Round-up: from EMs to Evergrande

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Charts editor

Is the Bank of England too optimistic about price pressures in the UK? What have we learned from the Evergrande crisis about the outlook for China's growth, and why will EMs be slower to bounce back post-pandemic than the US? Read on for a round-up of some of the economic insights Fathom sent to clients in September. Topics include:

1 September 2021: **Inflation may overstay its welcome in the UK**

8 September 2021: **COVID another headwind for emerging markets**

15 September 2021: **China's climate targets: more ambition, please**

22 September 2021: **The renminbi: not as weak as it seems**

29 September 2021: **Wanted: a new source for Chinese growth**

Inflation may overstay its welcome in the UK

- The current squeeze on raw materials, components and skilled labour is having a bigger impact on UK businesses than at any time since the 1970s, when inflation rose to over 25%, the latest UK CBI survey suggests
- Costs of components and materials have risen sharply, and this survey suggests they have some way yet to rise, pushing inflation even further above its target
- Businesses report struggling to find skilled workers such as HGV drivers— a problem made worse by the departure of a significant number of skilled EU workers as a consequence of Brexit and COVID
- These bottlenecks to production and output pose a threat to the UK's recovery, and are one of several reasons to think that high inflation could stick around for longer than the Bank of England is hoping

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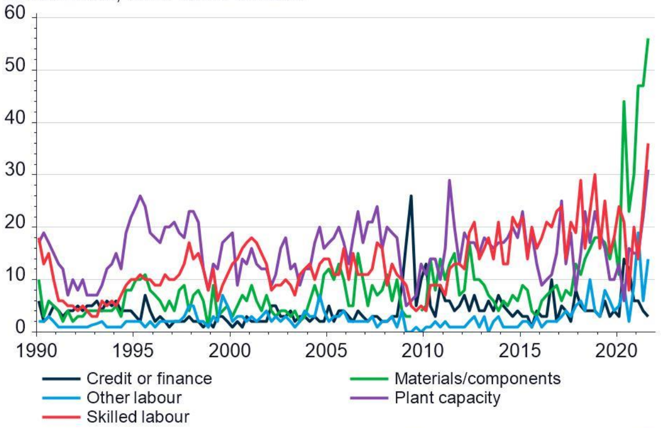
UK CBI industrial trends: factors limiting output

Net balances, three-month forecast



Source: Refinitiv Datastream / Fathom Consulting

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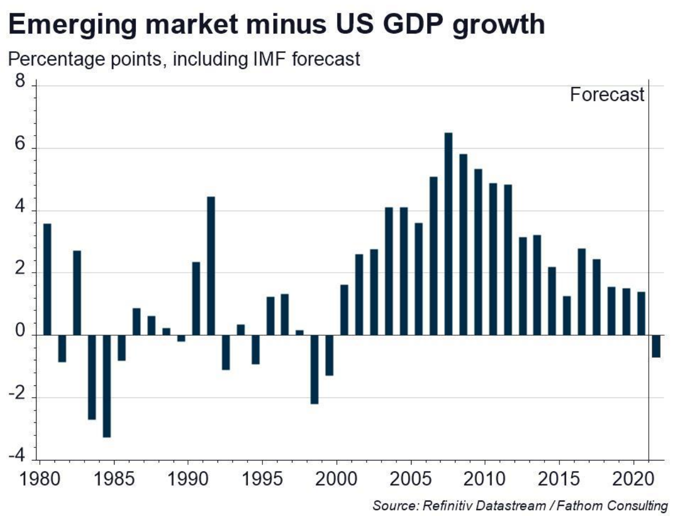
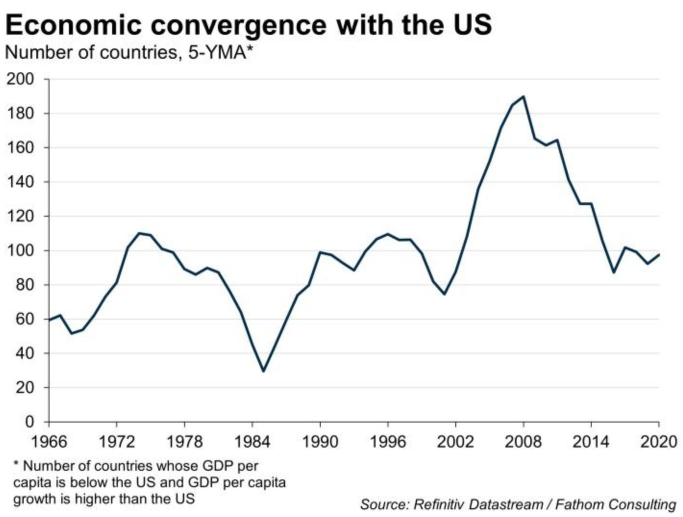
COVID another headwind for emerging markets

