

August 2022

# For whom stagflation tolls

No repeat of the 1970s nor 1997 for emerging Asia



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## Executive summary

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We forecast inflationary recessions in major advanced markets this year and next, but not structural stagflation.

History has shown faster than expected rate hikes in the US can precipitate financial crises in emerging economies.

We do not expect a repeat, particularly not in emerging Asia where inflation has so far risen by less,...

...and where we see growth outperforming that in advanced markets.

Lessons from the Asian Financial Crisis in 1997 have been learned, and today economies in emerging Asia are much more resilient.

Insurance markets in emerging Asia will likely also outperform those in advanced markets this year.

The Asian Financial Crisis (AFC) 25 years ago triggered sharp currency depreciation, a jump in inflation and recessions, but no sustained stagflation: instead there was strong recovery afterwards. If there is stagflation this year, it will likely hit major advanced markets but not go global, in our view. The geopolitical shocks of 2022 have added to the ongoing economic impact from COVID-19-related disruptions, causing a net stagflationary shock that will increase inflation and lower growth in many countries. Yet we believe a return to 1970s-style stagflation remains unlikely and forecast instead "inflationary recessions" in the US and euro area over the next 18 months.

The war in Ukraine and subsequent sharp rise in food and energy prices – typically a larger share of CPI baskets in emerging economies – means net importing economies have yet to see peak inflation. Add sharp US monetary policy tightening to food and oil price shocks, and the outlook for emerging markets looks ominous. In the past, faster than anticipated interest rate hikes to contain inflation have triggered financial crises in emerging markets. For instance, when the Fed chair Volcker increased the policy interest rate to a record 20% in 1981, what had been a sustained period of capital outflows from the US to emerging markets starting in the 1970s period of stagflation suddenly reversed, causing a series of painful debt and currency crises in emerging economies in the 1980s (in Latin America) and 1990s (in Mexico and Asia). The stagflation "hot potato" was passed from the US to emerging economies, which subsequently suffered both sharp economic contraction and soaring inflation.

But the risk of a stagflation outcome in any individual economy depends not just on the shock, but also on economic fundamentals. And here economies in emerging Asia are on stronger footing, including with the markets: sovereign debt yield spreads for emerging Asia have increased by less than for emerging markets overall this year. Domestically, the upward trend in inflation started later, especially in Asia, reflecting delayed and/or slower demand recoveries from the pandemic. Another signpost of stagflation is labour market tightness. Unlike in advanced markets, in emerging Asia unemployment rates have yet to return to pre-pandemic levels, and the risk of a of price-wage spiral that often characterises structural stagflation (and which many advanced markets now face), is lower.

Emerging markets are not immune to the coming global demand slowdown. But many in the Asian region should still see higher GDP growth rates compared with advanced economies. We do not forecast quarterly GDP contractions in emerging Asian economies this year or next. For 2023, we expect both slowing growth and lower inflation in Asia, with the notable exception of China that could experience a growth rebound in case of relaxation of its Zero Covid Strategy. If economies in emerging Asia can avoid stagflation, they may emerge with a larger share of global exports while advanced economies continue to face stubbornly high and faster-rising costs.

Twenty-five years after the AFC, many lessons have been learned and, in our view, the economies in emerging Asia are today more resilient on several parameters. These include current account surpluses (rather than deficits), still-favourable real interest rate differentials vs the US due to a combination of earlier interest rate lift-off and lower inflation, and less borrowing in foreign currencies. Indeed, the problem of "original sin" where emerging markets borrow in foreign currencies (mostly USD), creating mismatches with local currency earnings, has been largely mitigated.

We expect insurance markets in Asia will grow faster than in advanced economies. The recent outperformance in terms of lower inflation and higher growth may also deserve a re-rating from investors. Cyclically, economies relatively uncorrelated with the late-cycle slowdown/recession in the US and Europe should have scope to increase internal insurance demand. In the long-run, higher potential growth if, as we expect, countries in emerging Asia avoid a financial crisis, will support stronger real premium growth. Nevertheless, insurers will feel the same pain points as those faced by counterparts in other markets going through stagflation/inflationary recessions. These include greater lapse risk as GDP growth slows and unemployment rates increase. And, as interest rates and bond yields rise, balance sheet vulnerabilities and net capital impact may also emerge in case of imperfect asset-liability matching.

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Inflation in advanced economies is at record highs. More rate hikes are likely even with rising recession risks.

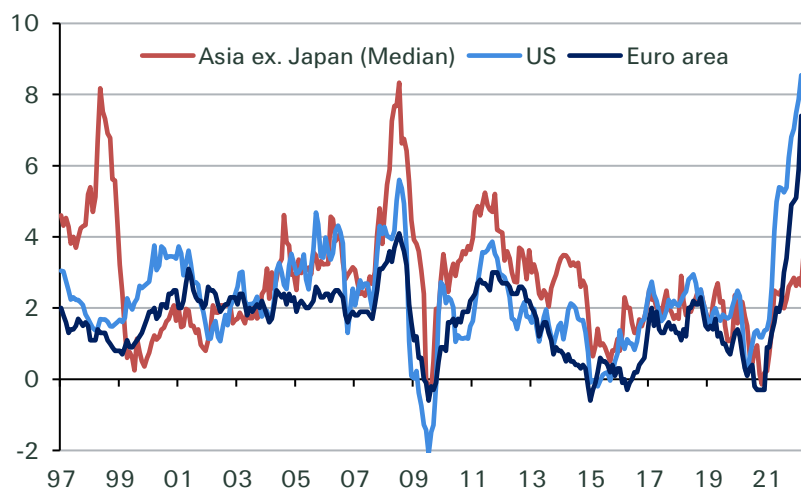
Inflation is rising rapidly in Asia too now.

