CitiFX | Corporate Solutions Group

Market commentary | October 2013

Emerging Markets: Is The Crisis Over?

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Contents

Summary

Tradable currencies: is the crisis over?

- Yes – for most currencies in both the short- and medium-term
- This does not mean that currencies cannot depreciate further – some will in the normal turn of events
- But a few are still at risk – most obviously the Turkish lira
- Appreciation for the Chinese renminbi & a number of other Asian currencies

Why did currencies rebound?

- Global factors – the Fed, China etc.
- Central bank signals – rather than intervention or tighter monetary policy per se

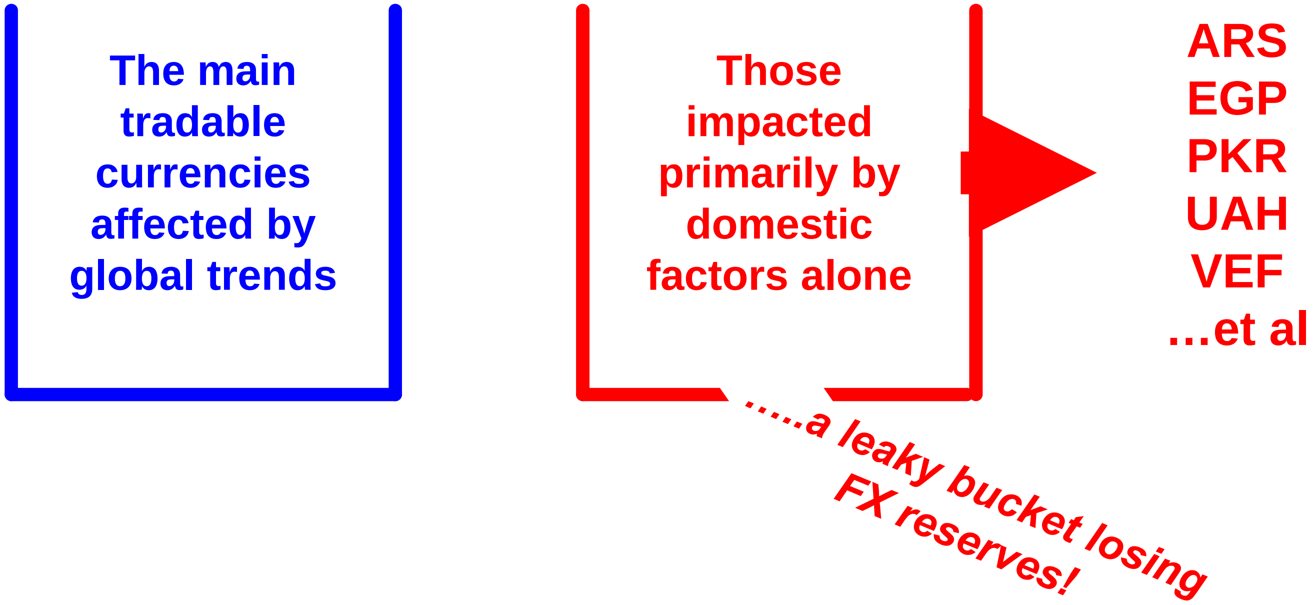
Summary

Non-tradable currencies: more problems ahead?

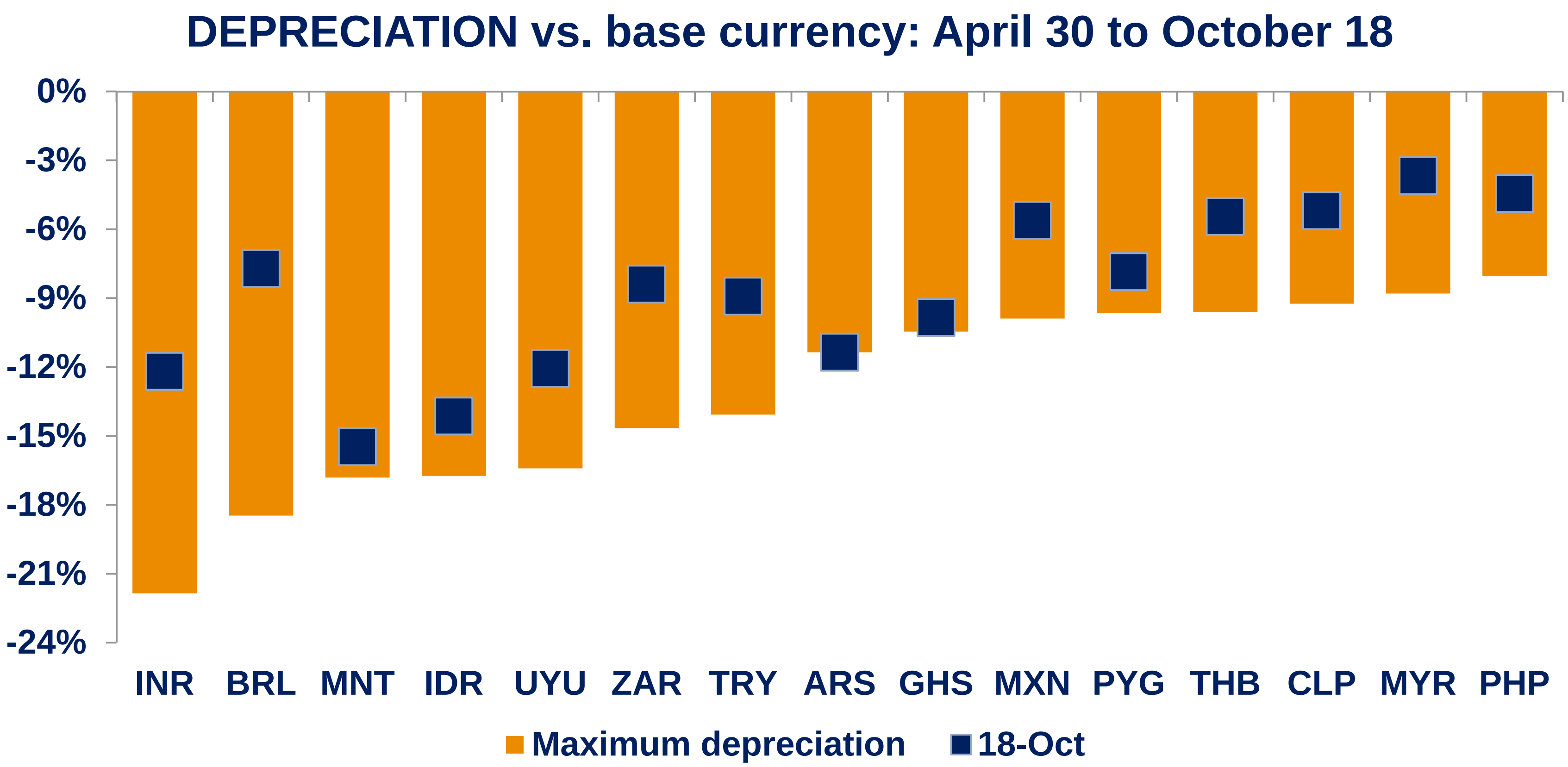
- The obvious candidates: Argentine peso, Egyptian pound, Pakistani rupee, Ukrainian hryvnia, Venezuelan bolivar
- A number of smaller currencies?

