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What to watch: COP28 – the decisive decade, opportunity time in CEE, and the emerging winners of the great decoupling with China

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Executive Summary

This week, we look at three important issues:

- First, **COP28 – the decisive decade.** Here we go again. COP28 will kick off on 30 November in Dubai, with a packed agenda: the energy transition, climate finance, climate adaptation, and resilience and inclusivity. In the tradition of previous COPs, we can expect new protocols and agreements, but no new commitments to phase out fossil fuels. Yet, the window of opportunity to achieve the 1.5°C target through mitigation alone has already closed. If current trends persist, the planet is on track to exceed the 1.5°C warming threshold within the next decade. To stay within the target, carbon emissions need to fall by nearly -13% every year from 2025 to 2033. The only way forward is to invest, invest, and invest. Global climate investments need to increase to USD3.6trn by 2026, and USD4.4trn by 2046.

- Second, it is **opportunity time in Central and Eastern Europe.** Regional growth appears to have bottomed out in Q3 although the recovery in 2024 is likely to be mild. We forecast annual regional growth of around +0.5% in 2023 (after +4.0% in 2022) and +2.1% in 2024. The unwinding of current account imbalances will reduce vulnerability to systemic shocks that may impact financing flows. However, Romania is one to watch: its coverage of the external deficit by net FDI inflows has recently fallen to just one third, posing a risk of a balance-of-payments crisis in the event of a reversal of portfolio investment inflows in case of a systemic shock. Meanwhile, lower inflation and falling interest rates should support a recovery in domestic demand in CEE over the coming quarters. But strong wage growth is a moderate upside risk to inflation, in particular in Hungary, Slovakia and Bulgaria.

- Third, **Emerging markets winners from decoupling efforts with China** are now visible. Indeed, pivoting emerging markets are reaping the benefits of the West's ambiguous relations with China, both in terms of financial flows and trade flows. The US trade balance shows a clear shift away from China towards other economies, especially in Asia, Mexico, Canada and Europe. Dependencies however remain through secondary suppliers. Foreign direct investments are also falling to unprecedented lows, and divergence in growth, inflation and the conduct of monetary policy are exacerbating the pressure on the renminbi.

COP 28 – The decisive decade

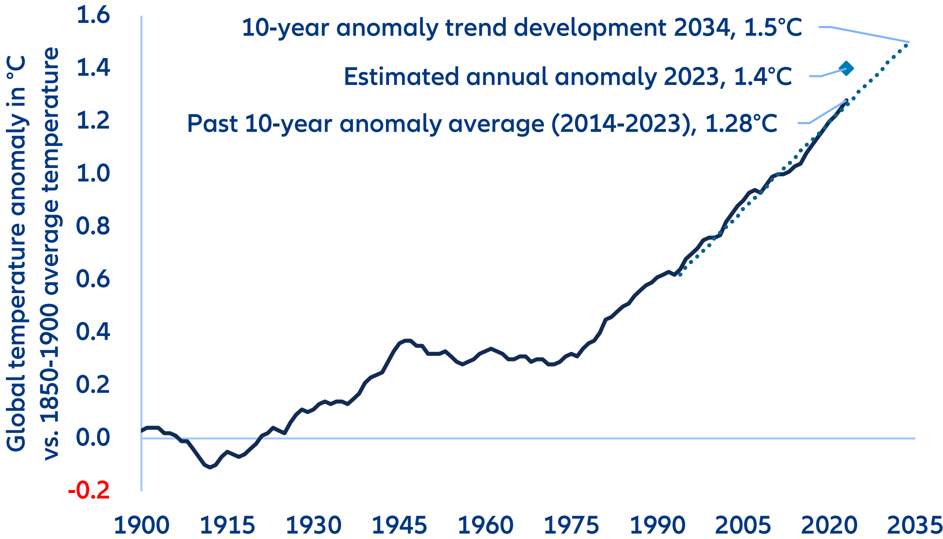
COP28 will kick off on 30 November in Dubai, with the energy transition, climate finance, climate adaptation & resilience and inclusivity at the top of the agenda. The energy transition pillar is especially ambitious, aiming to triple global renewable-energy capacity by 2030 and heavily invest in decarbonization technologies, including carbon capture and storage, and reducing methane emissions. On climate finance, a primary goal is the operationalization of the Loss and Damage Fund, established at COP27, to provide financial aid to nations grappling with the impacts of climate change. This includes finally fulfilling the promise for wealthy nations to provide USD100bn per year to poorer nations, first promised in 2010 to be fully established by 2020. For adaptation & resilience, this year's summit will focus on aiding lower-income countries in combating biodiversity loss and adopting sustainable practices. COP28 also aims to operationalize the Global Goal on Adaptation, a crucial framework from the Paris Agreement to measure countries' progress toward adapting to climate change. Finally, the UAE is also inviting youth delegates and representatives from marginalized communities, acknowledging that these groups are often underrepresented yet disproportionately affected by climate change.

