Less vulnerable, but not immune

- Resurgent risk aversion continues to dominate the market
- Growth forecasts for industrialised and emerging economies revised further downwards
- Trade conflict could keep currencies under pressure
- Reduced imbalances make EM less vulnerable…
- … but risks for many countries remain considerable

Global growth forecasts revised downwards
The slow expansion of world trade and the recent exacerbation of the trade war appear to be having a longer-lasting negative impact on the global economy than initially thought. US President Trump is threatening to widen the trade war to include more countries and appears to be less and less concerned about the reaction of the markets. In addition to the direct impact of higher trade tariffs, the continuing decline in (business) confidence, in particular, is squeezing the economy hard. This is all taking place in a world where a litany of other (geo)political developments are already driving up tensions. The consequences are being felt both in the emerging markets and in the industrialised economies, and have prompted us to lower our growth forecasts for a great many countries.

Lower growth in developed economies and more monetary easing
Among the major economies, the US is the least sensitive to global economic trends, though the consequences of Trump’s trade war will be felt there, too. We have accordingly lowered our growth forecast for the US economy from 2.3% to 2.2% for this year and from 1.9% to 1.5% for 2020. The euro area is more sensitive to movements in the global economy. Exports from the euro area look set to remain weak for some time, and this will increasingly weigh on domestic demand and investments and negatively impact the labour market. We are now projecting economic growth this year of 0.7% (down from 0.9%) in the euro area, and 0.9% (down from 1.3%) for 2020. During the course of the year, we had already downgraded the growth forecast for the US and the euro area several times; at the end of 2018, for example, we were still forecasting growth of 2.7% for the US economy in 2019 and 1.4% for the euro area. Our forecast for the euro area as a whole at that time was 3.5%; it is now 3.1%.

Underlying inflationary pressure remains weak both in the US and the euro area, creating scope for a further easing of the monetary reins. We now think that the US central bank (the Fed) will cut its key rate three times between now and the first quarter of 2020. This contrasts
with our earlier assumption that interest rates would remain unchanged. We expect to see the first cut of 25 basis points in the third quarter of this year (probably in July, though it could be deferred to September), followed by a second reduction in the fourth quarter and a third in the first quarter of 2020. If the economic slowdown persists for any length of time, the European Central Bank (ECB) is likely to react by at least deploying the big gun of quantitative easing once again.

**Pros and cons for emerging markets, but overall net reduction in growth**

The combination of higher import tariffs and weaker demand in the rest of the world is also affecting the emerging markets (EM), which are being particularly hard hit by declining business confidence throughout the world and the concomitant potential increase in risk aversion. On the other hand, the continuing low global interest rate climate is good for EM and, combined with a weaker exchange rate in many countries and the positive knock-on effect on exports, will limit the damage somewhat.

The adjustments to our growth forecasts lead to a fall in average growth in the EM from 4.4% in 2018 to 4.1% in 2019, probably followed by a slight recovery to 4.3% in 2020. While that is far below the average annual growth rates of 5% we have seen in EM over the last decade, it is substantially better than the 3.5% recorded in 2009, when the global financial crisis hit. We are therefore definitely not expecting an EM crisis in the form of large-scale balance of payment problems and/or a widespread recession or contraction within the EM universe. On a further positive note, the growth spread relative to the developed economies is forecast to widen from a low point of two percentage points in 2018 to around 2.5 percentage points in 2019 and 3 percentage points in 2020, though with the caveat that the downside risks remain, even with the new growth forecasts.

**Growth in emerging Asia still relatively strong**

Looking at the different regions, we see that emerging Asia is also being affected by the trade conflict, though growth there is holding up relatively well. We have also (further) cut our growth forecast for a number of countries and are now expecting regional growth to come in at 5.7% for 2019 (down from 5.9%) and 5.5% for 2020 (was 5.8%). A year ago, we were forecasting growth of 6% for 2019; The relatively small reduction is thanks mainly to the fact that China has enough scope to stimulate its economy through a more expansive policy – though it does have to be borne in mind here that Chinese industrial
performance and imports could disappoint, which could exacerbate the negative impact for other countries. Our forecasts for China’s economic growth are now 6.2% for 2019 (was 6.3%) and 5.8% for 2020 (down from 6%) (see also our latest China Watch). Turning to India, where growth has cooled significantly in recent quarters, we have lowered our growth forecasts for 2019/20 from 7.5% to 7%. We have similarly downgraded our growth forecasts (further) for other countries which are heavily focused on exports such as South Korea, Hong Kong, Singapore, Taiwan, Malaysia and Thailand.

Further deterioration in growth outlook for Latin America

Domestic developments in Latin America had already squeezed business and consumer confidence, and the global developments delivered a further blow, prompting us to trim our growth forecasts several times during the year. The Argentinian economy appears to be sliding ever deeper into the morass, contracting again in the first quarter by around 6% year-on-year. Growth in Mexico and Brazil remains in positive territory, but has slowed further from already low levels. Even countries where growth was relatively strong, such as Chile, Colombia and Peru, saw a substantial slowdown in growth in the first quarter. Given the combined backdrop of recent changes in the global picture and internal developments, we have further downgraded our growth forecast for Brazil and Mexico, in particular, and now expect the region to post growth of just 1% for 2019 (down from 1.5%). For comparison, at the end of last year we were projecting growth of 2% for Latin America in 2019, based on a presumed recovery in Argentina and Brazil.