Summary

- **Two buckets……..**

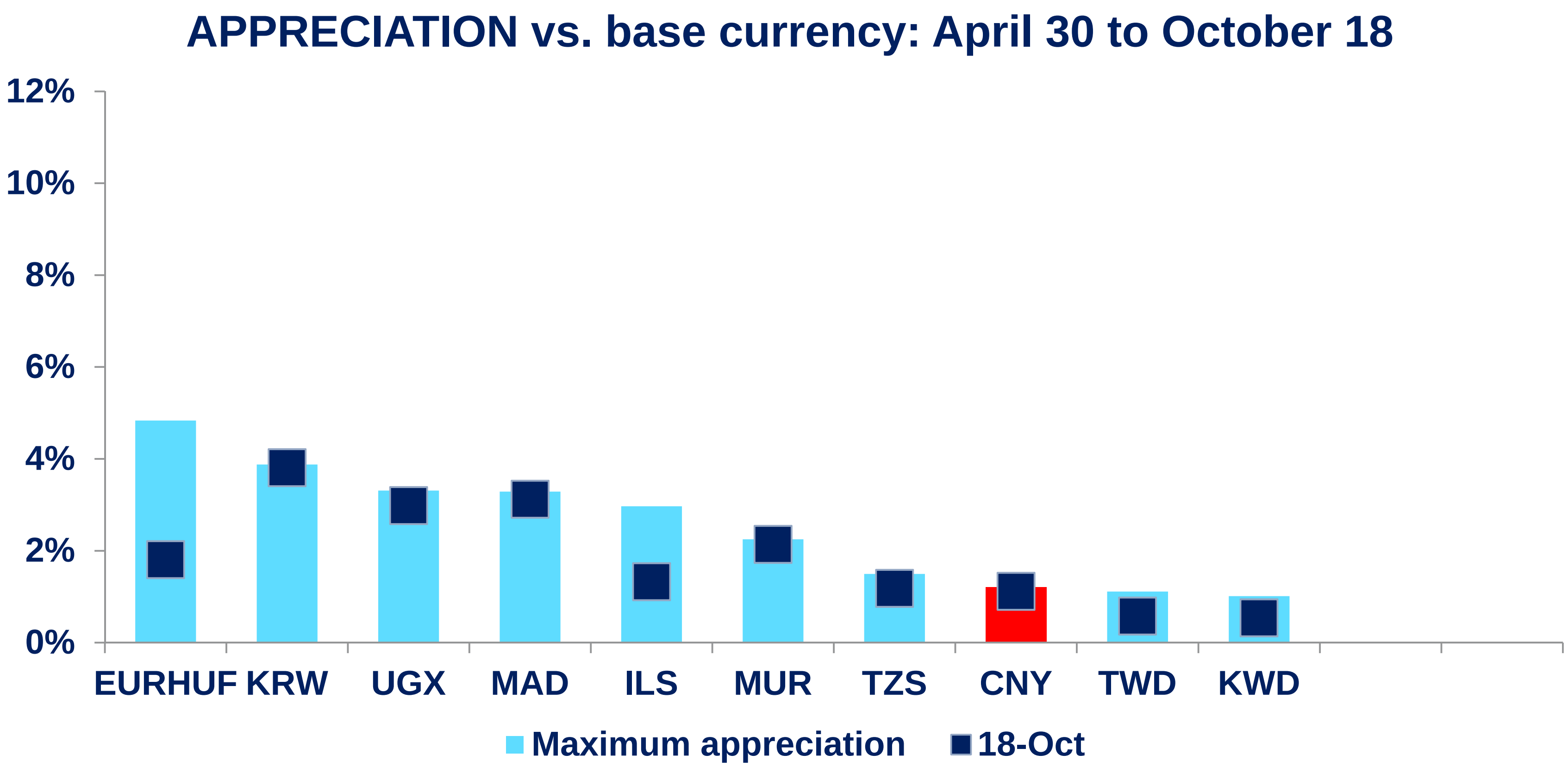


Summary



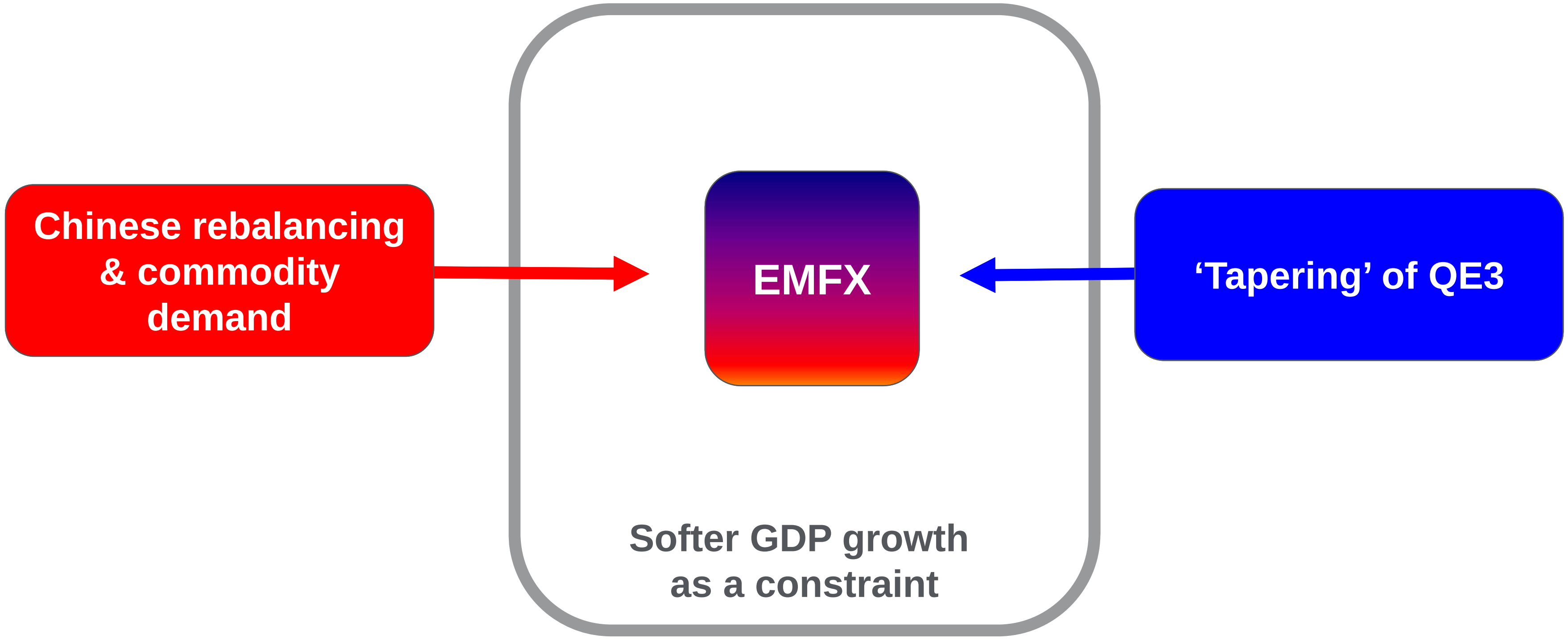
Source: Reuters, own database

Summary

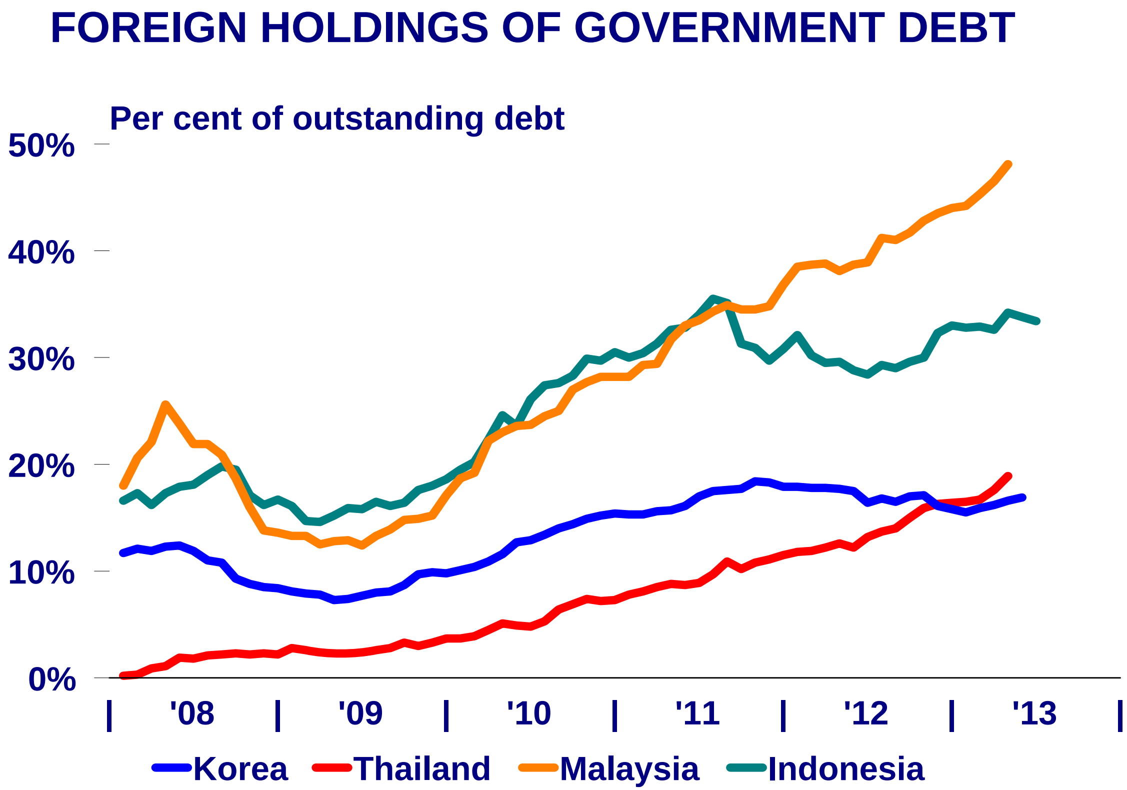


Source: Reuters, own database

Themes


Chinese rebalancing & commodity demand
EMFX
'Tapering' of QE3
Softer GDP growth as a constraint