- For the first time since 1999, GDP is forecast to grow more strongly in the US this year than in emerging markets, as the US enjoys a strong vaccine- and stimulus-led recovery



- The economic theory of convergence, suggesting GDP per capita will tend to grow faster in poorer countries than richer ones leading to a closing of the gap in living standards, has often not been borne out by the data
- Perhaps aided by the rise of China, emerging economies did start to grow strongly from the turn of the millennium, with almost all the countries in the world converging on the US[1]



[1] Defined as a) having a GDP per capita below US GDP per capita and b) having GDP per capita growth above US GDP per capita growth.

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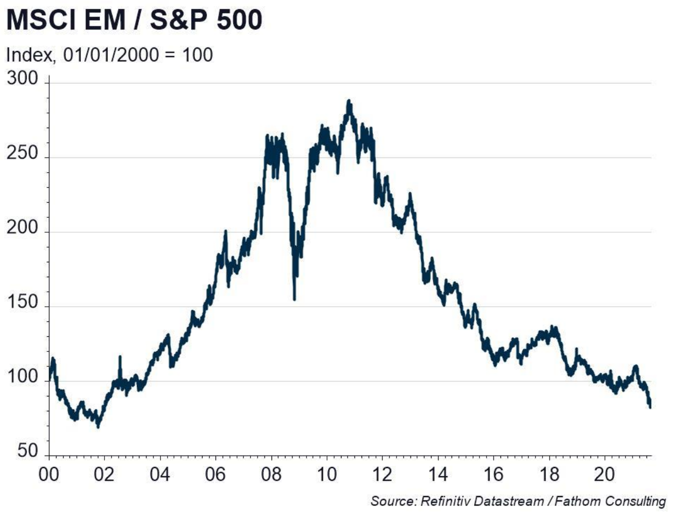
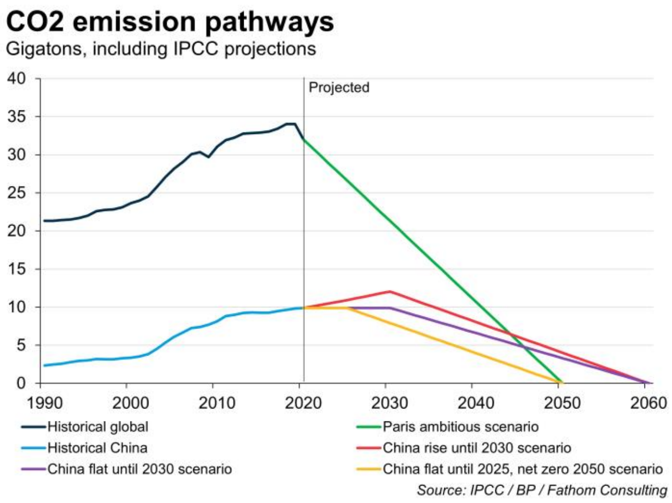
- But the number of countries converging fell steadily following the Global Financial Crisis. By 2016, only around half of the world's countries were still narrowing the GDP gap with the US
- COVID-19 has proved to be another blow to economic convergence, with medium-term economic effects from the pandemic likely to be heavily related to a country's ability to borrow, and to vaccine rollouts— two areas where the advanced economies, and the US in particular, hold large advantages
- Emerging market equities have broadly tracked the macroeconomic trends described above, suggesting their recent underperformance against the US dollar may not be over yet