Expect new protocols and agreements, in the tradition of previous COPs, but no new commitments to phase out fossil fuels. At COP28, governments will present their updated nationally determined contributions (NDCs), reflecting their commitment to limiting the global temperature increase to 1.5°C. UAE has already updated its NDC, now targeting a -40% reduction in emissions, we do not expect substantial additional pledges. This year's summit is significant as it marks the conclusion of the first global stock take - a critical evaluation of the progress made towards the commitments of the 2015 Paris Climate Change Agreement. The summit is likely to offer ambitious targets for enhancing energy efficiency, expanding renewable energy and increasing hydrogen production. But the role of fossil fuel companies at COP28 has raised concerns about their influence on the summit's outcomes. The shift towards the phrasing "phase down" of fossil fuels rather than "phase out" has sparked debate, given the urgent need for significant emission reductions.

Yet, net-zero emissions is no longer even a viable goal: The window of opportunity to achieve the 1.5°C target through mitigation alone has already closed. The global economy has made alarmingly slow progress towards achieving the promises of the Paris agreement. The pace of global warming has accelerated in the last decade, with predictions suggesting that the average global temperature for 2023 will be about 1.4°C higher than the pre-industrial average from 1850–1900. If current trends persist, the planet is on track to exceed the 1.5°C warming threshold within the next decade[1]. Given current emissions trends and a starting carbon budget of 250GtCO2 in early 2023 for staying within the 1.5°C target, the global economy would now need to cut carbon emissions by nearly -13% every year from 2025 to 2033. For context, the global pandemic in 2020 only managed to reduce carbon emissions by -7%. As a result, net-zero can no longer serve as a viable long-term goal but rather as a marker for when we need to transition into negative-emission territory. But time is running out, and incentives to promote carbon dioxide removal (CDR) technologies are only just emerging in the US and EU.

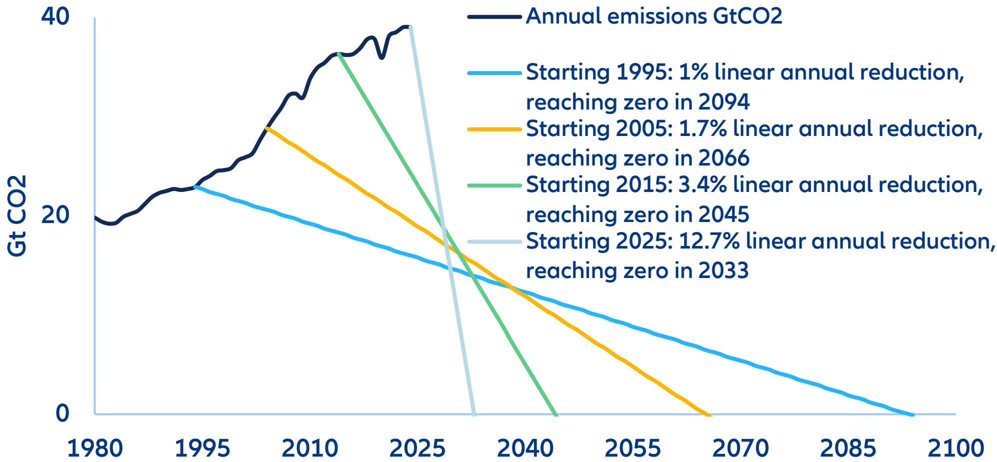
[1] The Intergovernmental Panel on Climate Change (IPCC) often uses 10- and 20-year rolling averages to gauge the Earth's surface temperature. But this approach can result in a significant delay between the IPCC's official global warming estimates and the actual average temperatures of any given year. By analyzing the warming anomalies over the past 40 years and continuously updating the rolling 10-year window with the current year at its center, we find that the IPCC's method tends to underestimate the actual warming anomaly by approximately 0.09°C. This adjustment would place the actual 10-year average global warming in 2023 at around 1.37°C, bringing the possibility of surpassing the critical 1.5°C threshold as early as 2030 into stark reality, four years earlier than with the lagged IPCC methodology.

Figure 1: Global warming trend



Sources: Berkeley Earth, Allianz Research.