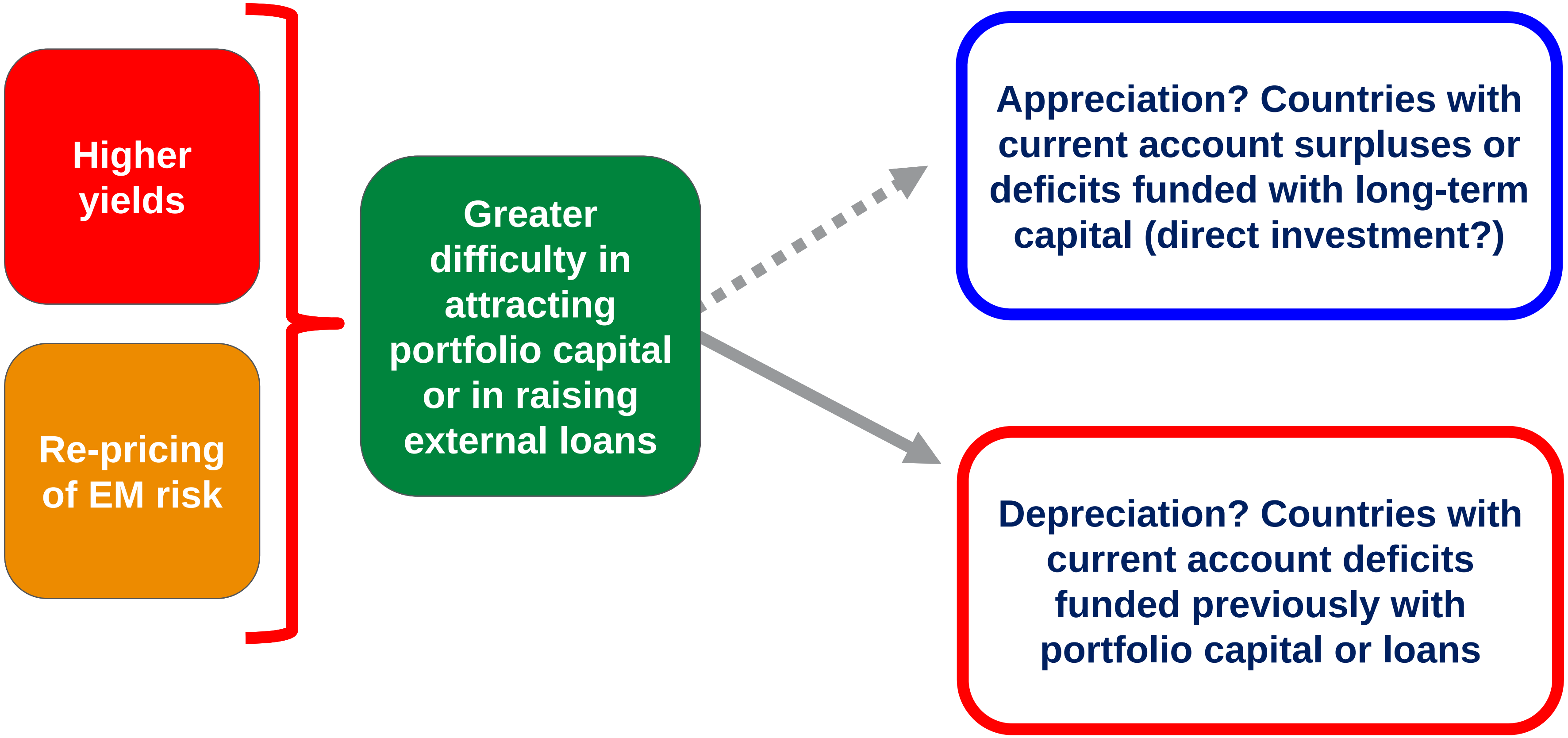
Themes



- Malaysia: not a risk of a 'sudden stop'; rather the risk of outflows

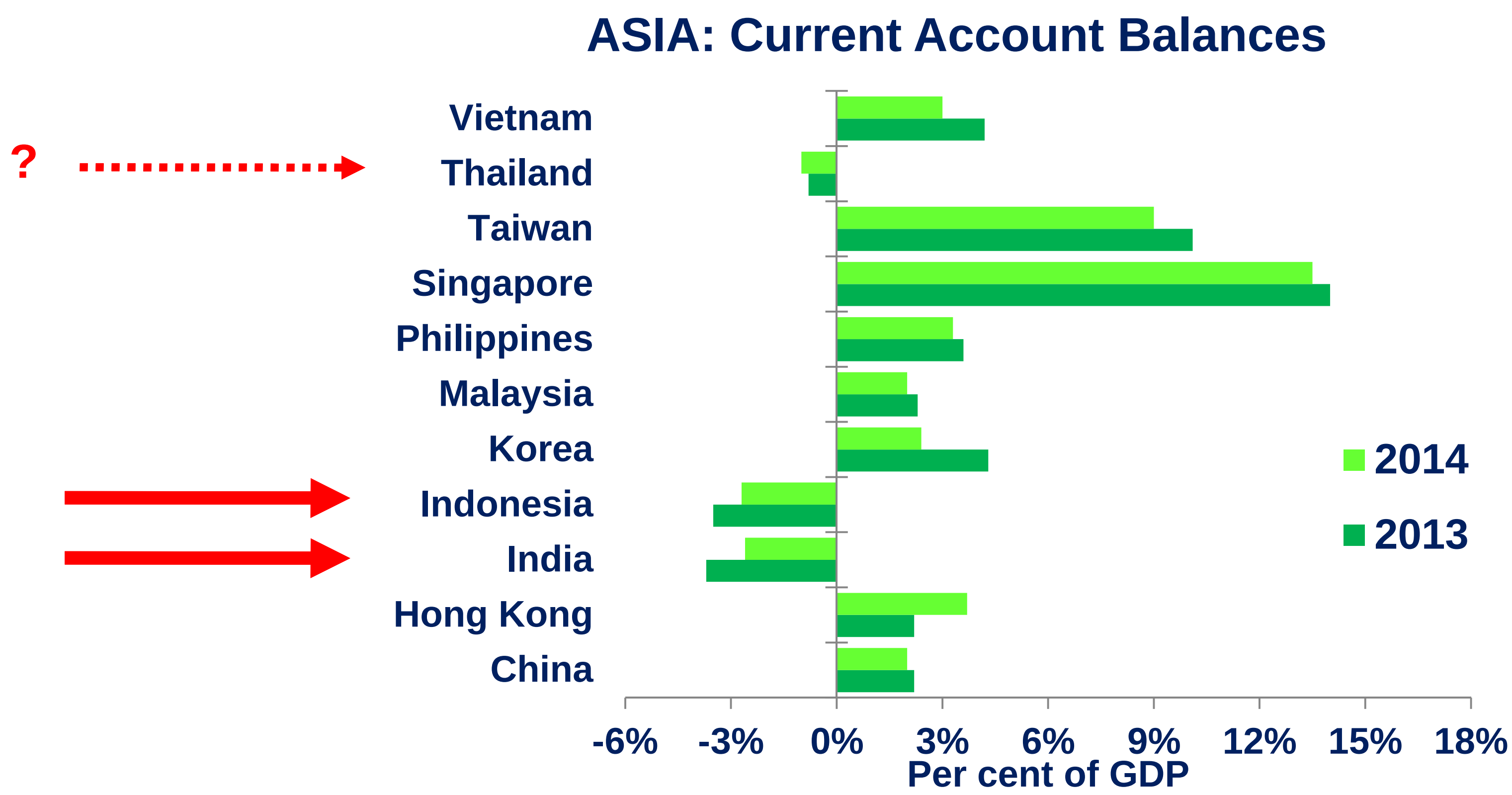
Source: Citi Asia Macro View, June 14, 2013

Themes



The (supposedly) longer-term issue……………..

