ECONOMIC VIEWPOINT

#1 BEST OVERALL
FORECASTER - CANADA

Is Higher Volatility in Emerging Country Currencies Something to Worry About?

Volatility on the foreign exchange market has been increasing since mid-April. Greater monetary tightening is now expected in the United States, driving up the U.S. dollar. Currency volatility is also a reflection of a stronger aversion to risk, fuelled recently by the spike in oil prices, the resurgence in financial tensions in the euro zone and the escalation of protectionist measures.

The currencies of a number of emerging countries were among those most affected. Should we be worried? Affected currencies are generally those of countries already struggling, especially financially. However, currency depreciation could make the situation worse, as this increase the weight of their foreign currency debt. If not currency depreciation, then higher interest rates often ordered to support currencies or limit inflationary pressures can also lead to problems. That said, the situation is still far from what a number of South Asian countries experienced in 1997 and 1998.

The International Climate Is Becoming Risky for Many Emerging Countries

The monetary tightening in the United States marks the end of a long period of low interest rates that helped not only the U.S. economy, but many emerging economies as well. Rising interest rates mean that it will likely be more difficult for many emerging countries to attract capital. Businesses, government and households risk having a harder time getting funding. Economic growth could therefore slow in these nations.

Higher oil prices are another factor that could hamper the economic growth of emerging countries by significantly reducing consumers' purchasing power. Economic growth could also be penalized by interest rate hikes introduced in an attempt to stymie inflation.

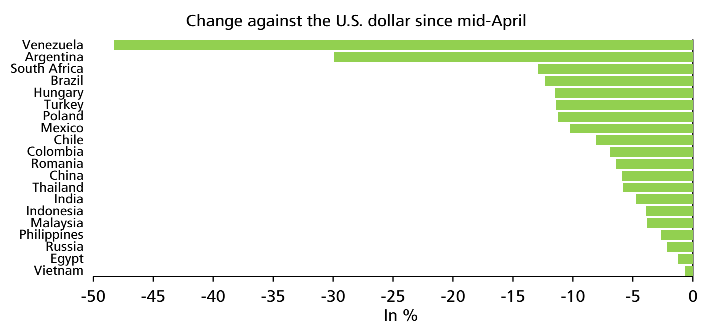
Financial tensions in Italy a few weeks ago revived old fears among investors. Even though no contagion effect was really noted, investors' appetite for at-risk countries appears to have been spoiled nonetheless. In good times, risk premiums tend to decline, but the opposite is true in times of turmoil, often affecting emerging countries deemed risky. Greater risk aversion adds to emerging countries' challenges in attracting capital and financing their economic growth.

Protectionism is another threat, especially for countries relying on export growth. An escalation in protectionist measures could also result in reduced global capital mobility, which would penalize a number of emerging countries.

Uneven Foreign Exchange Movements from Currency to Currency

Since mid-April, the euro has been down around 6% against the U.S. dollar. A similar depreciation is observed for the Canadian dollar and other advanced country currencies. Many emerging country currencies are posting higher depreciations of approximately 10% or more (graph 1). The Venezuelan and Argentine currencies dropped more than 25%.

GRAPH 1
Some currencies are far more penalized than others



Sources: Datastream and Desjardins, Economic Studies

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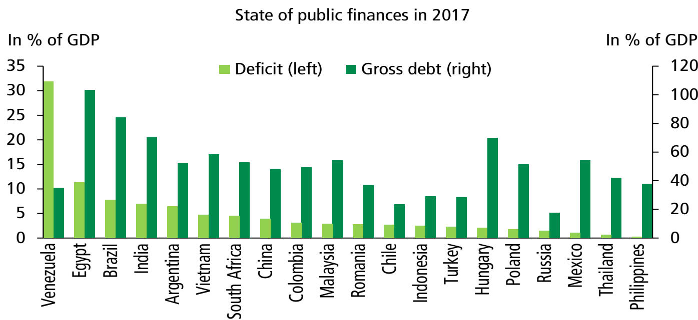
There is a wide disparity in movements within emerging country currencies. For example, the Chinese yuan and the Colombian peso depreciated in the same proportion as the euro and other advanced country currencies, while other currencies sustained lesser loses. However, not all currencies are under a flexible exchange rate regime. Some countries limit currency movements, as is the case in Egypt and Vietnam, which skews the overall situation.