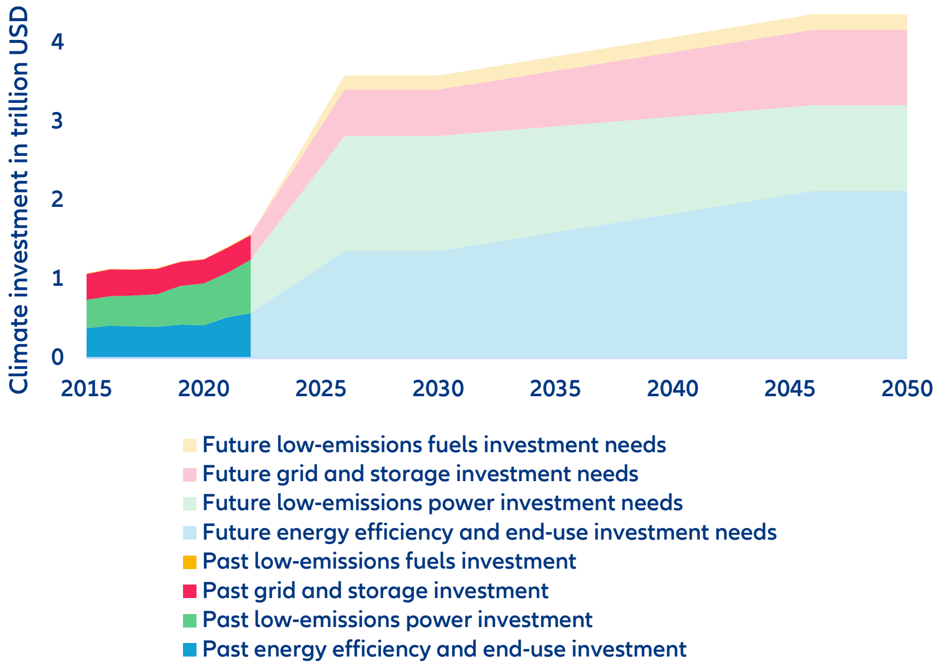
Figure 2: Past and present emission reduction pathways to limit global warming to 1.5°C



Sources: Global Carbon project, Allianz Research.

There is only one way forward: invest, invest, invest. In 2022, global climate investments reached USD1.6trn. However, they need to increase by 2.3 times to USD3.6trn by 2026, and by 2.8 times to USD4.4trn by 2046, to achieve the 1.5°C target (Figure 3), according to the International Energy Agency (IEA). However, the Climate Policy Initiative (CPI) identifies investment needs to exceed USD10trn by 2031, with a cumulative total from 2022 to 2050 nearing USD280trn. Considering the goal to reduce current total greenhouse-gas emissions of 53GtCO2e to about -3GtCO2e by 2050, this implies a staggering investment need of approximately USD5,000 per ton of annual CO2 emissions. Without applying any discount and disregarding impacts on operational costs, while assuming a social cost of carbon at USD200 per ton of CO2e, this level of investment would become financially viable after 25 years. However, the tendency to discount the value of these investments for future generations poses a significant challenge, making such large-scale financial commitments less appealing , given the focus on immediate returns.

Figure 3: Investment needs for limiting global warming to 1.5°C

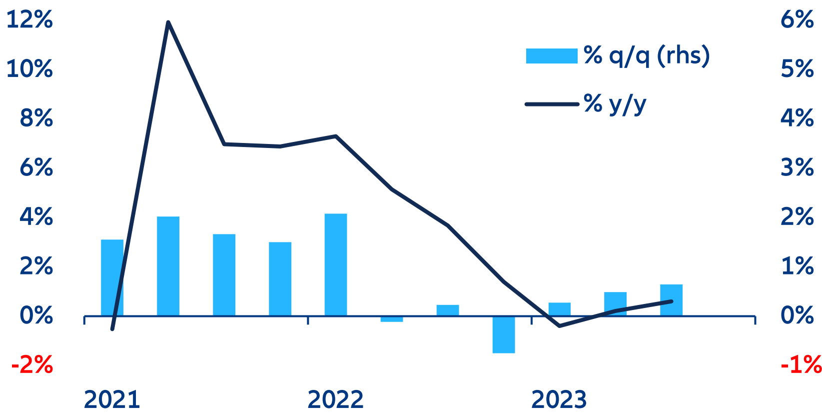


Source: IEA (2023 update NZE2050 and World Energy Investment), Allianz Research.

Central and Eastern Europe – opportunity time?

Regional growth in Central and Eastern Europe (CEE) appears to have bottomed out although the recovery in 2024 is likely to be mild. Preliminary estimates of real Q3 GDP growth showed a mixed performance across economies, but the worst seems to be over for the region as a whole. The weighted average real GDP growth of the 11 EU member states in the region (CEE-EU-11) improved to +0.6% q/q in Q3 from +0.5% in Q2 and +0.3% in Q1 2023. And seasonally-adjusted year-on-year regional growth strengthened to +0.6% in Q3 after +0.2% in Q2 and -0.4% in Q1 (Figure 4). Monthly activity data suggest that retail sales and industrial production have also bottomed out in large parts of the region. Overall, we expect this gradual upward trend in GDP to continue and forecast annual regional growth of around +0.5% in 2023 (after +4.0% in 2022) and +2.1% in 2024. Several factors support our outlook, although downside risks should not be underestimated.