## From stagflation-like to "inflationary recessions"

The geopolitical shocks of 2022 have added to the ongoing economic impact from COVID-19-related disruptions, causing a net stagflationary shock: high inflation and low growth.<sup>1</sup> Global growth momentum has faltered in major economies and inflation rates remain well above central bank targets, leading to concerns over incipient price-wage spirals. While we still believe a return to 1970s-style stagflation is unlikely, we forecast "inflationary recessions" in the US and euro area in 2022 and 2023.<sup>2</sup> At the same time, central banks are front-loading interest rate increases to get inflation back to targets.<sup>3</sup>

In emerging markets, the upward trend in headline inflation started later and has so far "only" reached historical average rates. These would not be considered especially high for individual economies, although the speed at which inflation has risen is a concern (see Figure 1). This "inflation outperformance" is especially notable in several Asian economies and mainly reflects delayed and/or incomplete recoveries compared with the US on the demand side, and less direct reliance on gas from Russia on the supply side. During the pandemic, more generous fiscal support in advanced economies relative to emerging markets<sup>4</sup> contributed to greater global demand especial for goods. However, industrial production did not/cannot adjust fast enough to meet the increase in demand. More recently, the war in Ukraine and subsequent sharp rise in food and energy prices – typically a larger share of the consumer price index (CPI) baskets in emerging economies – is another supply-side shock adding to cost-push inflation. Emerging markets, especially net importing countries where domestic demand and labour markets are still recovering, will likely see inflation peak later than in the US.

**Figure 1**  
Headline CPI inflation, %YoY



Source: National Statistics agencies and CEIC, Swiss Re Institute

Faster-than-expected US monetary policy has previously been a harbinger of financial crises in emerging markets.

### Emerging markets have been caught out by US disinflation before

The US Federal Reserve is currently raising interest rates at the fastest pace in decades, in a bid to prevent the highest inflation rates since the 1970s from sticking. A repeat of the 1970s is also a risk for emerging economies, but from a different perspective. When US inflation accelerated in the 1970s, capital flowed out of the US and into emerging markets (also helped by the end of the Interest Equalisation Tax in

<sup>1</sup> See [sigma 2/2022](#), Stagflation: the risk is back, but not 1970s style, Swiss Re Institute

<sup>2</sup> See [Economic and financial risk insights: Inflationary recessions on the horizon for major economies](#), Swiss Re Institute, 9 June 2022.

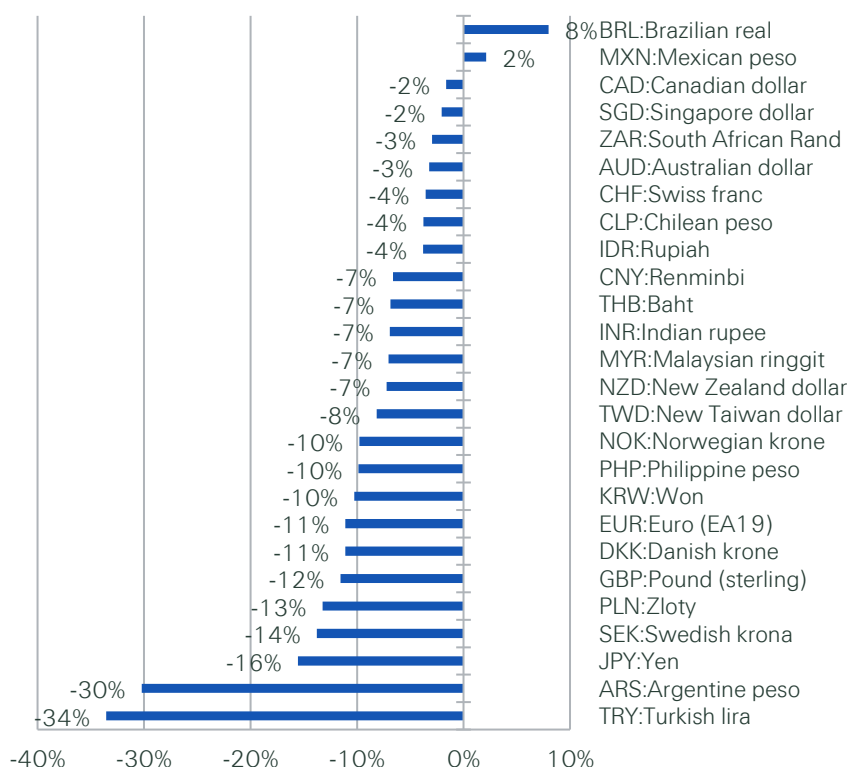
<sup>3</sup> See [Economic Insights - Goodbye to all that: central banks step into a brave new world](#), Swiss Re Institute, 21 June 2022.

<sup>4</sup> [The IMF estimated](#) the discretionary additional fiscal spending in response to Covid-19 averaged 11.7% of GDP for advanced economies compared with 5.7% for emerging market economies and just 3.2% for low-income developing countries

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1974).<sup>5</sup> At the time, US dollar depreciation after the end of the Bretton Woods era of fixed exchange rates helped keep import price inflation in emerging economies down. However, when US central bank chair Volcker eventually resolved to bring US inflation down and raised the Fed Funds rate to a record 20% by 1981, capital flow reversals and sudden stops (defined as large and rapid declines in portfolio and other inflows by non-residents) caused a series of painful debt and currency crises in emerging economies in the 1980s (in Latin America) and 1990s (in Mexico and Asia). The stagflation "hot potato" was passed from the US to the emerging economies, which subsequently suffered both sharp economic contraction and soaring inflation.

**Figure 2**  
YTD currency performance versus USD



Source: Bloomberg

Capital outflows and currency depreciations indicate rising emerging market financial stress.

This year's depreciation of almost all currencies against the US dollar (see Figure 2) is perhaps *prima facie* evidence of global investors having rotated towards the higher yields and perceived quality/safety of US assets. This has led to market worries about debt sustainability in emerging economies. The IMF recently calculated that 36% of issuers in the JPMorgan EMBI Global bond index now face yields of over 10%,<sup>6</sup> and that about 60% of a group of 73 low-income countries are at high risk of – or are already in – debt distress (defined as when a country has started, or is about to start, a debt restructuring, or when it is accumulating arrears).<sup>7</sup> However, it is also worth noting that the EMBIG Asia spread index had, at its highest point in 2022, increased by comparatively less than the overall EMBIG index (+92 vs +174). And the increase is nothing like the huge spike during the Asian Financial Crisis (AFC, from a low of 66 in February 1997 to 926 in September 1998).

<sup>5</sup> The US Interest Equalization tax became effective in 1963. It was a one-time tax on the purchase of foreign securities from foreigners by US entities. It was designed to reduce the balance-of-payments deficit by reducing the relative returns on foreign portfolio investment.