Debt Is an Aggravating Factor

Countries dealing with debt problems become more at risk in a context where interest rates tend to increase worldwide. The perception that these countries are more fragile causes investors to flee and increases exchange rate volatility. Venezuela and Argentina, whose currencies are among the most volatile, are experiencing such financial challenges (graph 2). Egypt, Brazil and India are other cases worth watching closely.

GRAPH 2
Investors are often more concern about a high debt or deficit



Sources: International Monetary Fund and Desjardins, Economic Studies

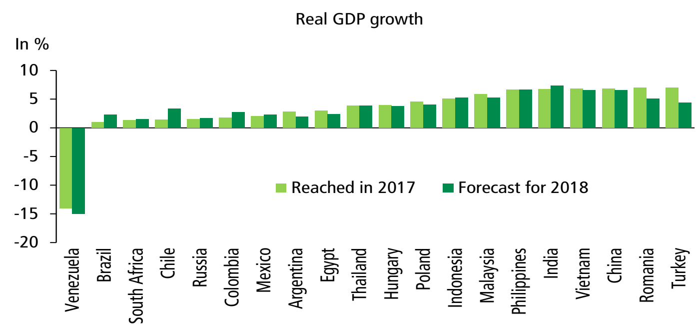
Venezuela is in deep financial crisis and ended 2017 with a government deficit of more than 30% of GDP. The Venezuelan government's trouble financing itself is forcing it to print money, among other things, further depreciating the bolivar in addition to plunging the country into hyperinflation. The bolivar has lost 99.9% of its value since the beginning of the year.

While Argentina is a less extreme case, the country is nonetheless considered very risky by investors due to its financial crisis history. Its government deficit reached 6.5% of GDP in 2017 and its debt, 53%. Its financial struggles recently required assistance from the International Monetary Fund (IMF). The Argentine peso has been trending downwards for the past few years already, but its depreciation became sharper in April.

Egypt's government deficit is one of the highest among emerging countries, at 11% of GDP. Its gross debt exceeded 100% of GDP in 2017. However, the Egyptian pound is not under a flexible exchange rate regime and has moved little in recent months. This does not prevent it from sometimes being devalued, such as in November 2016 when its value was halved.

India and Brazil posted a deficit of around 7% and 8% of GDP, respectively. Brazil's public debt exceeded 80% of GDP in 2017, compared to 70% in India. Despite similar public finances, the Indian rupee nonetheless depreciated far less than the Brazilian real over the past few months. Other factors must be considered. In particular, India has much higher economic growth than Brazil. India's GDP rose 6.7% in 2017 compared to barely 1% in Brazil (graph 3). Be that as it may, India is facing major long-term challenges, but these challenges do not appear to be worrying the markets too much for the time being.[1]

GRAPH 3
Debt appears less sustainable if economic growth is weak



Sources: International Monetary Fund and Desjardins, Economic Studies

South Africa is not in the worst of financial situations, but its weak economic growth is heightening fears and penalizing its currency. The IMF is predicting little improvement for 2018, with economic growth of barely 1.5%. Deterioration is forecast for Venezuela, Argentina and Egypt, while slight acceleration in growth is expected in Brazil and India.

The Turkish lira and the Mexican peso are two other currencies that have been quite volatile recently. Public finances seem to be less of an issue here. Economic growth was nonetheless subdued in Mexico, and little improvement is expected for 2018. Growth was a lot more sustained in Turkey in 2017, but a slower pace is expected for 2018.

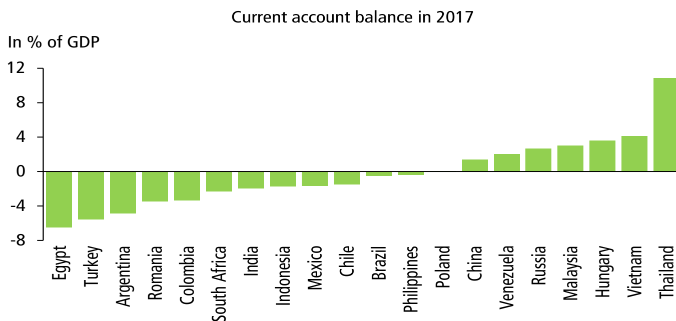
Other Issues Compound the Situation

The Mexican peso appears to be particularly affected by speculation surrounding certain Trump administration policies. For example, the peso depreciates significantly when plans for the Mexican border wall return to the fore or when access to the U.S. market is threatened by protectionist measures and by a potential scrapping of the North American Free Trade Agreement (NAFTA).