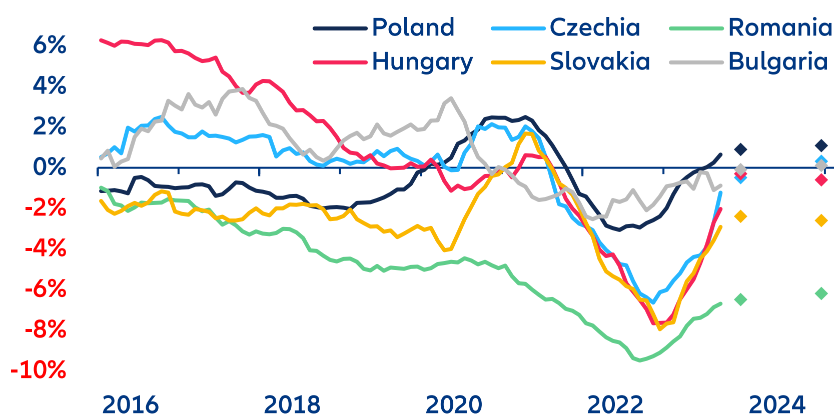
Figure 4: CEE-EU-11 – quarterly real GDP growth



Sources: National statistics, Refinitiv Datastream, Allianz Research.

The unwinding of current account imbalances will reduce vulnerability to systemic shocks that may impact financing flows. All economies in the CEE-EU-11 region – in particular Czechia, Romania, Hungary and Slovakia – experienced rising current account deficits in 2022 as a result of then surging (import) prices for energy and food, for which the region is a net importer. However, the external shortfalls have rapidly narrowed in 2023 in most of the region, mostly owing to lower energy import prices and declining imports due to the economic downturn, and in part thanks to the start of governments' energy-transition plans[2]. We forecast moderate annual current account deficits or surpluses for most CEE economies in 2023-2024. The notable exception is Romania, where large external financial inflows and high government deficits are likely to keep the external deficit above -6% of GDP in the next two years (Figure 5). Romania's current account shortfall already began to rise one year before the global energy-price surge but it has been largely covered by net foreign direct investment (FDI) and portfolio investment inflows since then. The country's foreign exchange (FX) reserves have actually increased since end-2020. However, the coverage of the external deficit by net FDI inflows has recently fallen to just one third. This poses a risk of a balance-of-payments crisis in Romania in the event of a systemic shock that would result in the reversal of portfolio investment inflows, which are usually short term in nature.

Figure 5: Current account balance (% of GDP, rolling 12 months)



Sources: Refinitiv Datastream, Allianz Research. Note: The dots are Allianz Research year-end forecasts.

Lower inflation and falling interest rates should support a recovery in domestic demand in CEE over the coming quarters. After peaking in late 2022 or early 2023 in the CEE-EU-11 countries, headline consumer price inflation has rapidly retreated in the course of 2023 (Figure 6a). And since core inflation has also declined, albeit with a slight lag (Figure 6b), we expect continued disinflation in 2024. That said, in October 2023, the downtrend in the headline figure ended (temporarily) in Czechia and Estonia. Although this was entirely driven by base effects due to the introduction of energy price subsidies last year, it indicates that the pace of disinflation is likely to slow down markedly in the coming months across the whole region as similar measures are also set to expire elsewhere. Overall, we forecast headline inflation to remain above central bank targets in 2024. Nonetheless, the central banks of Poland and Hungary embarked on a monetary easing cycle in September and October 2023, respectively, in response to falling inflation. The central banks of Czechia and Romania have remained more hawkish and their comments suggest that interest rates could be kept on hold until inflation eases more substantially. We expect them to pivot at some point in the first half of 2024. By the end of next year, all central banks in the region are expected to have cut their policy rates to the range of 4.00% to 5.00%, which should support the mild recovery in consumer and capital spending.

[2] See also What to Watch 13 July 2023, p.4-6.