<sup>6</sup> "Global Economic Growth Slows Amid Gloomy and More Uncertain Outlook", [blogs.imf.org](https://blogs.imf.org/2022/07/26/global-economic-growth-slows-amid-gloomy-and-more-uncertain-outlook/), 26 July 2022

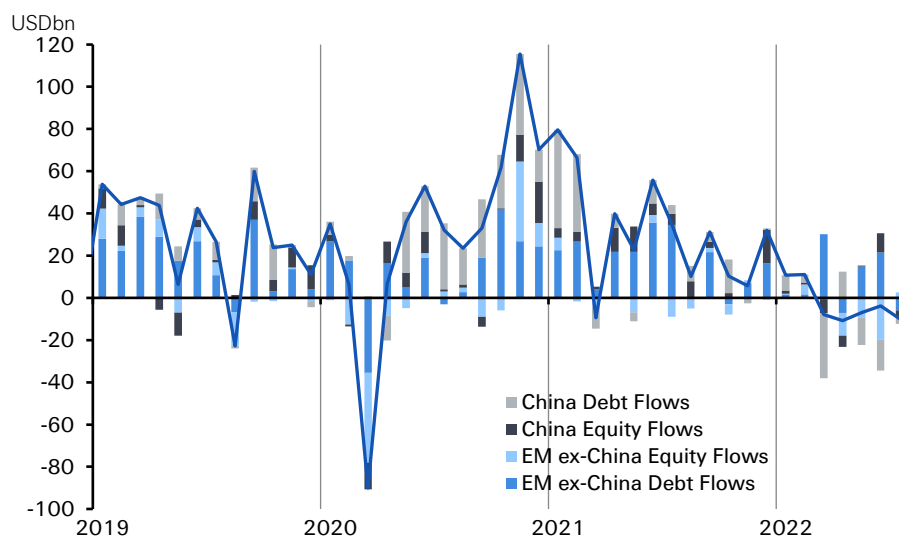
<sup>7</sup> "Restructuring Debt of Poorer Nations Requires More Efficient Coordination", [blogs.imf.org](https://blogs.imf.org/2022/04/07/restructuring-debt-of-poorer-nations-requires-more-efficient-coordination/), 7 April 2022



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**Figure 3**

Net emerging market equity and debt fund flows



Source: IIF

Markets in emerging Asia look more resilient today than 25 years ago...

The Institute of International Finance's capital flows monitor recently confirmed that emerging markets have experienced a fifth consecutive month of net portfolio outflows,<sup>8</sup> cumulatively amounting to near USD 40 billion across bonds and equities (see Figure 3). Compared with the March 2020 "dash for cash", when USD 90 billion was pulled out of emerging market funds in a single month, this year's net outflows are – for now and for most emerging economies – manageable. With Sri Lanka a recent exception, there are many reasons to believe this time is different for Asian economies. Many harsh lessons about capital flight were learned during the AFC twenty-five years ago and in our view, resilience to emerging market crises and contagion has increased due to progress on many dimensions including:

- all economies now have much higher (real) GDP per capita, meaning consumers are better able to absorb cost-of-living shocks;
- inflation in Asia is not especially high relative to past history;
- many countries in Asia have sustained current account surpluses compared with deficits prior to the AFC;
- there is less borrowing in foreign currencies and/or at short maturities than at the time of the AFC;
- fewer economies in Asia now maintain a peg to the US dollar;
- real interest rate differentials vs the US are currently positive due to a combination of earlier interest rate lift-off and lower inflation in Asia;
- the fiscal and monetary regimes (eg, more independent and/or inflation-targeting central banks) in Asia have become credible over the last 20 years;
- many countries in Asia have built up ample FX reserves; and
- new swap lines between central banks and the Fed's Foreign and International Monetary Authorities (FIMA) Repo Facility now provide emergency foreign currency backstops.

...and there is less risk of a repeat of old-style emerging debt crisis, in our view.

As such, in our view, the risk of a repeat of the emerging market debt crises with prominent sovereign debt restructuring of large issuers across the board as seen 25 years ago has fallen. An important reason is that the problem of "original sin", namely emerging markets borrowing in foreign currencies (mostly USD) and thereby creating mismatches with corporate earnings (mainly in local/other currencies), has been mitigated. Many emerging market governments and corporates are now able to borrow more in their own currencies as local bond markets have deepened since the 1980s and 1990s. The Asian Development Bank estimates that the proportion of

<sup>8</sup> See the IIF's [Capital Flow tracker](#).

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However, the next emerging market financial crisis may not look like those of the past.

Risk of disruptive capital outflows is more associated with a high share of foreign *investors*, rather than just high foreign *currency* debt

foreign currency debt as a share of total debt has halved in emerging Asia, from nearly 30% in the early 2000s to less than 15% just before the onset of the pandemic.<sup>9</sup>

### Original sin redux

However, continued financial globalisation including of many Asian economies since 1997 has given rise to a new kind of risk, one that the Bank for International Settlements has dubbed "original sin redux".<sup>10</sup> This is where currency mismatches have not disappeared altogether, but have instead migrated from the emerging economy borrowers' balance sheets to that of advanced market investors. During the 2013 Fed policy normalisation cycle, emerging economies with large exposures to foreign investors suffered larger spread widening than those with lower exposures. This new kind of emerging market financial crisis may proceed as follows:

- as global investor returns are measured in US-dollar terms, exchange rate movements amplify unhedged losses;
- at the same time, the advanced economy investors face obligations in their home currency (eg, through client redemptions);
- when these investors rebalance portfolios – for reasons that can be unrelated to country-specific economic fundamentals – by selling emerging market assets, it causes further tightening of financial conditions (eg, higher yields) and/or currency depreciation for emerging economies;
- that, in turn, increases US dollar-denominated losses, triggering more asset sales and a vicious cycle takes hold; and
- this pro-cyclicality may be further exacerbated as benchmark bond indices are usually constructed with reference to the US dollar.

In the past few months, bond investors in advanced economies have faced rising yields and emerging market currency depreciations against the US dollar – effectively a double (USD) loss on their domestic and foreign holdings. This and risk-off market sentiment may have triggered portfolio rebalancing and net outflows from emerging markets in the past few months. A mitigating factor from the borrowers' perspective is that in recent years, the share of foreign participation in local currency government bond markets has also fallen (although within Asia the share remains high in Malaysia and Indonesia, see Figure 4). Research has found that global factors, especially investor risk appetite (often proxied by the VIX index),<sup>11</sup> has become a stronger predictor of disruptive capital outflows than local economy fundamentals.<sup>12</sup> A lesson from original sin redux is that borrowing from local *investors* is more important than borrowing in local *currency* for the purposes of avoiding capital flight/sudden stops.<sup>13</sup>

<sup>9</sup> *Local Currency Bond Markets, Foreign Investor Participation, and Capital Flow Volatility in Emerging Markets*, Asian Development Bank, April 2021.