[1] *India: On the Cusp of Rapid Growth and Several Challenges*, Desjardins, Economic Studies, *Economic Viewpoint*, June 28, 2018, 5 p.

The Turkish lira has been rattled for some time by tensions with the West and domestic political problems, with a failed coup d'état in summer 2016 to top it off. More recently, attention has focused on Turkey's dependence on foreign capital. This dependence is reflected in a considerable current account deficit, assessed at 5.5% of GDP in 2017 (graph 4). At 11%, inflation is also high in Turkey, and may become a source of economic and financial instability.

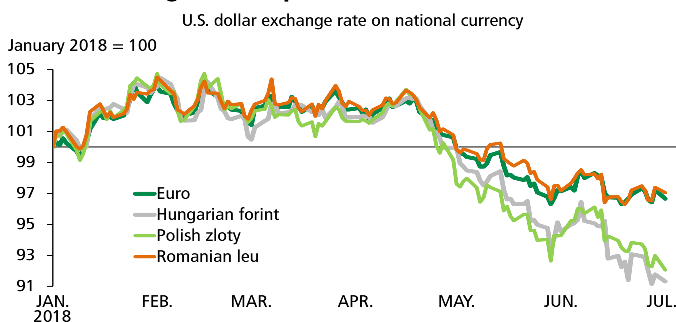
GRAPH 4
A negative current account balance means greater dependence on foreign capital



Sources: International Monetary Fund and Desjardins, Economic Studies

The currencies of emerging countries in Eastern European typically follow the euro's movements. The magnitude of the depreciation has, however, been greater recently for the Hungarian forint and the Polish zloty (graph 5). This divergence seems to be related to uncertainty following the resurgence of financial tensions in Italy. There are also certain fears about the Hungarian and Polish financial sectors. Furthermore, these countries are governed by Eurosceptics.

GRAPH 5
Eastern European currencies have essentially followed the euro, but some with greater amplitude

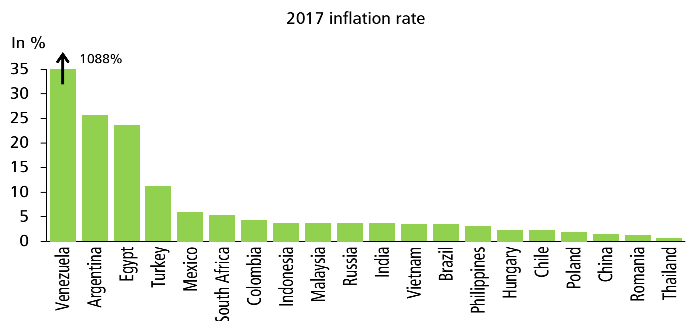


Sources: Datastream and Desjardins, Economic Studies

The Dilemma between Inflation and Economic Growth

Lower exchange rates typically go hand in hand with higher inflation caused by an increase in the price of imported goods (graph 6). Also, if accelerating inflation is interpreted as a loss in the value of a currency, this can encourage its abandonment

GRAPH 6
Inflation is high in many countries where currencies are depreciating

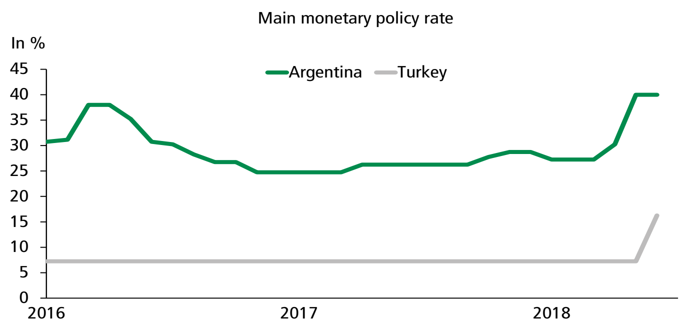


Sources: International Monetary Fund and Desjardins, Economic Studies

and result in further depreciation, potentially leading to an inflationary spiral. Excluding Venezuela, which is a special case owing to the government's money printing endeavour, inflation is particularly high in Argentina, Egypt and Turkey. The situation is less serious in Mexico and South Africa, but inflation in these countries is still around 5%.