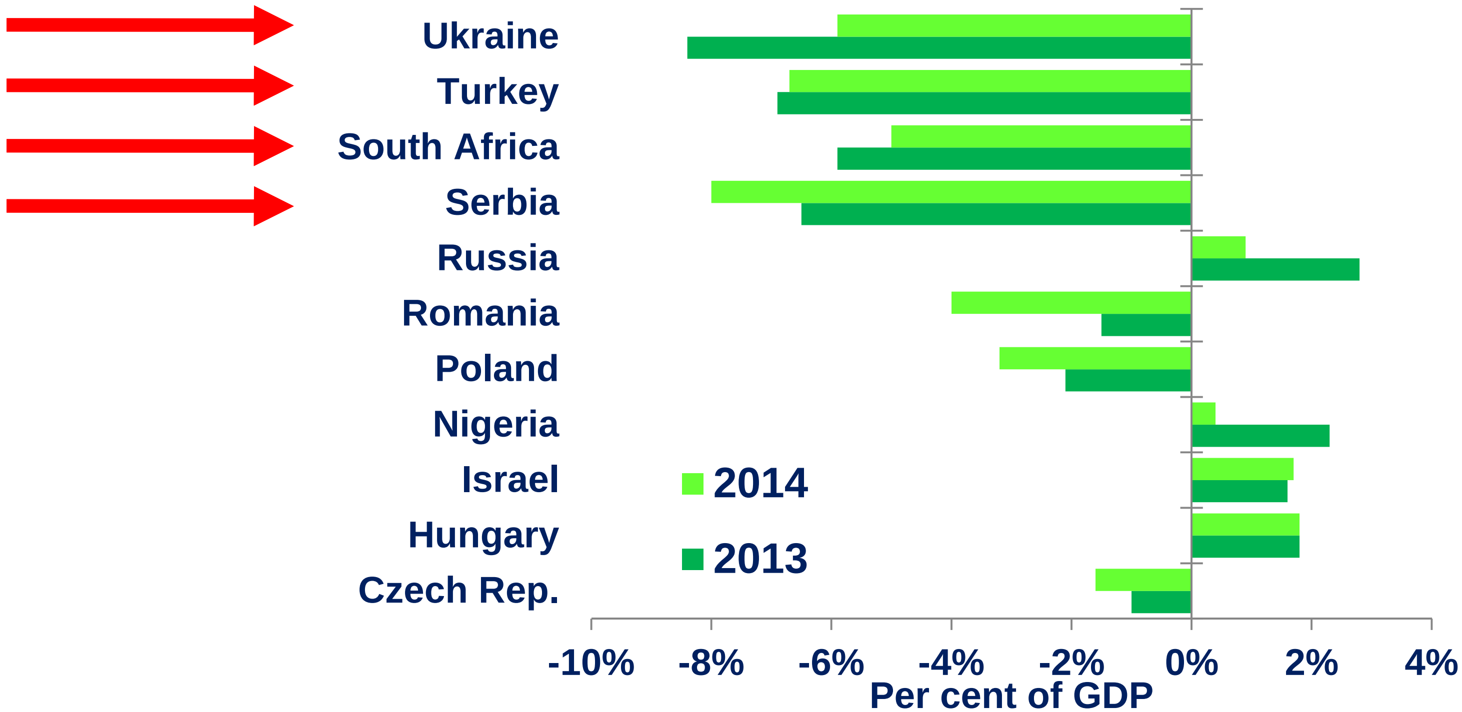
Themes



Source: Citi Global Economic Outlook & Strategy, September 2013

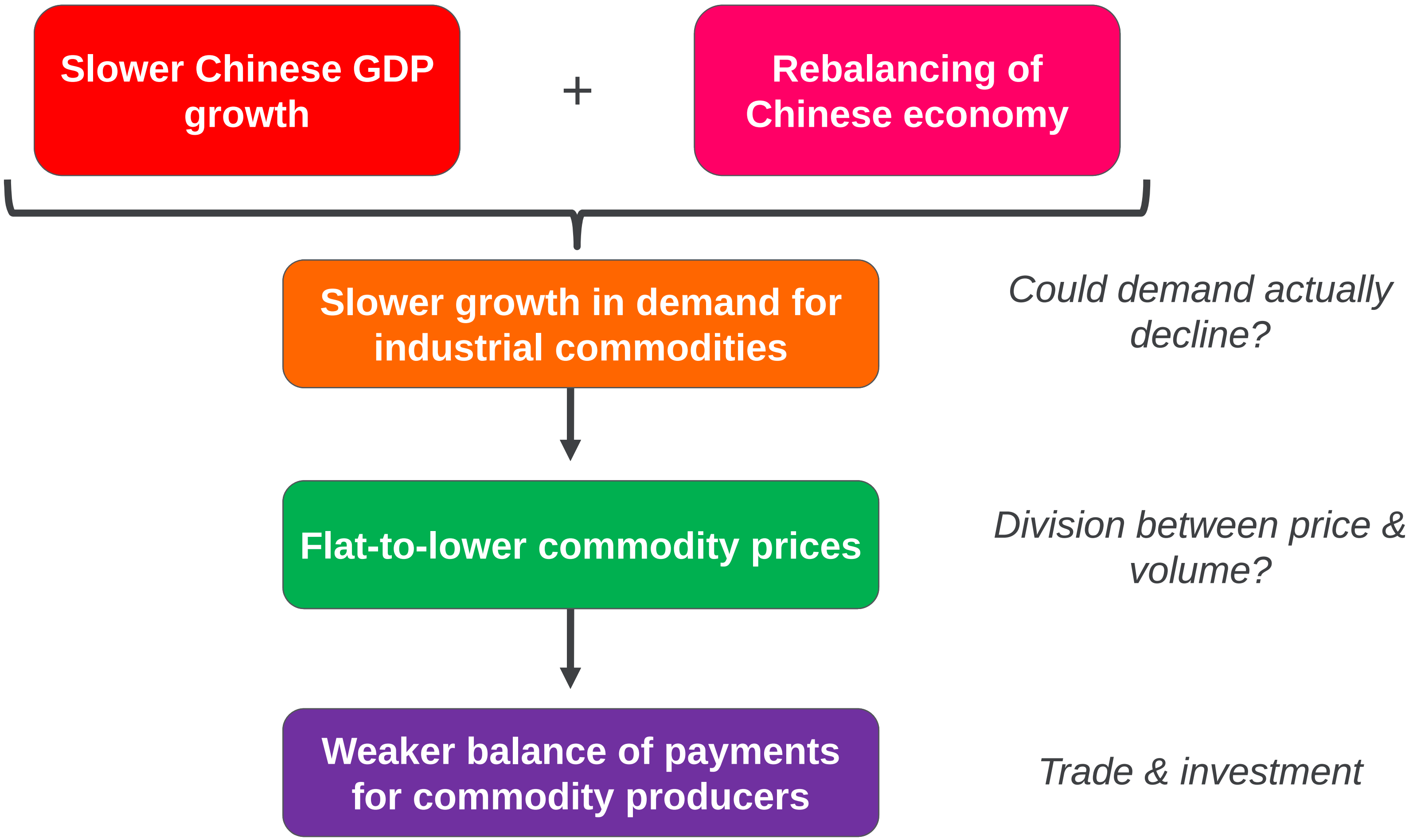
Themes

CEEMEA: Current Account Balances



Source: Citi Global Economic Outlook & Strategy, September 2013

Themes

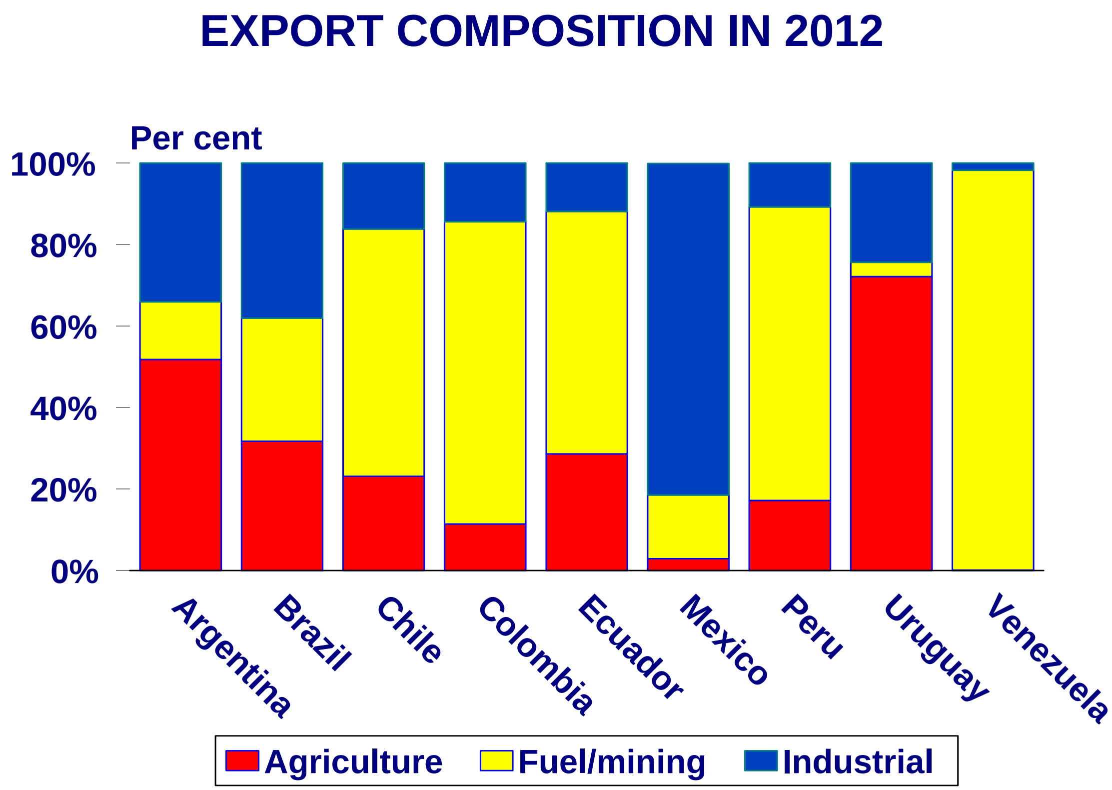

Slower Chinese GDP growth
+
Rebalancing of Chinese economy
Slower growth in demand for industrial commodities
Could demand actually decline?
Flat-to-lower commodity prices
Division between price & volume?
Weaker balance of payments for commodity producers
Trade & investment