<sup>10</sup> *Overcoming "original sin" to secure policy space*, Bank of International Settlements, November 2021.

<sup>11</sup> A first benchmark index to measure the market's expectations of future volatility. See *What is the VIX index*, Chicago Board Options Exchange.

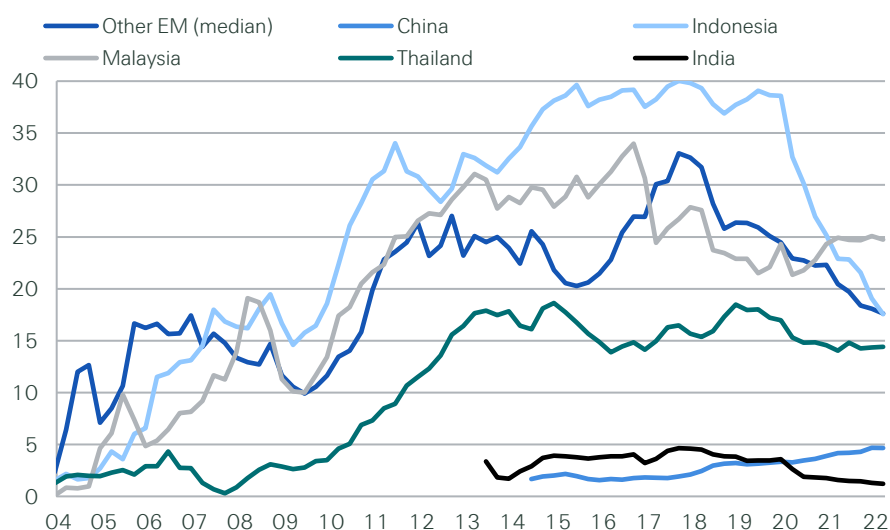
<sup>12</sup> *Managing sudden stops*, The World Bank, April 2016.

<sup>13</sup> *Original sin redux: a model based evaluation*, BIS, 22 February 2022.

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**Figure 4**

Foreign investor participation in local currency government bond market



Source: ADB, IIF

Emerging Asia is likely in a *different* rather than earlier stage of the same cycle that advanced economies are in.

### This stagflation will not be global

The key macro question for the coming months is whether emerging economies are on a different or at an earlier stage of the same "inflationary recession" cycle currently playing out in advanced markets. If the latter, emerging market central banks would still have time to front-load interest rate hikes to prevent inflation from broadening out, albeit at greater risk of recession and higher unemployment. On the other hand, if the Asian economic cycle is different altogether, it would be a policy mistake to follow the US in tightening policy. At present at least, we think two core Asian economies – China and Japan – are in different cycles given both weak growth and low inflation (ie, a "normal" economic slowdown rather than "stagflation-like").

Some stagflationary shocks are common in kind but different in degree.

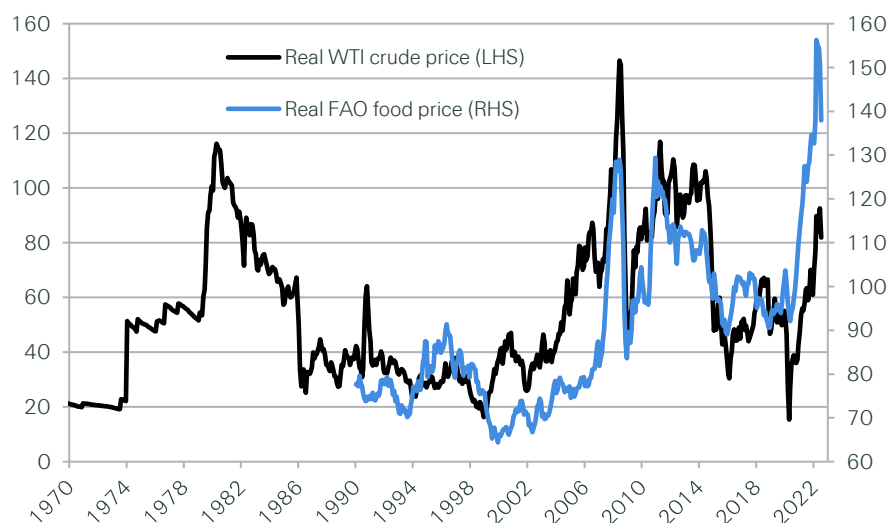
For emerging market net importers, a major concern is key import prices remaining higher for longer, like the experience of the 1970s. From 1973 to 1980, a current account surplus of USD 19 billion for the group of rich industrialised economies turned into a deficit of USD 44 billion by 1980.<sup>14</sup> Non-oil producing emerging markets saw their deficits explode from USD 12 billion to USD 80 billion. The accumulation of these current account imbalances reduced macroeconomic resilience, causing subsequent emerging market balance of payments crises. Today, oil prices have fallen back significantly in recent weeks, providing hope that this time they will peak at a lower level (in real terms) than in 1981 and 2008. Real food prices have also started to fall from record highs (see Figure 5). Given that consumers in emerging markets typically spend more on food than on energy, the risk of balance-of-payments crises is more likely to be triggered by any negative supply shocks preventing food prices from continuing the downward trend.

<sup>14</sup> [Silent Revolution: The International Monetary Fund 1979–1989](#), James Boughton, October 2001

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**Figure 5**

Real oil and food prices (in 2015 US dollars)



Source: EIA, Dow Jones, BLS, UN FAO, Swiss Re Institute

Labour markets in most of emerging Asia do not present same risk of price-wage spirals as in the advanced economies.

Finally, structural stagflation takes more than supply shocks. One of the signposts we flagged in our April *sigma* publication was tightness in labour markets and overheating with too much demand.<sup>15</sup> Compared with the US and other advanced economies, in most emerging Asian economies unemployment rates have yet to return to pre-pandemic levels. Since labour markets are not especially tight compared with the US, the risk of the kind of price-wage spirals that often characterise structural stagflations should be lower.

