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"Friend-shoring" : Does Regional Retrenchment Herald Lower EM Growth?

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Just as the world economy was recovering from COVID-19, 2022 brought fresh challenges. Russia's invasion of Ukraine, higher energy prices, food shortages and protectionist tensions all weigh on emerging-market (EM) growth. As a result, the IMF lowered its EM growth outlook for 2022 from +4.8% in January to +3.8% in April.

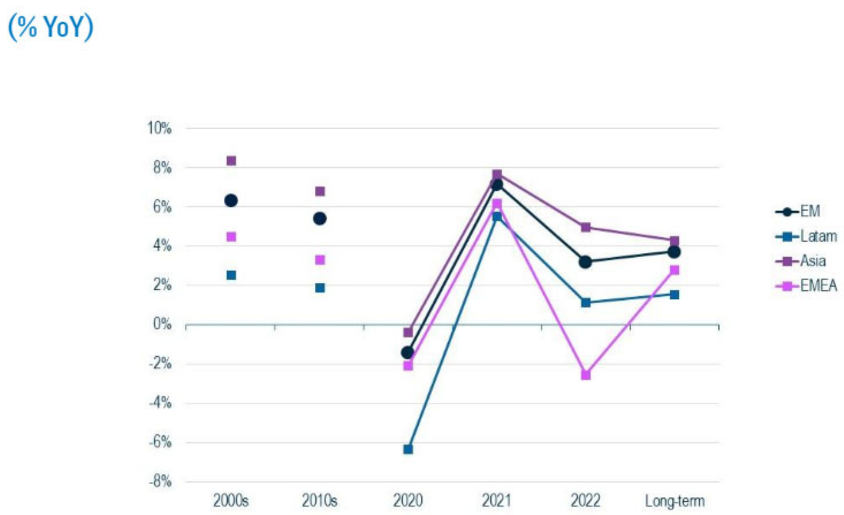
Surging prices for food and fuel have triggered higher inflation, and raised the risk of social unrest like in Sri Lanka. If these disruptions are short-term, policymakers can meet them with their customary mix of tighter monetary conditions and fiscal stimulus. But more persistent dislocations could force investors and policymakers to revise their longer-term outlook for EM growth.

Policymakers face disruptions all the time. But today's changes in international trade and investment are different. Indeed, a new paradigm for global trade and investment may have arrived, marked by regionalized, instead of global, flows of trade and investment.

Two decades of globalization have boosted emerging markets and advanced economies. But last week, attendees to the World Economic Forum in Davos were left grasping for their dictionaries, and their economics textbooks.

So-called "friend-shoring," a form of regionalization in which economic partners prefer supply sources nearby, could materially affect EM growth.[1] If the world splits into geopolitical blocks, new trade constraints could lead to a reallocation of capital and a reduction in growth. Some countries would benefit more from that shifting order than others.

FIGURE 1: REAL GDP GROWTH



Source: IMF, Haver Analytics, PGIM Fixed Income.

On aggregate, we expect EM GDP growth to fall to around 3.7% p.a. in the foreseeable future, compared to around 6.5% and 5.5% p.a. during the 2000s and 2010s, respectively (Figure 1).

Key secular trends underpinning our revised trajectory precede the COVID-19 pandemic and will probably continue. These include slower growth of the working-age population in large emerging markets such as China, Russia and Brazil, reduced investment and supply-side reforms that previously drove productivity growth, less budgetary space for governments to boost activity, and slowing economic development in China.

The COVID shock may have exacerbated some of these trends. It appears to have restrained labor supply, e.g. because older workers retired earlier, faced child care responsibilities, or exited the workforce due to health concerns. It has certainly limited the budget space of governments with a COVID-induced debt overhang to stimulate their economies.