Mixed picture for Emerging Europe

The picture in Emerging Europe is more mixed. Central and Eastern Europe currently appears to be the least affected by the slowdown in global economic growth. Despite the cooling of the euro area and the threat of a recession in Germany, exports from Central and Eastern Europe rose steadily. In addition, rising wages steadily boosted the role of consumption, making the region less dependent on exports and therefore better protected against the consequences of the trade conflict. Direct trade between the US and China is moreover minimal. The economic growth figures for Central and Eastern Europe were actually better in many countries than we had anticipated. Poland recorded year-on-year growth of 4.7% in the first quarter, with Hungary posting 5.3%. Given these Q1 figures, we have actually raised our growth forecasts slightly for both countries: We are now assuming growth of 3.6% in 2019 and 3% in 2020 for Central and Eastern Europe.
The imposition of sanctions in 2014 means that Russia is also now less dependent on global economic developments, and we expect the Russian economy to continue growing at around its long-term trend (1.5% in 2019 and 2020). Turkey is another story. The Turkish economy remains vulnerable to increasing risk aversion, and has already contracted in the first quarter of this year by 2.6% year-on-year. We expect the state of the domestic economy, combined with political developments, to create a bumpy road to recovery. We were already assuming a contraction of 1.5% in the Turkish economy for the full-year 2019, and have not downgraded this forecast any further.

We have upped our growth forecast slightly for Emerging Europe as a whole, from 1.4% to 1.5%, and are leaving our forecast for 2020 unchanged at 2.2%.

Slowdown comes on top of an equally weak 2018
The latest disappointing growth figures in the emerging markets follow what were already poor figures in 2018, when growing risk aversion on the part of investors was already impacting negatively on the emerging markets. The principal reason was the tightening of monetary policy in the US, evoking parallels with the period of the 'taper tantrum' in 2013. Last year, however, the situation was made worse by uncertainty regarding the consequences of the growing trade conflict between the US and China, coupled with a number of (geo)political issues.

Country-specific issues also played a role. Ultimately, Argentina and Turkey were the hardest hit. That came as no surprise given that both countries were confronted with major macroeconomic imbalances, such as a high current account deficit and fragile public finances. The Argentinian peso came under heavy pressure in April 2018, followed by the Turkish lira in the summer. Fears of contagion from Turkey and Argentina generated negative sentiment towards investment in EM and other emerging economies, such as Brazil, India, Indonesia, Mexico, Russia and South Africa, also saw their currencies pulled down sharply last year due to capital flight. Ultimately, most countries managed to limit the economic damage by continuing a prudent monetary policy. This did mean that growth in some of these countries turned out lower than anticipated, but they managed to avoid a recession, unlike Argentina and Turkey.
Argentina and Turkey remain the weakest links

The imbalances in most countries have reduced since 2018. In Argentina and Turkey, the current account deficit has shrunk to less worrying proportions thanks to the weaker currency and a decline in domestic demand. This is also evident from the fact that there are far fewer red cells in the accompanying table. This table helps us to determine whether or not we regard countries as vulnerable. As early as the beginning of 2018, even before EM sentiment began to weaken markedly, we used this table to highlight Argentina and Turkey as the countries that were most susceptible to an increase in risk aversion by investors.

Given the size of its foreign and government debt and the rate of inflation, Argentina now appears to be in the weakest position. The presidential elections in October are also inducing a degree of uncertainty and caution among both consumers and investors. While the imbalances in Turkey have reduced more than in Argentina, the risks remain substantial, with the shrinking economy and (geo)political developments making the country vulnerable to increasing risk aversion. This also applies to a number of other EMs, albeit to a lesser extent, such as Brazil, Chile, Colombia, Indonesia and South Africa, which are all struggling with excessive levels of foreign and/or domestic debt. Mexico is a case on its own; although the economic fundamentals are in reasonable shape, the problem here is the uncertainty about the role of the US and the internal political developments, which could put further pressure on the currency and stock markets. An added consequence is that all these countries have only limited scope to follow the interest movements in the developed economies, despite the often low rate of inflation. The risk of capital flight is outweighed here by the benefits of lower domestic interest rates.

The scope for fiscal expansion is also limited in most countries.
Slight increase in foreign direct investment

One bright spot is that, despite all the turbulence over the past year, foreign direct investment in EM is continuing to grow. This contrasts with the more volatile portfolio investments (see also our EM Watch, Portfolio flows to EMs: Trade tensions vs. Fed, published in early June). According to the annual World Investment Report published by UNCTAD in June, global foreign direct investment (FDI) fell by 13% in 2018, whereas direct investment in EM showed a slight increase. As a result, for the first time in several years the share of FDI in EM in 2018 (USD 706bn) was higher than FDI in developed economies (USD 557bn). At the same time, however, the Institute of International Finance (IIF) pointed out that, expressed as a percentage of GDP for emerging markets, FDI has fallen to a meagre 2%. As in recent years, a handful of countries accounted for the lion's share of FDI. The top five is made up of China, Hong Kong, Brazil, India and Indonesia: together, these five countries received almost 60% of total FDI flowing into EM. The monetary expansion in the US and the euro area will make EM more attractive going forward for both direct and the more volatile portfolio investments, although the trade conflict will continue to create downside risks.

Main economic indicators/forecasts

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<th>GDP growth (%)</th>
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Source: EIU, ABN AMRO Group Economics

* figures Emerging Markets regions are rounded

**Inflation Latin America and World without Venezuela

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