**Table 1**

Headline unemployment rates in Asia

Unemployment rate (%)	Latest	as of	Pre-Covid (Jan 2020)	Mean (2010-19)	Recovered to Pre-Covid?	Below long-term mean?
China, Mainland	5.4	July 2022	5.3	5.0	No	No
Hong Kong SAR, China	4.3	June 2022	3.4	3.3	No	No
India	6.8	July 2022	7.2	6.5	Yes	No
Indonesia	5.8	February '22	5.0	6.0	No	Yes
Japan	2.6	June 2022	2.4	3.6	No	Yes
Korea, Rep. of	2.9	July 2022	4.1	3.6	Yes	Yes
Malaysia	3.8	June 2022	3.2	3.2	No	No
Philippines	6.0	June 2022	5.3	6.3	No	Yes
Taiwan Prov. of China	3.7	June 2022	3.6	4.1	No	Yes
Thailand	1.4	2Q 2022	1.0	0.9	No	No
Vietnam	2.3	2Q 2022	2.2	2.3	No	No
Australia	3.5	June 2022	5.3	5.5	Yes	Yes
New Zealand	3.3	2Q 2022	4.1	5.4	Yes	Yes

Source: National statistics agencies and CEIC, Swiss Re Institute

<sup>15</sup> *sigma* 2/2022 Stagflation: the risk is back, but not 1970s style, Swiss Re Institute.



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Emerging market central banks' inflation and general policymaking credibility has improved.

A related signpost is the dominance of fiscal over monetary policy. Structural stagflation requires central banks to repeatedly accommodate inflation, causing inflation expectations to become unanchored. For example, in Latin America in the 1980s, central bank financing of large fiscal deficits through creation of new money contributed to rapid monetary expansion, and several countries (Argentina, Brazil, Chile and Mexico) experienced very high inflation. While no government would explicitly announce a policy of fiscal dominance, markets will infer, based on the interactions between monetary and fiscal authorities on inflation, whether policy is a “fiscally-dominated reaction function” (ie, central banks placing a lower weight on controlling inflation). A recent World Bank study finds that since the beginning of the pandemic, there have been marked increases in inflation and inflation expectations in emerging and developing Europe and Central Asia, Latin America and the Caribbean, and South Asia. The uptick in inflation expectations has been associated with the impact of higher food and energy prices, currency depreciation, political instability in some countries, as well as the recovery in domestic demand<sup>16</sup>. By contrast, over the same period, inflation expectations have *decreased* in East Asia and Pacific.

We do not expect Asian economies will experience stagflation this year, neither cyclical nor structural.

### **Outlook for Asia: growth and inflation normalisation, not stagflation**

Cyclical expansions and contractions are ultimately driven by the interaction of shocks with other economic forces and underlying economic structures. Today's stagflationary supply chain and energy/food price shocks are global, and emerging markets are certainly not immune. But the risk of a stagflationary outcome in any individual economy depends not just on the shock. Given better fundamentals, we believe stagflation – either cyclical or structural – will not become a global phenomenon and expect most economies in Asia to avoid either form.

Most countries will not see quarterly GDP contractions...

On growth, recent second-quarter GDP data for several Asian economies (eg, South Korea, Malaysia, Indonesia, Vietnam) beat consensus forecasts. There is still growth momentum given delayed or slower reopening from pandemic restrictions in many emerging economies just catching up on vaccination rates. Barring a few advanced economies where growth rates are structurally lower (eg, Hong Kong, Japan), in our view there will not be quarterly GDP contractions in most of Asia this year or next.

...and potential boosts from China stimulus and recovery later this year.

Nevertheless, strengthening domestic recoveries will soon face weakening external demand conditions. Recent survey and hard activity data suggest significant slowdown in the US and euro area in the coming quarters. This, however, should be put into context of a long-term downward shift in the share of trade with the US and a rising share vis-à-vis China. The GDP of Asian economies has not decoupled from the US, but for many the correlation with China's growth is now higher. That contrasts with many major economies in Europe, where the cycles are still more correlated with the US (see Figure 6). A growth recovery in mainland China supported by more policy easing, perhaps starting in the fourth quarter of 2022 and continuing into 2023, especially if it can exit from the Zero-Covid Strategy, represents more of an upside risk scenario for economies in Asia. This divergence in economic cycles between China and the US and the euro area, could partially offset the demand impact of slowdowns in advanced markets on economies in emerging Asia.

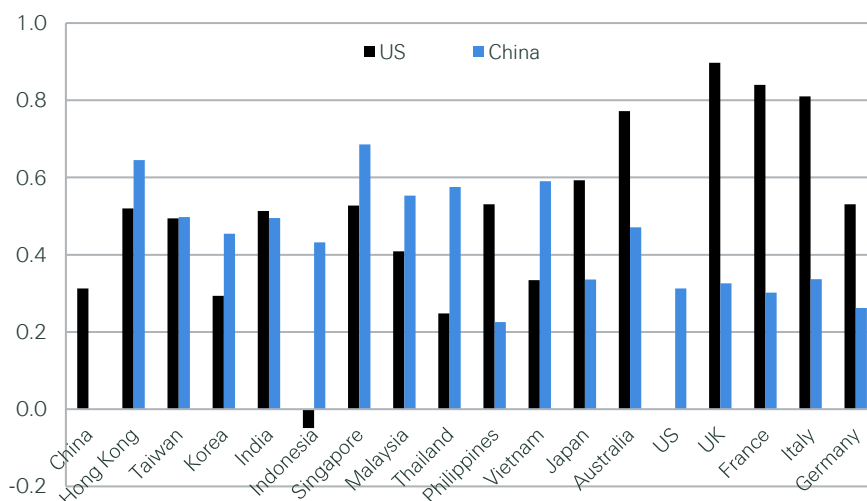
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<sup>16</sup> *Global Economic Prospects*, World Bank, June 2022.