Themes

- **Official target = 7.5%....**
- **….or is it really 7.0%?**
- **Caveat: 7.5% growth adds as much GDP as 11.5% just five years ago**

Source: Bloomberg for history, Citi Global Economic Outlook & Strategy September 2013

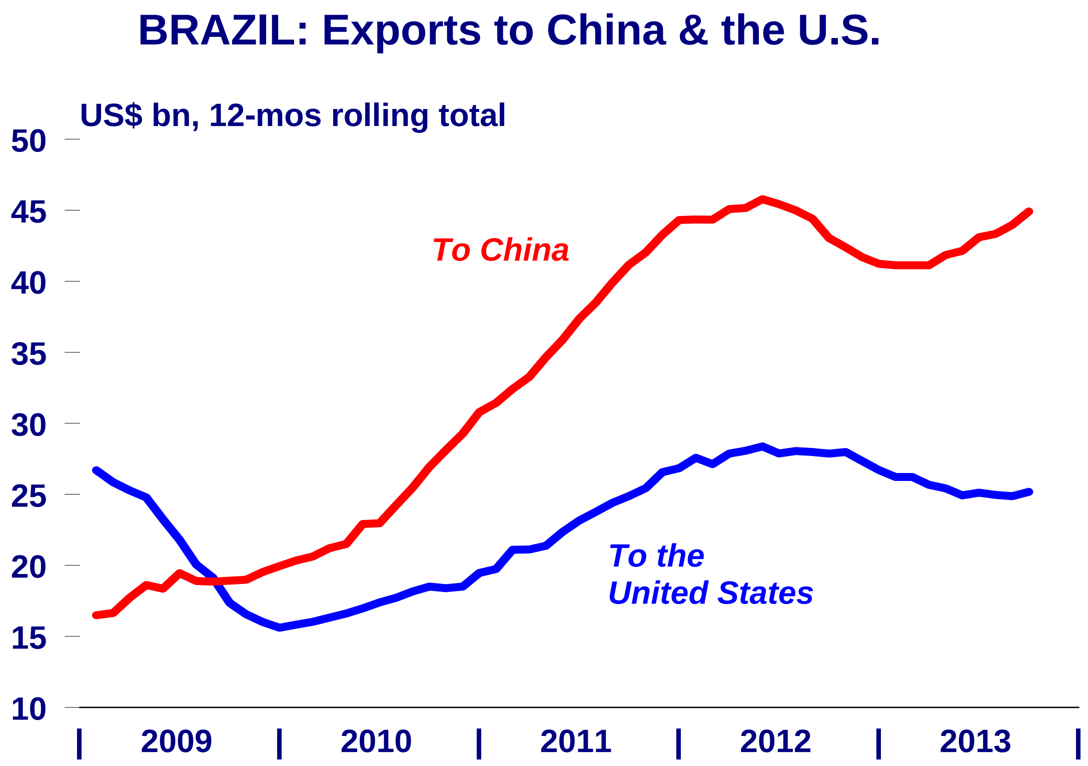
Themes



- **Mexico is the standout in terms of a low exposure to commodity exports and thus to China**

Source: IIF, Latin America, Call of the Yield, March 2013; own calculations

Themes



- Not as exposed to commodities as some, but China is by far its largest single export market

Source: Bloomberg, own calculations

Themes

‘Tapering’ of QE3

Large unfunded current a/c deficits

+

China

+

Local factors

+

Economic ‘soft patch’

SOUTH AFRICA

Current a/c deficit about US$24 bn

FDI less than US$1.3 bn

Dependence on commodity exports

Continuing labor unrest

Extremely large real wage increases

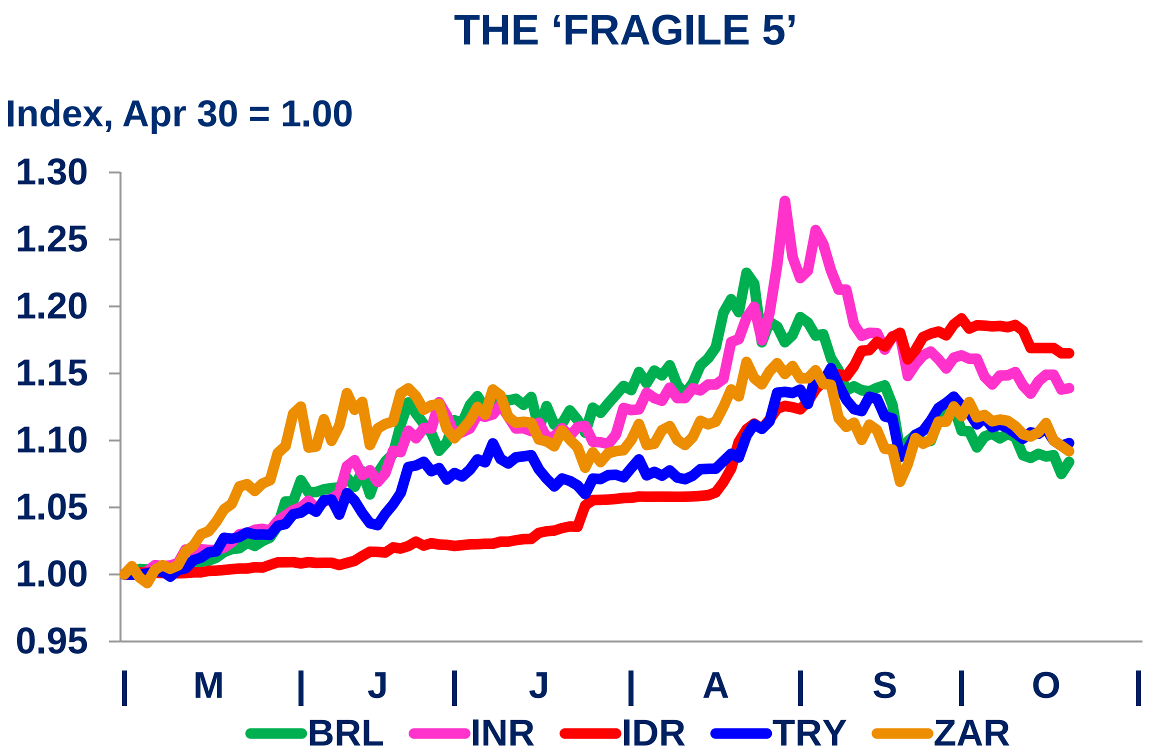
Sluggish growth = no rate increases

Longer-term political concerns

Large depreciation of the rand

Extreme volatility

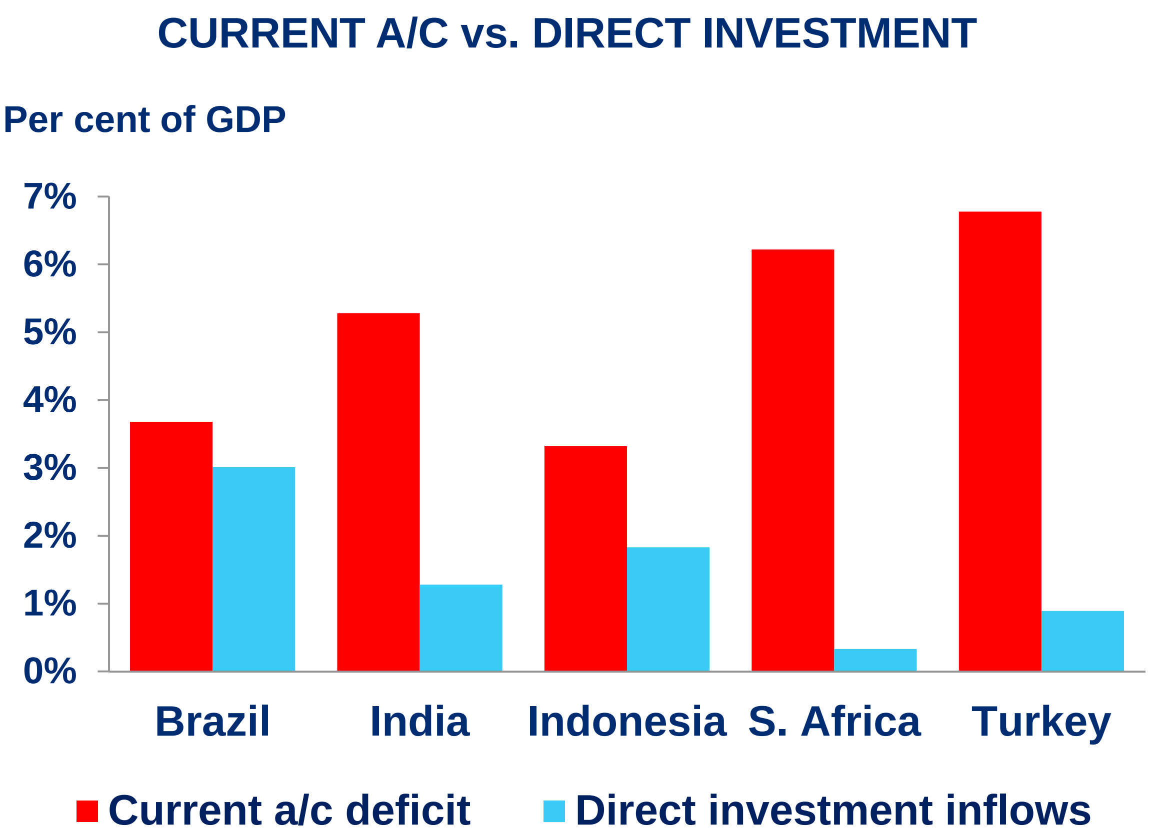
The 'Fragile 5'