Figure 6a: Consumer price inflation (% y/y)

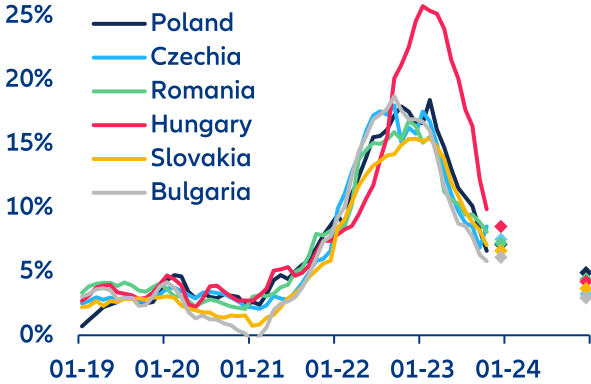
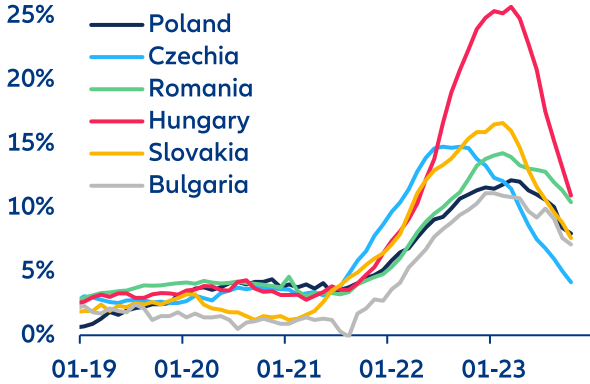


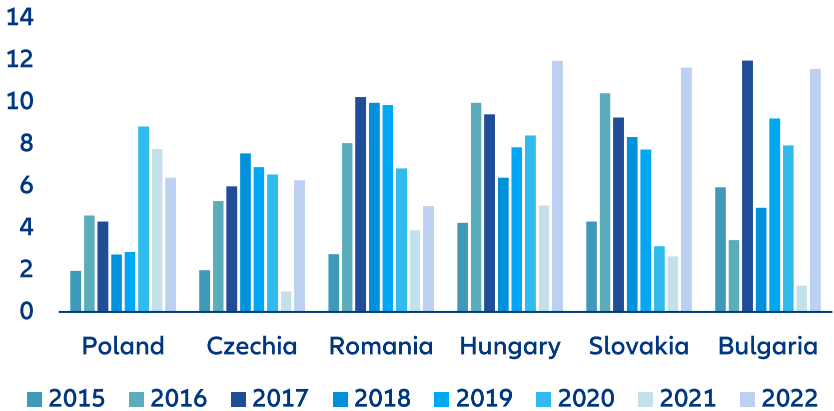
Figure 6b: Core inflation (% y/y)



Sources: Eurostat, Refinitiv Datastream, Allianz Research. Note: The dots are Allianz Research year-end forecasts.

Strong wage growth in CEE is a moderate upside risk to inflation, in particular in Hungary, Slovakia and Bulgaria. As employees and trade unions have successfully fought for substantial wage increases amid surging inflation, nominal wage growth has markedly risen in CEE countries over 2022-2023. Except for Czechia, it was well in double digits across the whole region in Q3 2023. And since consumer price inflation has come down, real wage growth has returned to positive territory in the meantime. On the one hand, this provides further support to consumer spending and thus growth. On the other hand, if strong wage growth is well above productivity growth, it entails the risk of a wage-price loop, which could disrupt the disinflation process. Figure 7 shows the annual differences between average nominal wage growth and productivity growth in six major CEE economies over the last eight years. In 2022, the difference grew markedly over 2021, except for Poland. However, the 2022 difference was not much higher in the case of Czechia and even lower in the case of Romania when compared to the average of the previous seven years, during which they did not trigger rising inflation. As a result, we conclude that the risk of a wage-price loop is comparatively low in Poland, Czechia and Romania. The picture is a bit different for Hungary, Slovakia and Bulgaria, where the differences between nominal wage and productivity growth marked record or near-record highs of close to 12pps in 2022. Here policymakers should take particular care to normalize wage growth in the coming years to bring it back in line with lower inflation and productivity growth, otherwise an emerging wage-price loop cannot be ruled out.

Figure 7: Difference between nominal wage and productivity growth (pp)