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**Figure 6**

Correlation coefficients of GDP growth with US and China since 1990



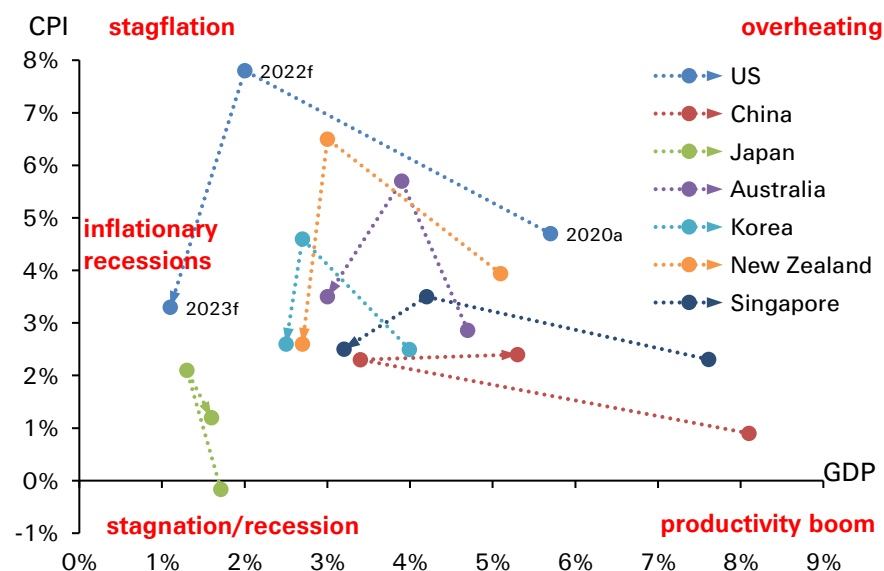
Source: IMF, Swiss Re Institute

In 2023, we see slowing growth and lower inflation across Asia, except for China.

We expect the near-term growth and inflation mix in major Asian economies will involve CPI inflation and GDP growth peaking later in 2022 than in the US. Even so, we still expect many Asian economies will grow faster than the US and Europe this year, and that average levels of inflation will be lower (see Figure 7). We forecast that growth in emerging Asia (excluding China) will average 6.2% in 2022–2023, helping the emerging markets' aggregate growth rate (3.9%) outpace that of the advanced markets (2.0%). In 2023, we expect both slowing growth and lower inflation in Asia, except for China where a potential exit from the Zero-Covid Strategy could drive a confidence-fuelled rebound next year compared with a weak 2022.

**Figure 7**

Combination of SRI CPI inflation and real GDP growth forecasts for a sample of Asian economies compared with the US



Note: The figure shows the combination of CPI inflation and real GDP growth for 2021 (actual), 2022 and 2023 (SRI forecasts) along the direction of the arrows.

Source: Bloomberg, Swiss Re Institute

There is long-tail risk of stagflation in Asia, but from different sources than currently at play in advanced economies.

The key medium-to-longer-term downside risk scenario for Asia is the same as for advanced economies: structural stagflation. However, emerging economies can get into stagflation in ways that do not apply in advanced economies. For instance, there is a history of emerging markets having gone into IMF programmes following balance of payments crises. These programmes required fiscal austerity and often caused

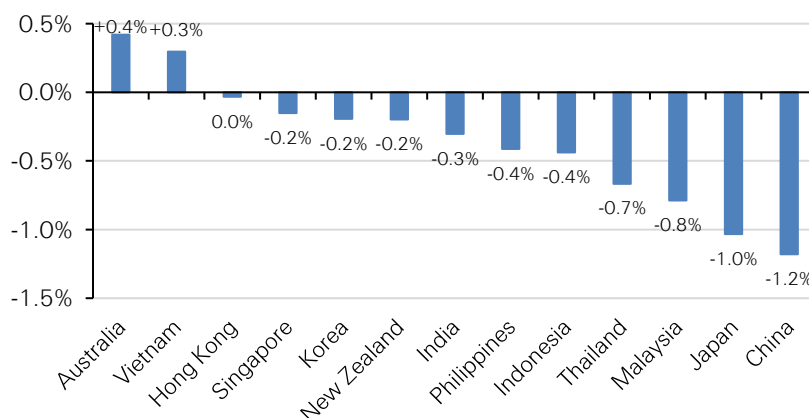
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We expect insurance markets in Asia will grow faster than in advanced economies.

Emerging market inflation – and the associated risk premia – have typically been much higher than for advanced markets. This may be changing.

**Figure 8**

Asia 10-year government bond yield spreads over US Treasuries (YTD ppt% change)



Source: Bloomberg, Swiss Re Institute

Even so, insurers in Asia will face the same lapse and inflation risks as their advanced market peers as growth slows before inflation next year.

deep economic recessions. In some cases, the cure was deemed more painful than the disease, and countries exited programmes without have completed the fiscal, monetary and structural reforms needed to bring inflation expectations back down. This only meant a re-acceleration of inflation in already depressed domestic economies, completing the transition to structural stagflation.<sup>17</sup>

### Implications for insurers

Under almost all scenarios, we expect insurance markets in Asia will grow faster than in major advanced economies. Cyclically, economies relatively less correlated with the late-cycle slowdown/recession in the US and Europe should have scope to maintain domestic insurance demand growth, as well as offer a source of diversification for global re/insurers. In the long-run, higher potential growth and catch-up on market development is a structural growth story if, as we expect, countries in emerging Asia avoid a major financial crisis and maintain relatively high GDP growth rates. That will support stronger real premium growth in the coming years.

For insurance asset management, higher growth does come with risk premia attached, and the latter is rising due to geopolitical tensions and generally lower macroeconomic resilience.<sup>18</sup> However, this year policymakers in emerging markets have arguably outperformed in terms of macroeconomic outcomes. Compared with much high actual inflation and lower growth rates in major advanced economies, most of Asia has so far avoided a stagflation-like outcome. That could contribute to perceptions shifting away from the past when emerging market inflation – and the inflation premia demanded by investors – was typically much higher. Assets in inflation "outperformers" may therefore warrant some upward re-rating by global investors relative to advanced and other emerging markets. For example, for much of Asia, long-term sovereign debt yield spreads over US Treasuries have narrowed this year (see Figure 8). And unlike other types of investors, insurers' liabilities (claims) and assets (local currency bonds) are more naturally matched, avoiding original-sin redux.

Asian insurers will nevertheless feel similar pain points to those faced by others as more of the world economy transitions towards cyclical stagflation or inflationary recessions. These are likely to include greater lapse risk as GDP growth slows and unemployment rates increase. As interest rates and bond yields rise, balance sheet vulnerabilities and net capital impact may also emerge in case of imperfect asset-liability matching. That may be more so true for less developed emerging economy capital markets, which will reduce the resilience of insurers. For instance, inflation-linked bonds are relatively scarce or non-existent in emerging markets.

<sup>17</sup> S Edwards, "On Latin American Populism, and Its Echoes around the World", *Journal of Economic Perspectives*, 2019.

<sup>18</sup> See [Resilience Index 2022: risks to resilience on the rise again after a year of respite](#), Swiss Re Institute, June 2022.