- Starting point: May 1 when U.S. 10-year yields reached their low

Source: Reuters, own database

The 'Fragile 5'



Source: various central banks

- **Based on the most recent data**
- **India, South Africa & Turkey have large financing gaps = risk of sustained FX pressure**
- **Brazil has a small gap that can easily be filled by reserves – if necessary**

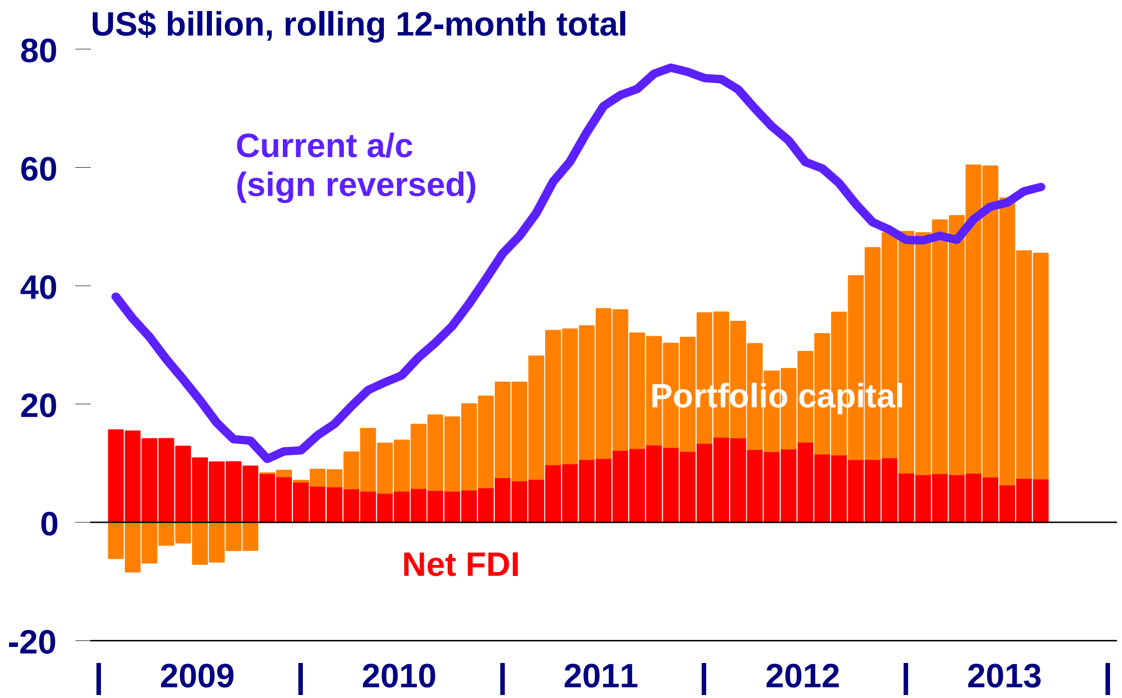
The ‘Fragile 5’

Risk factors

	Large financing gap?	Over- or under-valued?	Political constraints on policy
Brazil	No	Over-	Yes
India	Yes	Under-	Yes
Indonesia	Yes?	OK	Yes
South Africa	Yes	OK	?
Turkey	Yes	Over-	?

The ‘Fragile 5’

TURKEY: Current a/c vs. Capital a/c

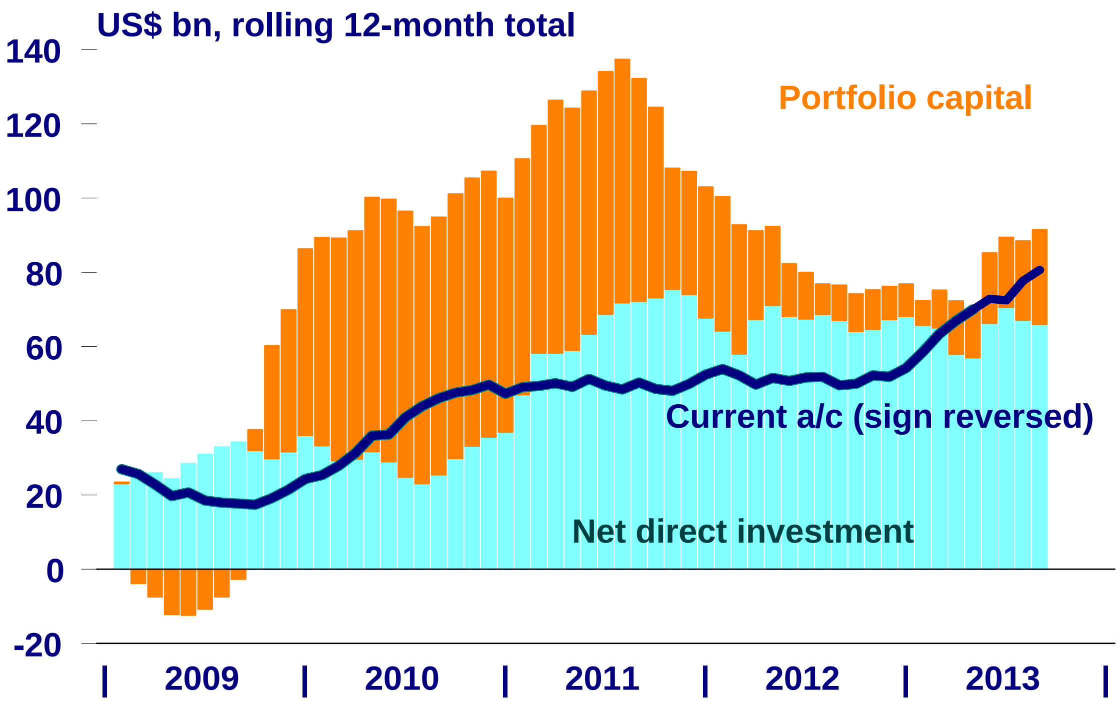


- **The Turkish government forecasts a current a/c deficit of 7.1% of GDP in 2013, falling to 5.5% by 2016**
- **Too slow & not enough**

Source: Central Bank of Turkey

The ‘Fragile 5’

