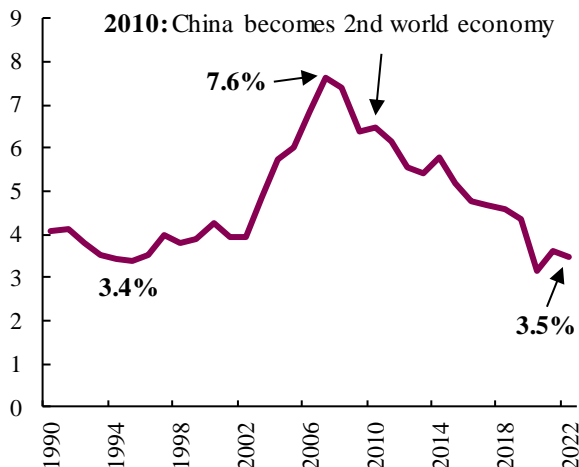


Emerging markets growth is set to face significant headwinds

Emerging markets (EM) have been a symbol of economic dynamism in recent decades. Many thriving economies globally embodied the possibility that, given the appropriate set of policies and reforms, they could sustain a rapid pace of growth.

Growth in EM rose sharply in the early 2000s, from 5-year average rates that were close to 4%, to a peak of 7.6% in 2007. To a large extent, this development process was accounted for by the ascent of the Chinese economy, through both direct and indirect effects. Directly, given the Chinese average annual growth rates of close to 10%, and its increasing weight in EM, as it became the second largest economy in the world. Indirectly, the effect on other economies materialised through supply-chain linkages, the mounting appetite for imported commodities, and a growing influence in international investment flows. This pace of growth was remarkable relative to the more advanced economies (AE): during 2010-2019, the average growth rate in EM was 3.1 percentage points (p.p.) higher than in AE. The pandemic is considered as an anomaly and hence not included in this discussion.

GDP Growth in Emerging Economies
 (% , 5 year moving average)

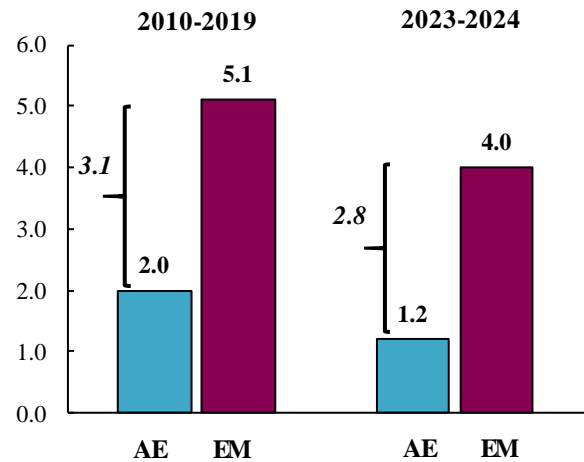


Source: IMF World Economic Outlook, QNB Economics

However, this multidecade trend of high EM growth rates began to lose strength in more recent years, and deteriorated further during the Covid-pandemic. Importantly, we believe that this trend will continue over 2023-2024. In this article, we analyse three

main factors that will weigh on EM performance going forward.

AE and EM GDP Growth and Differentials
 (% , and difference in percentage points)



Source: IMF World Economic Outlook, QNB Economics

First, the Chinese economy is undergoing a significant deceleration relative to its historical pre-pandemic performance, and its role as a global growth driver is beginning to fade. After 40 years of soaring growth rates averaging 9.5% during 1980-2019, this pace in 2023 and the upcoming years is likely to fall below 5% on average. The slowdown is broad-based, and driven by numerous structural factors. These include demographic headwinds, declining productivity growth, high debt levels, a slower pace of structural reforms, and the rising threat of geoeconomic fragmentation. Furthermore, the government has not considered so far implementing an aggressive policy stimulus package, signalling a more cautious approach to long-term growth in an already highly levered economy. Given the importance of the Chinese economy for EM growth through direct and indirect channels, the slowdown in China implies an important challenge in the upcoming years.

Second, higher global interest rates and tighter financial conditions have set a more challenging environment for growth. The US Federal Reserve has increased interest rates at the fastest pace in more than four decades, accumulating increases of 525 basis points (b.p.) since mid-2022, while the cycle of the European Central Bank has pushed policy rates

up by 400 b.p. Although the two major central banks of AE are approaching the end of their tightening cycles, we expect relatively high global interest rates and tighter credit constraints to remain in place for a longer period of time, limiting foreign as well as domestic investments into EM.

Third, soft external demand in 2023-24 implies a weaker impulse for growth from international trade. This is particularly important for the trade-dependent economies of Southeast Asia, which represent a significant contribution to EM growth as a group. In 2023, growth in international trade volumes is

expected to be approximately 1.7%, which is a weak mark compared to the 2.5% 5-year average of the pre-Covid pandemic period. Without a substantial recovery in external demand on the horizon, this represents yet another headwind for EM growth.

All in all, going forward, economic growth in EM will converge to a more moderate pace than in previous decades, given a slowdown of the Chinese economy, high interest rates with tighter financial conditions, and weaker external demand. This raises the bar for EM to double down on reforms in order to improve their economic performance.

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