges. When all hands are needed, we are convinced that better trade can accelerate the process.

Main indicators forecasts

	GDP growth (% yoy)			**Inflation** (CPI, % yoy avg)			**Government debt/GDP** (%)			**Government balance/GDP** (%)			**Current account** (% GDP)		
	2019	2020	2021 forecast	2019	2020	2021 forecast	2019	2020	2021 forecast	2019	2020	2021 forecast	2019	2020	2021 forecast
Argentina	-2.0	-9.9	5.8	52.8	40.5	48.8	97.8	92.4	84.4	-3.7	-8.3	-7.1	-0.8	0.8	2.7
Brazil	1.4	-4.4	5.2	3.7	3.2	7.5	89.7	88.6	88.9	-5.9	-13.8	-8.0	-3.4	-1.7	-0.7
Chile	0.9	-6.0	8.7	2.6	3.0	3.8	19.8	18.0	16.8	-2.8	-7.3	-6.2	-3.8	1.3	-2.6
China (mainland)	6.0	2.3	8.4	2.9	2.5	1.5	20.6	20.7	21.6	-4.9	-6.2	-4.1	0.7	1.9	1.6
Colombia	3.3	-6.8	7.1	3.5	2.5	3.3	57.4	50.1	45.9	-1.9	-7.5	-8.0	-4.5	-3.4	-3.5
Hungary	4.6	-5.1	6.1	3.4	3.4	4.6	78.5	80.9	78.3	-2.0	-7.7	-7.3	-0.5	0.0	0.6
India	4.1	-7.4	7.7	3.7	6.6	5.7	50.5	54.8	56.9	-4.2	-6.5	-7.5	-1.0	1.2	-0.5
Indonesia	5.0	-2.0	2.2	2.8	2.0	1.6	39.9	44.3	49.4	-2.2	-6.1	-5.7	-2.7	-0.4	-0.6
Malaysia	4.4	-5.7	3.1	0.7	-1.1	2.9	63.2	65.4	65.7	-3.5	-3.8	-6.2	3.5	4.1	1.5
Mexico	-0.2	-8.5	5.9	3.6	3.4	5.4	40.9	37.7	36.9	-1.7	-2.8	-2.3	-0.4	2.5	1.0
Peru	2.2	-11.1	8.8	2.1	1.8	3.1	33.9	38.5	39.6	-1.4	-7.7	-4.4	-1.1	0.8	0.4
Philippines	6.1	-9.4	5.0	2.5	2.6	4.0	54.6	55.4	54.3	-3.3	-7.5	-8.4	-0.8	3.6	1.1
Poland	4.8	-2.7	5.0	2.1	3.7	4.4	58.2	61.3	61.2	-0.6	-6.9	-5.2	0.5	3.5	0.8
Russia	2.0	-2.9	4.2	4.5	3.4	6.0	18.6	16.7	23.5	2.1	-4.0	-0.6	4.0	2.4	2.1
South Africa	0.2	-7.0	4.3	4.1	3.3	4.3	76.0	78.8	85.2	-4.5	-9.7	-8.6	-3.0	2.3	1.1
South Korea	2.2	-0.9	4.0	0.4	0.5	1.6	50.8	50.6	51.4	-0.6	-3.7	-1.4	3.6	4.5	6.1
Taiwan	3.0	3.1	6.0	0.6	-0.2	1.6	28.0	27.2	26.6	0.6	0.7	0.1	10.6	13.8	15.7
Thailand	2.3	-6.2	0.8	0.7	-0.8	1.1	44.9	47.6	46.9	-1.9	-5.9	-6.1	7.0	3.3	2.1
Turkey	1.0	1.6	6.1	15.2	12.3	17.8	36.1	33.3	31.9	-2.9	-3.6	-3.4	0.8	-5.1	-4.7

Source: IHS

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