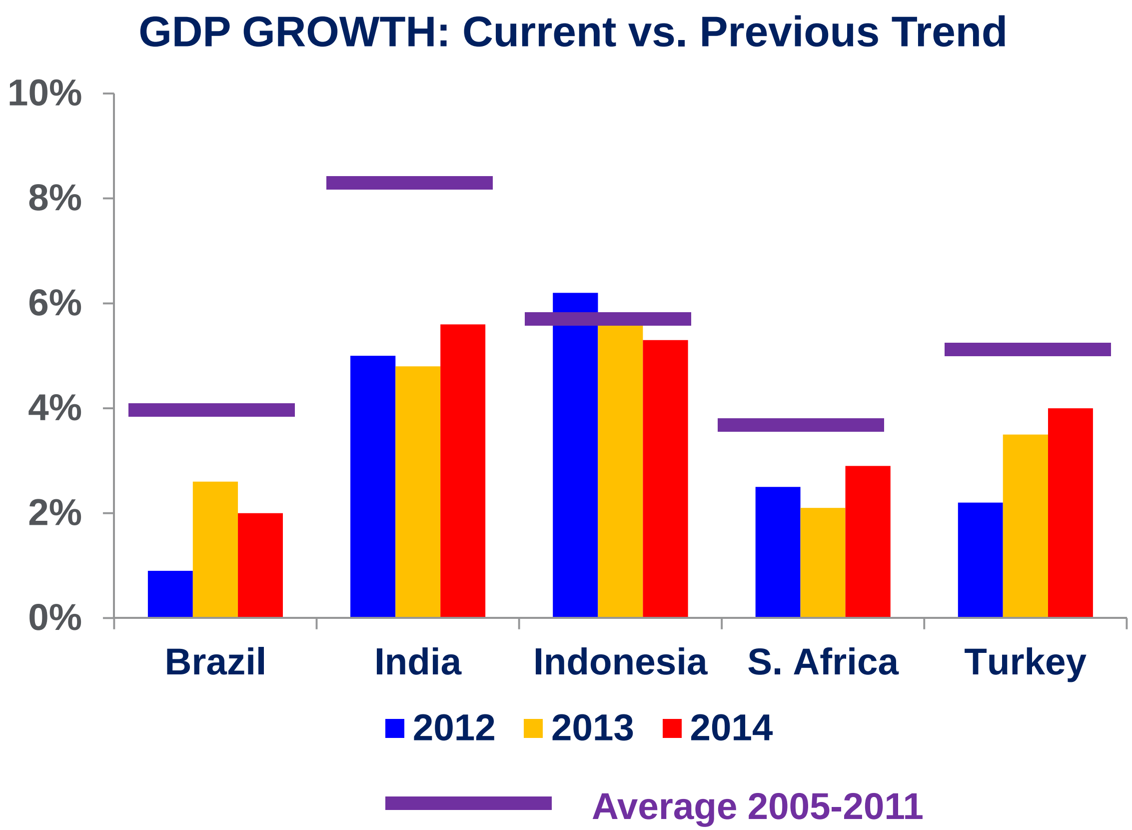
BRAZIL: Current a/c vs. Capital a/c



- **Current account deficit still being covered**
- **Can FDI be sustained in a period of slower commodity demand?**
- **Can Petrobras continue to attract financing?**

Source: Banco Central do Brasil

The 'Fragile 5'



Source: Citi Global Economic Outlook & Strategy, September 2013

Almost a common theme:

- **Less resistance to depreciation at a time of disappointing GDP growth**

Central bank response

Signaling can be critical

- **Brazil:**
  - Depreciation stopped only with an intervention package, not with intervention
- **India:**
  - Depreciation stopped only when the new RBI governor outlined his policy approach, not with higher interest rates
- **Indonesia:**
  - The central bank pulled back from distorting the market

Central bank response

Signaling can be critical

- **South Africa:**
  - Is the best signal no signal at all -- a laissez-faire approach to the exchange rate
- **Turkey:**
  - Unorthodox policies have worked so far but signals have been confused if not confusing

Central bank response

- Intervention package announced August 22
- Represented a signal that the central bank would resist further depreciation
- Previous intervention had been focused on 'smoothing' the depreciation, not stopping it

Source: Reuters, own database

Central bank response

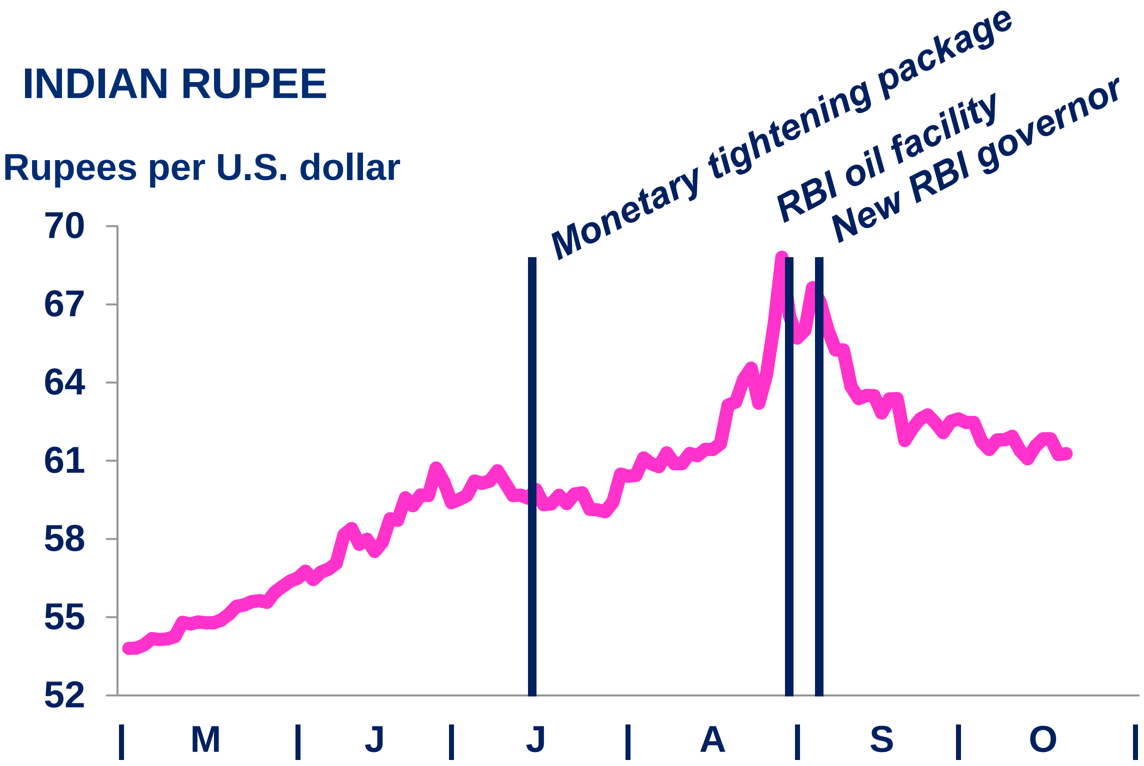
BRAZIL:

- **An extremely convoluted foreign exchange market – with a larger role played by domestic futures than anywhere else**
- **Two types of intervention:**
  - ‘Currency swaps’ – transactions in the domestic futures market, with the central bank selling a dollar-real hedge with net settlement at maturity – no net drain on liquidity, the equivalent of sterilized intervention
  - ‘FX repos’ – sales of U.S. dollars in the spot market, with a simultaneous purchase at some specified future date

-- both pre-announced, through an auction mechanism

Central bank response

INDIAN RUPEE



- **Trend reversed only with RBI's Rajan announcing policy of "transparency & predictability"**

Source: Reuters, own database

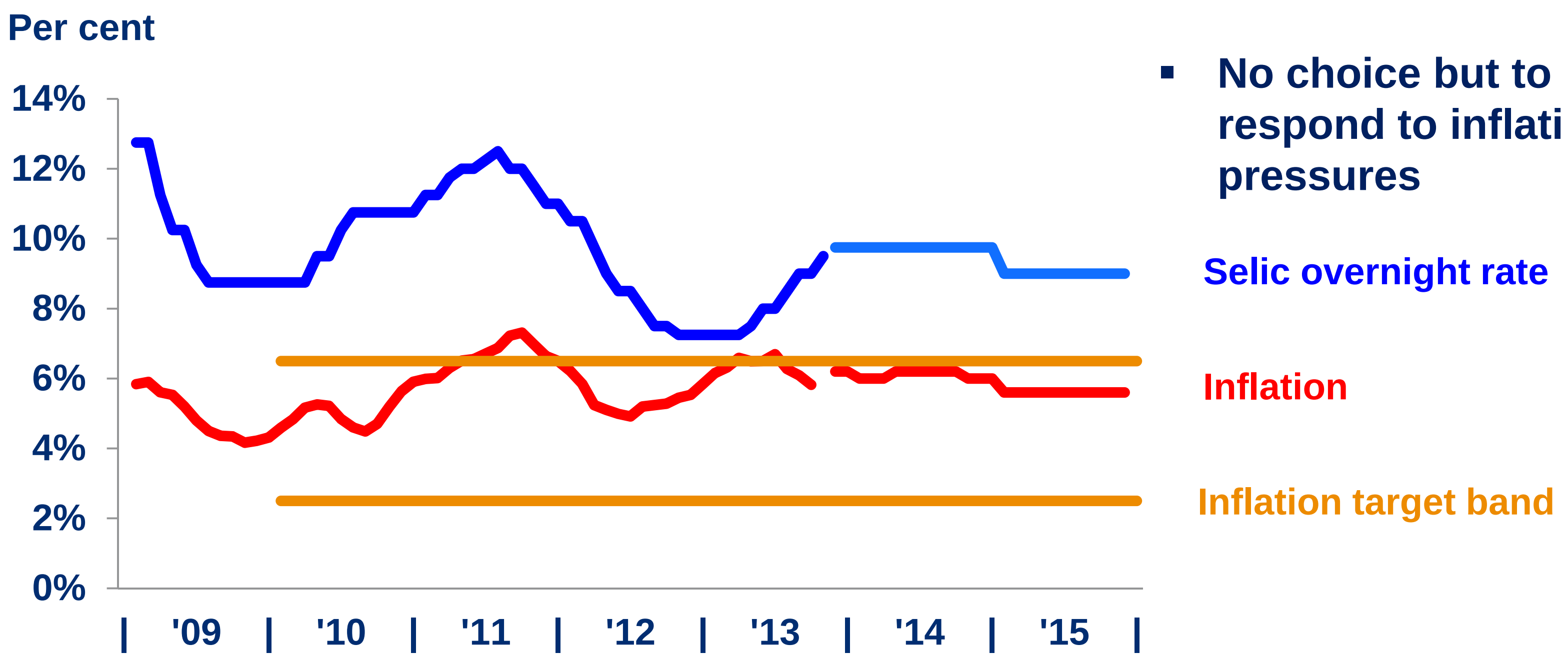
Central bank response

BRAZIL & INDIA:

- **But the problem they both face is “how to reverse course”**
  - Neither central bank favors a further appreciation in light of the current weak economic performance
  - Central Bank of Brazil is continuing to raise interest rates to fight inflation

Central bank response

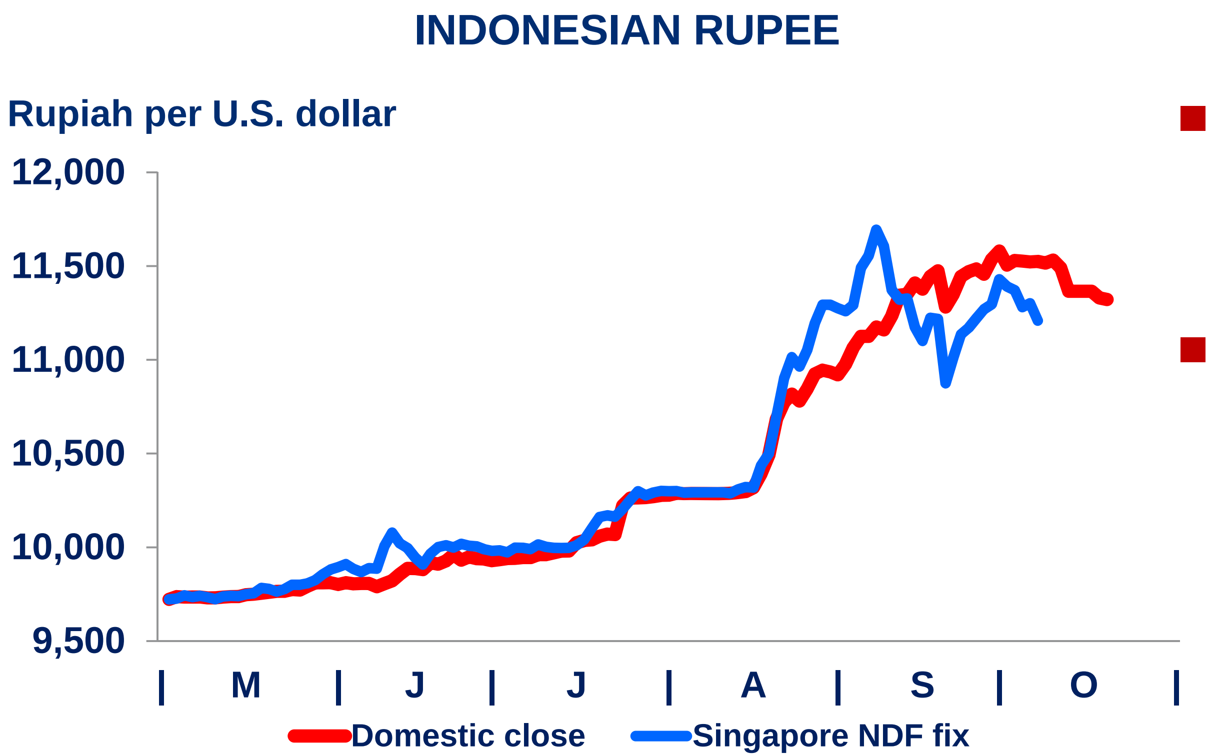
BRAZIL: Interest Rates vs. Inflation



Source: Bloomberg, own database

- **No choice but to respond to inflationary pressures**
- **Financial repression an ongoing problem**

Central bank response



- Local banks were not able to quote accurate transaction rates
- Unconfirmed reports that actual spot rates hit 12,000

Source: Reuters, Bloomberg, own database

Central bank response

INDONESIA:

- **The whole range of measures:**
  - Higher interest rates,
  - Intervention,
  - New BI facilities to attract hard currency deposits &
  - Interference in the market mechanism
- **Recovery?**
  - Clear sense that it was only when BI allowed the market to function

Central bank response

SOUTH AFRICA: None

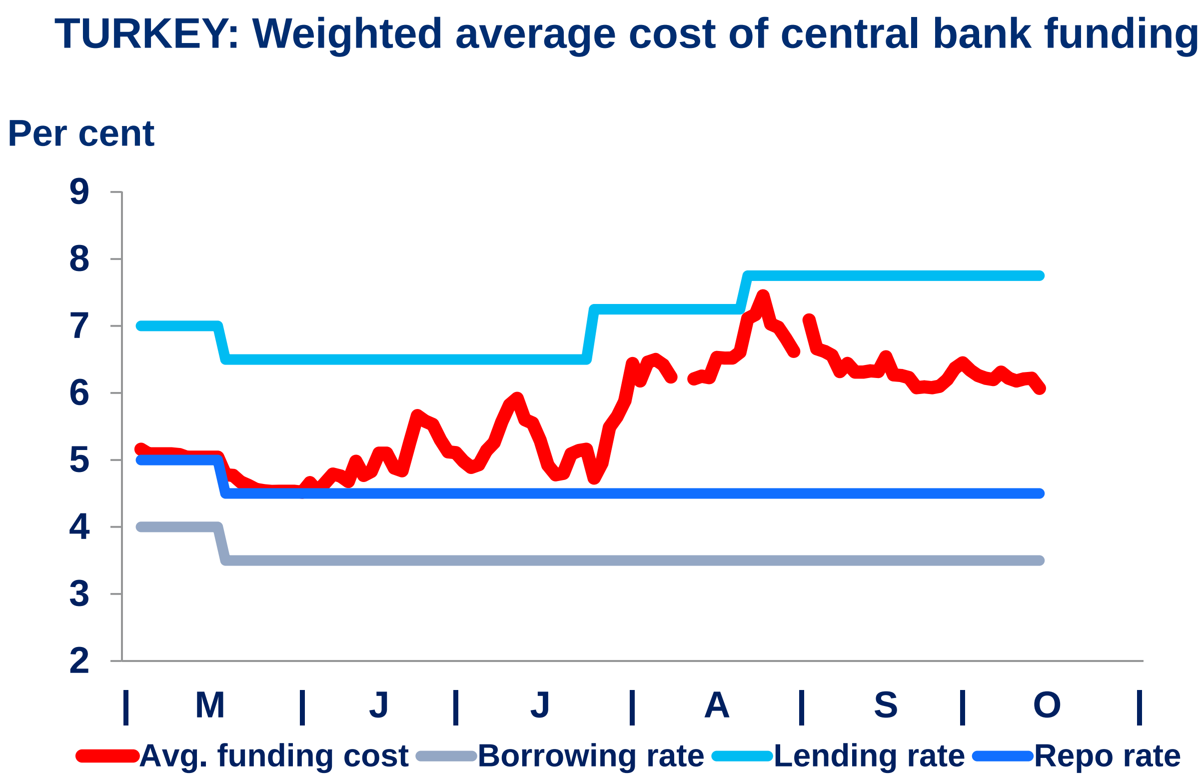
- **No scope for higher rates due to economic weakness**
- **No scope for intervention due to low level of reserves**
- **Trend depreciation due to (wage) inflation**

Central bank response

- No significant recovery

Source: Reuters, own database

Central bank response



Source: Central Bank of Turkey

- An unorthodox & erratic policy
- Refuse to raise interest rates to defend currency

Central bank response

TURKEY:

Goals

Fight inflation

~~Higher interest rates~~ → **Stronger currency**

Higher reserve requirements → **Reduced credit growth**

Reduce current a/c deficit

Lower interest rates → **Weaker currency**

(More recently) Prevent excessive depreciation

Intervention → **Willing to spend US$40 bn**

Reserve option mechanism

Variable liquidity injections

citi

Outlook

U.S. fiscal crisis

↓

Less robust U.S. economy

↓

Delay in tapering

Time for emerging markets to adjust

Changes risk attitudes toward emerging markets

Outlook

INDIA: The key issue: reform under a new government

Strong coalition government
↓
Committed to reform
↓
Upswing in growth
↓
Upswing in investment inflows
↓
Exchange rate stability

Weak coalition government
↓
Limited reforms
↓
Weak growth
↓
Anemic investment inflows
↓
Further depreciation

Outlook

TURKEY:

No effective strategy for reducing current account deficit
+
Poor outlook for increasing foreign direct investment

A resumption of downward pressure on the lira

and/or

The adoption of more conventional macro-economic policies

Non-global currencies

- ARS
- EGP
- PKR
- UAH
- VEF

A lack of FX reserves

FX markets not working/ being allowed to work

Dysfunctional institutional/political structure

Risk of large discrete devaluations …..

Or currencies being allowed to 'float'

Black markets

Payment arrears

Debt restructurings

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