Emerging Markets: Is The Crisis Over?

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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

The main tradable currencies affected by global trends

Those impacted primarily by domestic factors alone

ARS
EGP
PKR
UAH
VEF
...et al

....a leaky bucket losing FX reserves!
Summary

DEPRECIATION vs. base currency: April 30 to October 18

Source: Reuters, own database
Summary

APPRECIATION vs. base currency: April 30 to October 18

Source: Reuters, own database
Themes

Chinese rebalancing & commodity demand → EMFX → ‘Tapering’ of QE3

Softer GDP growth as a constraint
FOREIGN HOLDINGS OF GOVERNMENT DEBT

Per cent of outstanding debt

Malaysia: not a risk of a ‘sudden stop’; rather the risk of outflows

Source: Citi Asia Macro View, June 14, 2013
Higher yields
Re-pricing of EM risk
Greater difficulty in attracting portfolio capital or in raising external loans
Appreciation? Countries with current account surpluses or deficits funded with long-term capital (direct investment?)
Depreciation? Countries with current account deficits funded previously with portfolio capital or loans

The (supposedly) longer-term issue..............
ASIA: Current Account Balances

- Vietnam
- Thailand
- Taiwan
- Singapore
- Philippines
- Malaysia
- Korea
- Indonesia
- India
- Hong Kong
- China

Per cent of GDP

Source: Citi Global Economic Outlook & Strategy, September 2013
Themes

CEEMEA: Current Account Balances

- Ukraine
- Turkey
- South Africa
- Serbia
- Russia
- Romania
- Poland
- Nigeria
- Israel
- Hungary
- Czech Rep.

Source: Citi Global Economic Outlook & Strategy, September 2013
Slower Chinese GDP growth + Rebalancing of Chinese economy

- Slower growth in demand for industrial commodities
- Flat-to-lower commodity prices
- Weaker balance of payments for commodity producers

- Could demand actually decline?
- Division between price & volume?
- Trade & investment
CHINA: GDP growth

Per cent

- 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
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
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’

Current a/c deficit vs. Direct investment inflows

- 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

Source: various central banks
The ‘Fragile 5’

<table>
<thead>
<tr>
<th>Risk factors</th>
<th>Large financing gap?</th>
<th>Over- or under-valued?</th>
<th>Political constraints on policy</th>
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</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>No</td>
<td>Over-</td>
<td>Yes</td>
</tr>
<tr>
<td>India</td>
<td>Yes</td>
<td>Under-</td>
<td>Yes</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Yes?</td>
<td>OK</td>
<td>Yes</td>
</tr>
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<td>South Africa</td>
<td>Yes</td>
<td>OK</td>
<td>?</td>
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<tr>
<td>Turkey</td>
<td>Yes</td>
<td>Over-</td>
<td>?</td>
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</table>
The ‘Fragile 5’

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

<table>
<thead>
<tr>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
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<tr>
<td>0</td>
<td>20</td>
<td>40</td>
<td>60</td>
<td>80</td>
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-20

US$ billion, rolling 12-month total

- **Current a/c (sign reversed)**
- **Portfolio capital**
- **Net FDI**

- 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**

US$ bn, rolling 12-month total

- **Portfolio capital**
- **Current a/c (sign reversed)**
- **Net direct investment**

- **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’

GDP GROWTH: Current vs. Previous Trend

Almost a common theme:

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

Source: Citi Global Economic Outlook & Strategy, September 2013
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

BRAZILIAN REAL: 2012-2013

- 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

Trend reversed only with RBI’s Rajan announcing policy of “transparency & predictability”

Source: Reuters, own database
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

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

Source: Bloomberg, own database
Central bank response

INDONESIAN RUPEE

Rupiah per U.S. dollar

- 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

TURKISH LIRA

Basket value

No significant recovery

Source: Reuters, own database
Central bank response

TURKEY: Weighted average cost of central bank funding

<table>
<thead>
<tr>
<th>Per cent</th>
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<tbody>
<tr>
<td>9</td>
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<td>8</td>
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</table>

- **Avg. funding cost**
- **Borrowing rate**
- **Lending rate**
- **Repo rate**

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

Source: Central Bank of Turkey
Central bank response

TURKEY:

Goals
- Fight inflation
- Reduce current a/c deficit
  (More recently) Prevent excessive depreciation

Higher interest rates → Stronger currency
Higher reserve requirements → Reduced credit growth
Lower interest rates → Weaker currency

Intervention
- Reserve option mechanism
- Variable liquidity injections

Willing to spend US$40 bn
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
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

- 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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