China's climate targets: more ambition, please

- The climate targets China announced last year — peak emissions by 2030 and net zero by 2060 — are inconsistent with the Paris climate agreement, which seeks to limit global warming to well below 2.0°C, and ideally to just 1.5°C
- According to Fathom's calculations based on figures in the latest IPCC report, China's targets — if met — would use up more than 50% of the world's carbon budget in a 1.5°C warming scenario (Paris 'ambitious'); and around 30% if temperature rises are restricted to less than 2.0°C (which we call Paris 'cutting it fine')



- China will argue that it should be given more time to decarbonise than advanced economies, perhaps with good reason. But to keep 1.5°C 'within reach' (a key goal of the upcoming COP26 conference) the world simply does not have the budget for China — the world's largest emitter — and other EMs to drag their feet, even if the rich world decarbonises very quickly
- A more ambitious Chinese target — no rise until 2025 and then gradual reduction to zero by 2050 — would use 34% of the global carbon budget in the 'Paris ambitious' scenario and 19% in the 'Paris cutting it fine' scenario. Better still would be for China to start cutting emissions now

Further reading: China's climate challenge ahead

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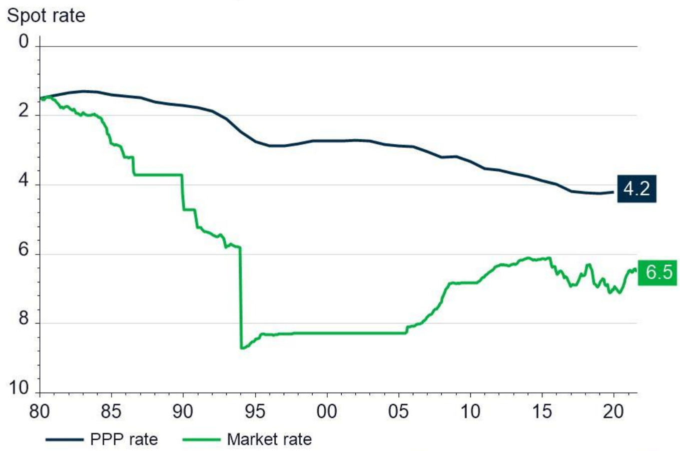
The renminbi: not as weak as it seems

- Former US president Donald Trump famously accused China of being a currency manipulator, and to a degree it is: the renminbi is not free-floating, but rather is part of the PBoC's policy toolkit

- The concept of purchasing power parity (PPP) provides one way of thinking about fair value for a currency. China's PPP exchange rate – effectively the exchange rate that would leave a basket of China's GDP costing the same as a basket of US GDP when both are measured in US dollars – provides a starting point

- Our first chart shows that the renminbi has been 'cheap' relative to PPP for several decades, but that does not mean that China's currency is fundamentally undervalued

USDCNY exchange rate



Source: Refinitiv Datastream / Fathom Consulting

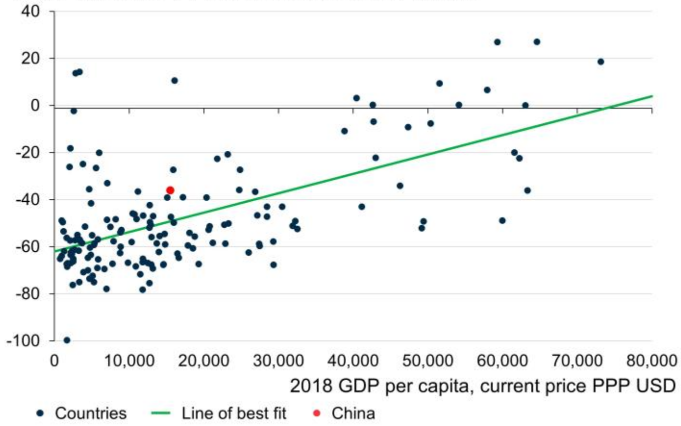
- The so-called 'law of one price' holds only for tradeables, which to a first approximation means goods rather than services – there is no equilibrating mechanism that causes, for example, haircuts to cost the same the world over

- As an economy develops, productivity in the manufacturing sector tends to rise faster than productivity in the services sector, which means that when we compare EMs and DMs we find in EMs goods tend to be relatively expensive and services relatively cheap