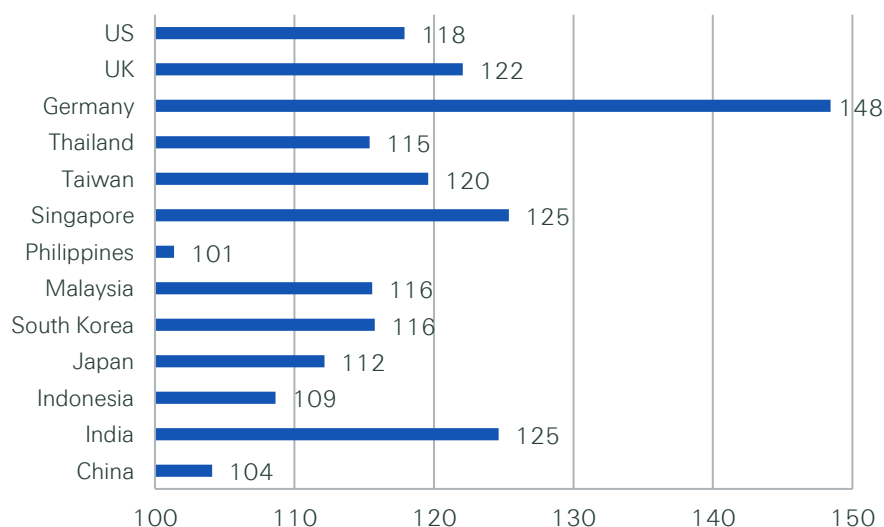
# Silver-linings for Asia, if it avoids stagflation

## Winners and losers

Emerging Asia leads in the race to keep inflation low.

**Figure 9**

Producer price index, change between Jan 2020=100 and latest data as of June/July 2022



Source: National statistics agencies and CEIC, Swiss Re Institute

Countries that can avoid stagflation-like conditions – and we currently think most of Asia will – could gain competitiveness.

By contrast, if economies in emerging Asia can maintain their current "relative outperformance" and avoid stagflation when all about them are experiencing stagflation-like conditions, they stand a good chance of increasing their share of global exports. It may be no coincidence that the 1980s, before stagflation finally ended in the US, saw the emergence of the East Asian "tiger economies". In absolute terms and relative to the rest of the world, South Korea, China and Taiwan grew rapidly, and Indonesia, Malaysia, Singapore, the Philippines and Thailand were not far behind. Over the 1980s as a whole, East Asia recorded average annual GDP growth rates of 6% compared with 3% for all emerging markets and 2.4% for advanced economies.<sup>20</sup>

Sustained periods of diverging inflation outcomes will likely cause structural shifts in where production and investments are located

The lessons of the 1970s are therefore also about relative shifts in relative prices competitiveness. The 1970s US stagflation was also exacerbated by the collapse of the Bretton Woods system of fixed exchange rates. From the end of 1972 to end-1978, the US dollar depreciated by 36% against the Japanese yen (and by 43% vs the German mark). The yen's appreciation after the Plaza Accord of 1985<sup>21</sup> was supposed to be part of the solution to stagflation (at least for the US). It effectively increased the price of Japanese exports in US-dollar terms, which should have reduced the US trade deficit. What happened, however, is that yen appreciation eventually amplified deflation in Japan when the country went into recession in the 1990s. The subsequent two "lost decades" saw reduced import demand (including from the US). Indeed, yen appreciation in the 1980s has been cited by a current Bank of Japan policymaker as a proximate cause for Japanese manufacturers shifting their

<sup>19</sup> "Germany's much-vaunted trade surplus disappears as import prices surge, [cnbc.com](https://www.cnbc.com), 5 July 2022.

<sup>20</sup> Calculations based on IMF data, emerging markets include the developing economies grouping.

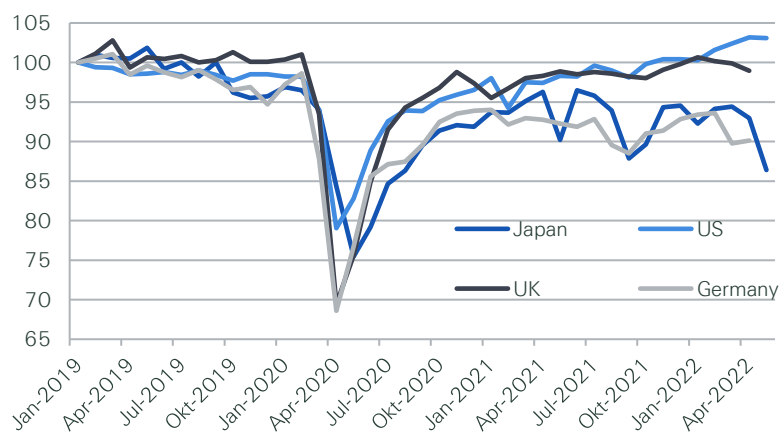
<sup>21</sup> In 1985, the G5 countries declared the US dollar overvalued and agreed that the main current account surplus countries (Japan and Germany) would boost domestic demand and appreciate their currencies (see [text](#)).

## Silver-linings for Asia, if it avoids stagflation

production overseas and caused greater job losses and wage declines across Japan.<sup>22</sup> Despite the sharp depreciation of the yen to a 24-year low against the US dollar this year, Japan's central bank has maintained its highly accommodative quantitative monetary easing and yield curve control policy.