Sources: Eurostat, Allianz Research

Exchange rate risk will be moderate in 2024 in most of CEE, though it is a potential upside risk to inflation in Romania if currently strong portfolio inflows are disrupted by a systemic shock. CEE currencies have been volatile in 2023 but fared relatively well overall. The Polish zloty (PLN) and the Hungarian forint (HUF) in particular have strengthened against the euro (EUR) this year. The Czech koruna (CZK) also gained versus the EUR in the first half of 2023 but has lost these gains in the second half. Meanwhile, the Romanian leu (RON) has been kept stable against the EUR through continued FX interventions when necessary (Figure 8a). A look at the development of the real effective exchange rates based on producer price indices (PPI) since end-2021 (i.e. covering the downturn period) indicates that the PLN and the HUF are currently not overvalued (Figure 8b). This may have supported the central banks of Poland and Hungary in their recent decisions to begin monetary easing. In contrast, the CZK and the RON appear somewhat overvalued at the moment. In the case of Czechia, however, we do not expect a sharp or disruptive currency depreciation, given the expected shift to a current account surplus in 2024 as well as ample FX reserves (covering around 130% of maturing short-term external debt) that would allow the central bank to defend the CZK if needed. The position of Romania is somewhat weaker. The current account deficit is forecast to remain large in 2024 (Figure 5) and is to a large extent covered only by short-term portfolio inflows, while FX reserves cover less than 90% of the maturing short-term external debt. In the absence of a systemic (external) shock, this should not be problematic and the Romanian central bank should be able to keep the RON stable. However, if such a shock occurs and leads to capital outflows from Romania, the RON could come under pressure and inflation might rise again. Economic policies in Romania should focus more on reducing this vulnerability, for example through targeted fiscal consolidation.

Figure 8a: Currency movements versus the EUR (31 Dec 2021 = 100)

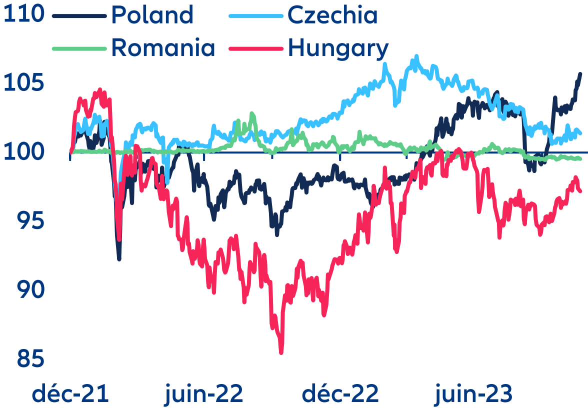
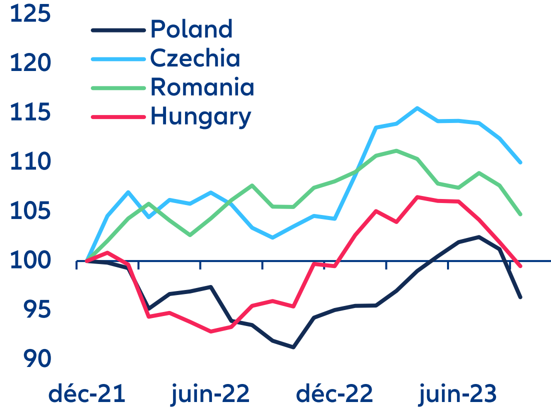


Figure 8b: PPI-based real effective exchange rate (Dec 2021 = 100)

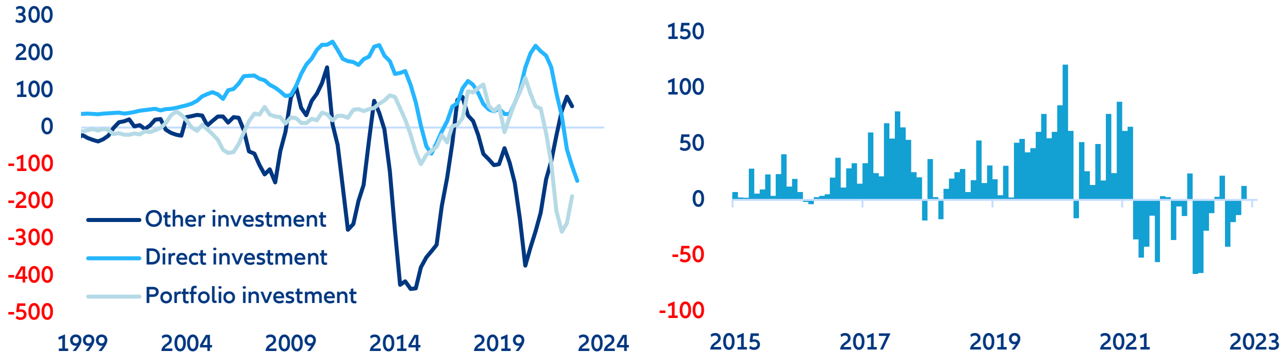


Sources: LSEG Datastream, Allianz Research.