In our analysis, the relative performance among EM regions since the turn of the century will probably persist:

- **Asia** will continue to outperform other regions, largely because of growth in China and India, even if these countries grows more slowly than before. Asia’s high savings rates and supportive institutional arrangements will continue to attract the capital it needs to sustain that growth. And favorable demographics enable outside of China will drive productivity gains, bringing it closer to developed-market output levels. Low-cost Vietnam and Cambodia, for example, are yet to integrate into global production chains and could benefit from closer integration with China.
- At the other end of the spectrum, **Latin America** will continue to lag. Latin America’s structural shortcomings, which predate Covid, will continue to constrain its growth. So will its volatile economic policies, much of which result from swings in the region’s political landscape. Occasional home-made crises triggered by unmanageable macroeconomic imbalances will further dent the region’s growth.

On the other hand, a decade after the so-called commodity “super cycle,” the return of higher commodity prices could revive the tailwind to Latin American growth. And some countries may benefit from “friend-shoring.” Mexico, for example, might benefit from its deep integration in global supply-chains and from its proximity to the US, especially if the US pivots away from Chinese suppliers.

- The **EMEA** region will grow more rapidly than Latin America but more slowly than Asia, and some countries will grow faster than others. According to our analysis, growth in Central and Eastern Europe will continue to outstrip neighboring Germany and the Eurozone, as it benefits from re-shoring and regionalization.

Turkey should continue to do well, thanks to its flexible private sector and proximity to Europe and the Middle East, but its economic policy poses significant risks. The countries of the Gulf Cooperation Council (GCC) should also perform well. Their shift towards non-oil sectors, their energy transition as well as structural changes in their tax system may weigh on growth, but should also make it more steady.

On the other hand, Russia’s short- and long-term growth outlook has become highly contingent on the fallout of its invasion of Ukraine. Russia’s growth may remain lower for longer by the country’s dependence on extractive industries, its lack of reforms exacerbated by sanctions on technology transfers, its rapidly ageing population, and the ongoing brain drain.

We see Russia’s long-term growth reduced by around half a percentage point, implying a mild 0.2% drop for the EMEA region’s long-term growth as a whole. Ukraine’s growth, too, will depend on the war and subsequent reconstruction, which makes predictions highly uncertain.

- **Sub-Saharan Africa** will experience a rebound, but performance will vary. Higher oil prices will boost oil exporters in the short term, but not in the long term, as the world shifts to greener technologies. Some countries, like copper exporter Zambia, will benefit from that “green revolution” but, overall, its effects on Africa’s exports remain uncertain. Large areas of Africa may hold significant deposits of “green” minerals, such as lithium or graphite, but little has been explored so far.

The reshoring of higher value-added productions to developed markets could even re-establish the trading patterns of the 1950s and 1960s, i.e. the exports of commodities from emerging markets and their imports of manufactured goods from advanced economies. Such a retrenchment would affect economic growth and living standards. It risks popular discontent, the emergence of populist or nationalist leaders, the disruption of international alliances and a souring of trading relations with the G10.

Demographic factors increase these risks: Africa’s population is younger than the rest of the world and many young people may try to migrate. This would exacerbate political tensions with advanced economies and might lead to changes in political or economic allegiances.

As the long-term growth outlook falls, investment opportunities will require analysis that emphasizes geopolitical factors more than before. Emerging patterns of international trade based on “friend-shoring” might deepen rifts between countries and regions. It creates new opportunities but also new risks, against a backdrop of higher debt, higher inflation, and higher interest rates.

From an investment perspective, EM debt remains one of the most varied asset classes - from AA-rated credits to defaulting borrowers, governments to corporates, local-currency to hard-currency bonds. This diversity continues to generate relative-value opportunities, which may become more pronounced as regional flows become more prevalent.

Our bottom-up security selection focuses on identifying resilient issuers, such as commodity exporters or those with balanced financing needs. Vulnerable issuers usually have weak policies and poor debt sustainability. After the events of the past few years, friend-shoring is here to stay. An understanding of regional trading patterns and capital flows is set to become more prominent in our analysis.

1 “U.S. Treasury Secretary Janet Yellen on the Next Steps for Russia Sanctions and “Friend-shoring” Supply Chains,” Atlantic Council, April 13, 2022.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of June 6, 2022.

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