**Figure 10**

Real industrial production of major advanced economies, rebased Jan-2019=100

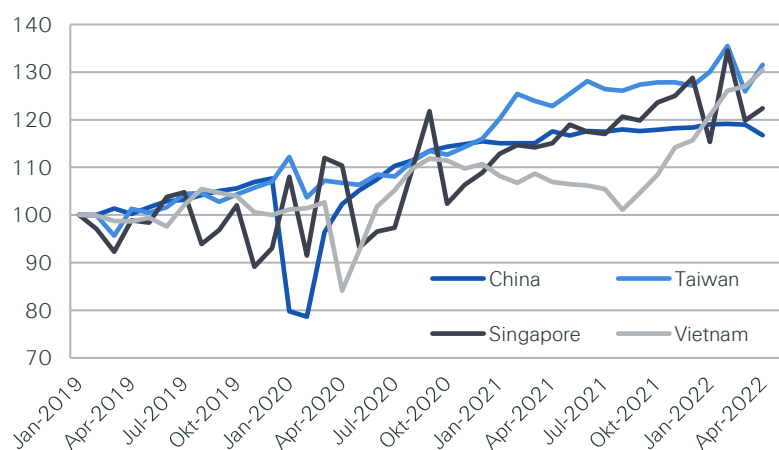


Source: UNIDO, Swiss Re Institute

The 1970s parallel with today is far from perfect. The problem for emerging markets this year is that the US dollar is too *strong*, leading to import price inflation. Yet even with higher imported inflation, manufacturers in emerging markets have managed to keep input cost inflation lower and expanded production. Supply-side bottlenecks are also part of the reason why industrial production has stalled (see Figure 10). It is also notable that several major Asian manufacturing economies have recovered more strongly, despite occasional stricter pandemic controls. Some (eg, Vietnam) were growing fast pre-pandemic and were always going to at least partially revert as the economy reopened permanently. Others specialised in production of in-demand goods such as semiconductors (eg, Taiwan, Singapore). In general, East Asia is less dependent on energy from Russia or wheat Ukraine (rice is usually the staple food) and so may have avoided the worst of the commodity price shocks.

**Figure 11**

Real industrial production of selected Asian economies, rebased Jan-2019=100



Source: Unido, Swiss Re Institute

<sup>22</sup> [Speech: Economic Activity, Prices, and Monetary Policy in Japan](#), Bank of Japan, 2 June 2022.



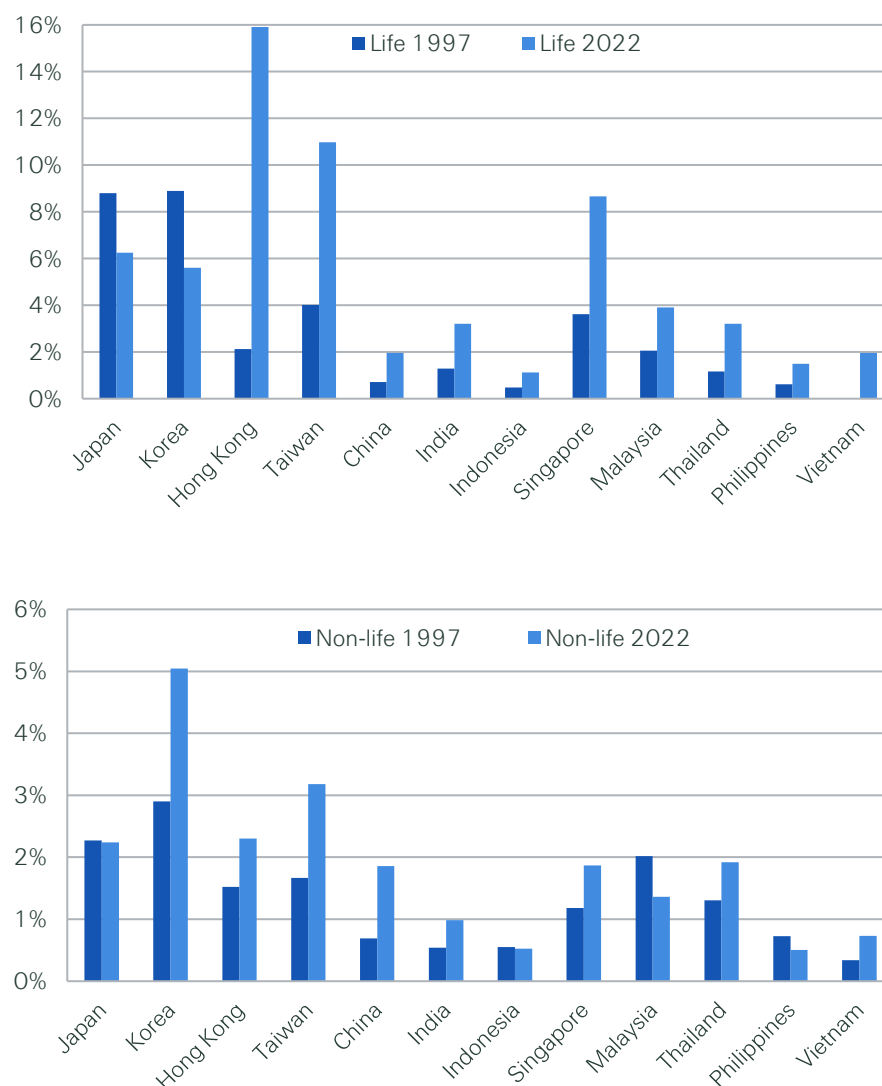
## Conclusion

Asian economies rebounded strongly from the financial crisis in 1997, in large part because they remained open.

**Figure 12**

Insurance penetration rates for East Asian economies, now vs 1997

For emerging markets, there is always a trade-off between preventing financial crises caused by volatile international trade and capital flows, and the benefits that come from greater openness. After the AFC in 1997-98, East Asia rebounded and developed further than many emerging regions that remained closed. East Asia GDP growth averaged 5.6% a year in the decade 1998-2007, compared with 5.3% for emerging markets and developing economies as a whole, and 2.6% for advanced economies.<sup>23</sup> Insurance markets eventually recovered, and insurance penetration rates continued to rise across nearly all of emerging Asia after the crisis.



Source: Swiss Re Institute

Encouragingly, signs are that Asian economies will remain open.

If there is an optimistic conclusion to draw on the 25<sup>th</sup> anniversary of the AFC then it is that Asia remained committed to globalisation, and trade continued to grow. The Regional Comprehensive Economic Partnership, a free trade agreement which came into effect earlier this year, is a hopeful sign that Asian economies remain on the side of more trade, more foreign investment, new ideas and technologies, and new sources of growth.

<sup>23</sup> *The Regional Comprehensive Economic Partnership: a new mega trade bloc for Asia*, July 2022.

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Swiss Re Management Ltd  
Swiss Re Institute  
P.O. Box  
8022 Zurich  
Switzerland

Telephone +41 43 285 2121  
Email [institute@swissre.com](mailto:institute@swissre.com)

Author  
John Zhu, Chief Economist Asia, Swiss Re Institute

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Dr Jerome Jean Haegeli  
Swiss Re Group Chief Economist

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Swiss Re Management Ltd.  
Swiss Re Institute  
Mythenquai 50/60  
P.O. Box  
8022 Zurich  
Switzerland

Telephone +41 43 285 2121  
[institute@swissre.com](mailto:institute@swissre.com)  
[swissre.com/institute](http://swissre.com/institute)