Emerging market winners from decoupling efforts with China

China is facing the perfect storm of economic headwinds and decoupling efforts. Low interest rates and an economic slowdown would hurt any country's financial account, but China is being hit harder because of the West's stumbling efforts to de-couple one day, or de-risk another. The worsening business climate (especially for foreign investors), less attractive returns as the economy slows and Western companies' explicit supply chain de-risking strategies have sparked one of the worst recorded declines in foreign direct investments. While the portfolio account has been registering outflows since the 2021 government crackdowns on various sectors, the sharp decline in the direct investment account is even more telling as it has taken place at the same time that the country reopened to the world (Figure 9, lhs). And it is not only real estate developers' debt that has lost its luster: Chinese sovereign bonds (which offer a similar yield as the Bund) are also facing their own challenges and have become hardly attractive to foreign investors (Figure 9, rhs). This situation is ramping up the pressure, especially on local governments struggling with the ongoing property crisis, which could really use the relief from foreign inflows.

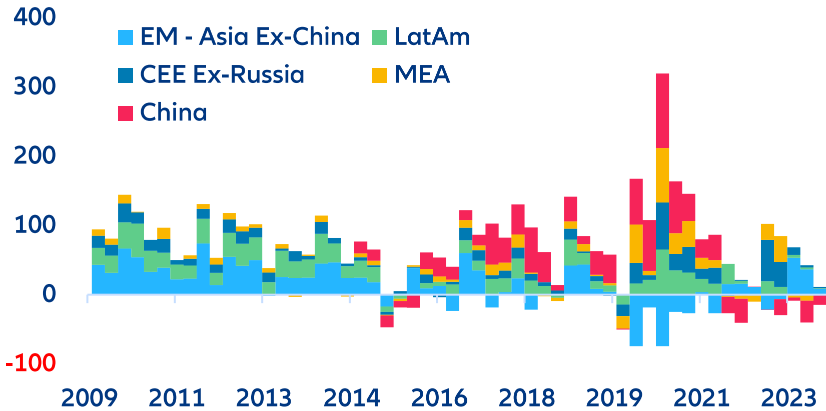
Figure 9: Financial accounts of China. 12M rolling, USD$ (left), changes in the China treasury bonds held by external institutions (right)



Sources: LSEG Datastream, Bloomberg, PBoC, Allianz Research.

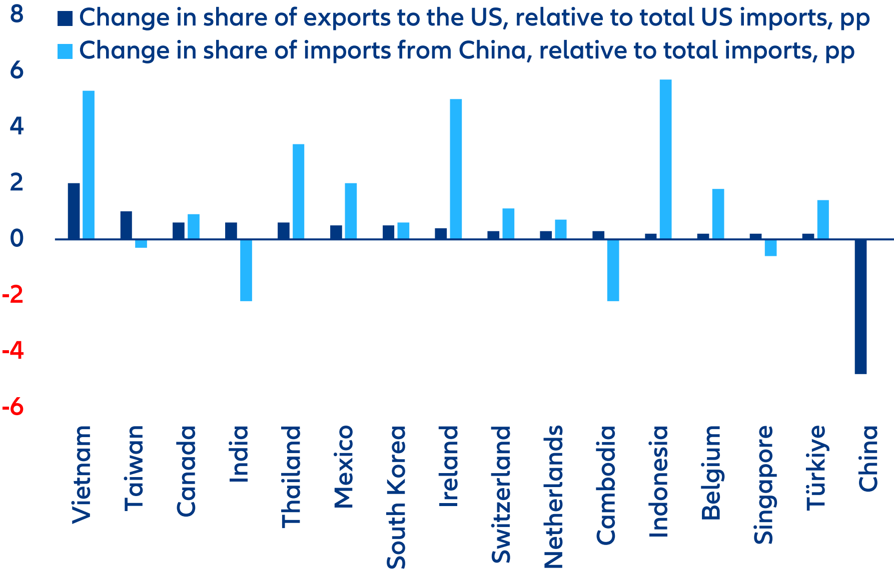
Other emerging markets are reaping the benefits – both in terms of financial flows and trade flows. If China had maintained its allure for foreign investors, the effects of the global monetary policy tightening could have been much worse for other emerging markets. Instead, unlike China, other major EMs have recovered at least part of the bond and equity return losses recorded in 2022. And although they have also been affected by tighter access to capital markets, they have managed the wave better (Figure 10). At the same time, looking at the US trade deficit shows a clear shift away from China towards other economies, especially in Asia, Mexico, Canada and Europe – despite the higher cost. In the second quarter of 2023, the total US trade deficit widened to -3.1% of GDP (+0.3pp from the previous quarter). Asia-Pacific excluding China and India accounted for the largest share, representing more than one-third of the US trade deficit (-1.1% of GDP), followed by China (-0.9% of GDP) and Mexico (-0.6% of GDP). Looking at the period between the first quarter of 2018 and the second quarter of 2023, we find that the US trade deficit with China narrowed by +0.7pp, while the trade deficit with the Asia-Pacific widened by -0.6pp, with Mexico by -0.3pp and with Canada by -0.2pp. This is also consistent with the fact that between 2017 and 2022, the share of US imports from China declined by close to -5pp to 17.1% of total imports, while those from Vietnam (+2pp to 4%), Taiwan (+1pp to 2.8%), Canada , India, Thailand (+0.6pp each to 13.3%, 2.7% and 1.9%, respectively) and Mexico (+0.5pp to 13.6%) increased (Figure 11), broadly offsetting the share lost by Chinese imports.