- Theory suggests, therefore, that EM currencies will be under-valued relative to PPP – a phenomenon known as the Balassa-Samuelson effect. We can see this effect clearly in our second chart, which compares GDP per capita in 2018 with the degree of over- or under-valuation relative to PPP in that same year across 159 countries

GDP per capita and deviations from PPP

Under- (-) or over- (+) valuation relative to PPP in 2018



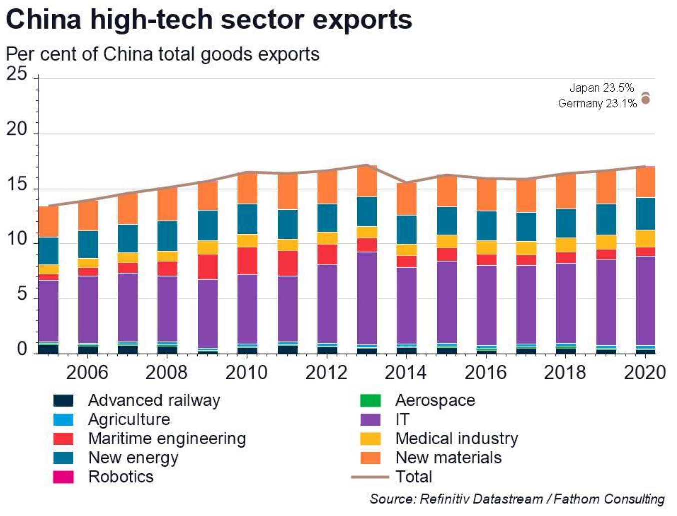
Source: Refinitiv Datastream / Fathom consulting

- If anything, China's degree of under-valuation relative to PPP in 2018 appears less than one might expect — China was above the line of best fit
- If we strengthen our model, by allowing a country's degree of over- or under-valuation relative to PPP to depend not just on its level of economic development, but on its current account balance (with countries running a surplus tending to have a stronger currency and vice versa), we find that China's currency continues to look dearer than one might expect
- Our simple model suggests one might expect USDCNY to trade at around 7.70, given China's stage of economic development and its current account position
- With China's economy slowing, however, and with problems at Evergrande a threat to financial stability internally if not elsewhere, the barriers to a weaker renminbi appear few and far between

Further reading: China's housing bares all

Wanted: a new source for Chinese growth

- The Evergrande saga has exposed the unsustainable nature of China's recent growth, which has been driven by a credit-fuelled property boom
- One way for the economy to rebalance would be to shift towards higher innovation and higher productivity
- However, our measure of Made in China 2025 exports shows that China's progress in transforming its manufacturing sector into a high-tech powerhouse has been sluggish



- Support for strategic industries has yet to pay off in a big way for China, whose high-tech export share still lags well behind that of Germany and Japan
- Meanwhile, a political desire for control, exemplified by a recent crackdown on technology companies, risks stifling innovation and hampering growth
- Indeed, we find that it is almost only democracies that succeed in moving beyond 50% of US GDP per capita

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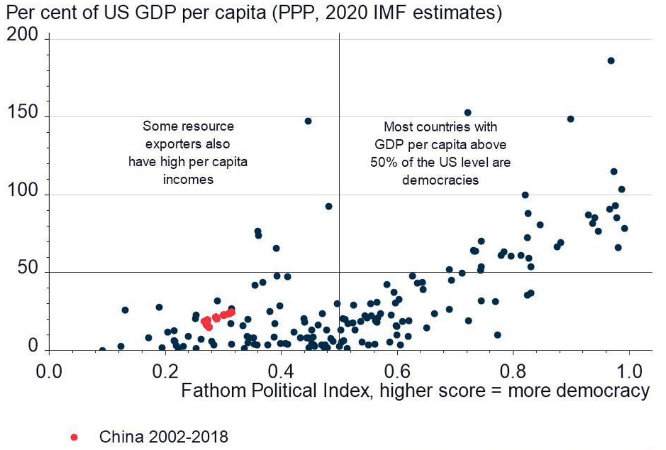
Fathom Political Index 2018 and GDP per capita



Source: Refinitiv Datastream / Fathom Consulting

- The upshot is that China's economy faces a material slowdown with trend growth set to fall to around 3% within three years, according to Fathom estimates

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