Figure 10: Quarterly portfolio flows by region



Sources: IIF, Allianz Research. Monthly data aggregated by quarter, last available datapoint Q4 2023 contains only October, so magnitude not comparable.

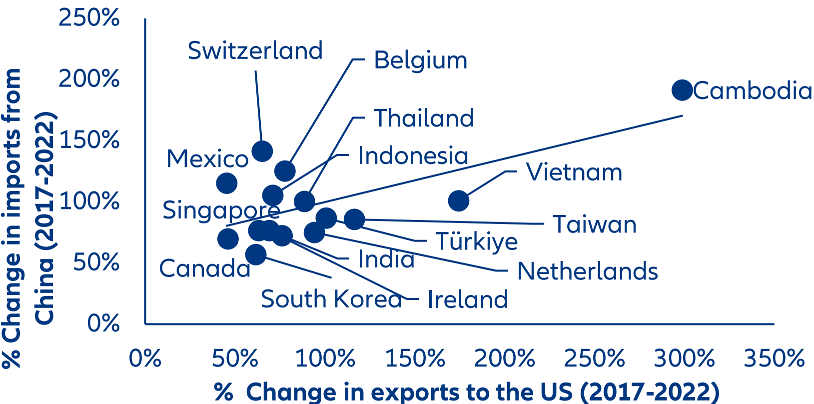
Figure 11: Key US trade partners have broadly increased their reliance on China between 2017-2022



Sources: ITC, Allianz Research.

However, a complete US decoupling from China is not on the cards: Inter-linkages in the global supply chain still keep the US exposed to China as an end supplier. The US may have shuffled its main trade partners in the Asia-Pacific region, but imports from China account for the largest share of total imports in Asian emerging economies (e.g. close to 35%, 33% and 23% in Cambodia, Vietnam and Thailand, respectively). Moreover, the economies that increased their market share of total imports in the US also increased their own shares of Chinese imports (Figure 11). A closer look at the growth in trade patterns of these economies reveals a positive correlation between the growth in exports from these countries to the US and a growth in imports by these countries from China (Figure 12). This underscores the fact that the though US has successfully reduced its 'direct dependence' on China, it is still indirectly buying its wares.

Figure 12: Change in exports to the US and imports from China between 2017 and 2022, %



Sources: LSEG Datastream, Allianz Research.

The Chinese renminbi is also feeling the heat of monetary divergence. The resilience of the US economy, the interest-rate differential and the deterioration of the business climate all play in favor of the USD. We note that since the phase of greater flexibility and depreciation observed in 2015-2016, the USDCNY pair has reached 7 (Figure 13, left), a level that has become a sort of psychological barrier, with markets paying extra attention to any trading above this barrier. Figure 13 (right) shows that much of the renminbi appreciation since the re-opening after Covid-19 lockdowns last October has eroded due to poor economic performance and the rate cuts in August. This has brought the USDCNY pair very close to 7.32, the lowest level in 16 years. Should the currency fall further below this

level, it could have a major impact on the markets and capital outflows. But going above would have major consequences for the economy, which we think the Chinese government would like to avoid in the current situation. In fact, on 01 September, the government decided to cut the foreign exchange reserve requirement ratio for all financial institutions by 2pps, from 6% to 4%, possibly a measure to reduce the need for dollars. Since August, the government has also been trying to reaffirm its commitment to currency stability, which has allowed the USDCNY to range-bound around 7.20-7.32, a level we expect to continue in the coming months.

Figure 13: USDCNY long (left) and short (right) windows

Sources: LSEG Datastream, Allianz Research. Higher values imply a depreciation of the yuan. Note that we can observe at least six phases for the CNY over the past two decades: 1) 2000 - 2005: fixed regime; 2) 2005 - 2007: strong appreciation (around 18%) (moving out of the fixed regime in 2005); 3) 2007 - 2009: stability around 6.80; 4) 2010 - 2013: strong appreciation; 5) 2015 - 2016: attempt to increase flexibility (large depreciation of 12% in 2015 and the currency again traded close to the 7 level) and 6) 2017 - now: Since the last phase, the USDCNY 7 level has become a kind of psychological barrier for the markets.

These assessments are, as always, subject to the disclaimer provided below.

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