The solution often used to put the brakes on rising inflation is to raise interest rates. This also aims to curb exchange rate depreciation and prevent an increase in the weight of external debt denominated in foreign currencies. Argentina and Turkey raised interest rates significantly in recent months (graph 7). India joined them, but with a more restrained increase of 25 basis points, bringing its key interest rate to 6.25%.

GRAPH 7
Argentina and Turkey already raised interest rates significantly



Sources: Datastream and Desjardins, Economic Studies

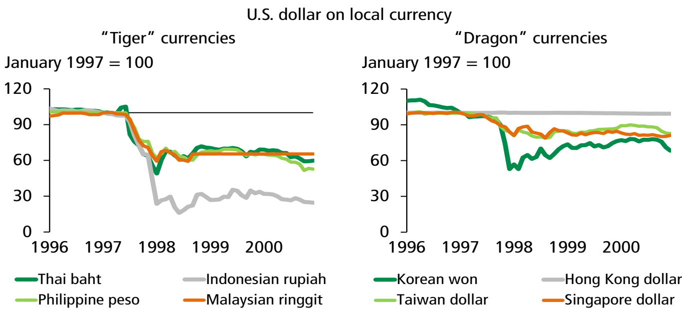
However, higher interest rates penalize economic growth. Yet, growth that is too weak will worry investors, which may also result in further currency depreciations. Rather than helping, the interest rate increase risks moving the economy into stagflation. Eventually, deflationary pressures underlying weak economic growth take over, but that may take a very long time.

This therefore poses a real dilemma. For the time being, many emerging countries have refrained from raising their interest rates. That said, higher oil prices are complicating the situation. Inflation could accelerate to the point where it will be too hard to wait to raise interest rates. Protectionist measures could also generate inflationary pressure.

A Context unlike 1997

While the current currency volatility in a number of emerging countries may appear significant, it is still low compared to the currency movements observed during the 1997 and 1998 financial crisis that hit the Asian countries referred to as the "tigers" and "dragons" (graph 8). This crisis erupted after a period of overinvestment. Many countries had taken on too much foreign debt. Problems maintaining fixed exchange rate regimes triggered the crisis, which left Thailand and Indonesia particularly hard hit. The Thai baht lost more than 50% of its value in a few months, while the Indonesian rupiah shed more than 75%. Hong Kong managed to shield its exchange rate, but at the cost of a considerable interest rate hike.

GRAPH 8
Nothing to do with the drop in "tiger" and "dragon" currencies in 1997

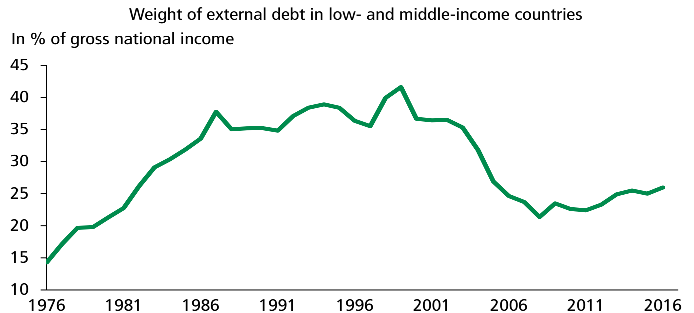


Sources: Datastream and Desjardins, Economic Studies

Overinvestment is less of an issue today and, on average, external debt is much lower than in the 1990s (graph 9). Since there are fewer fixed exchange rate regimes, there is also less speculation on potential devaluations. Foreign exchange adjustments are less drastic and span longer periods. Lastly, countries under a flexible exchange rate regime are not obligated to systematically defend their currency at the cost of high interest rates and slower economic growth.

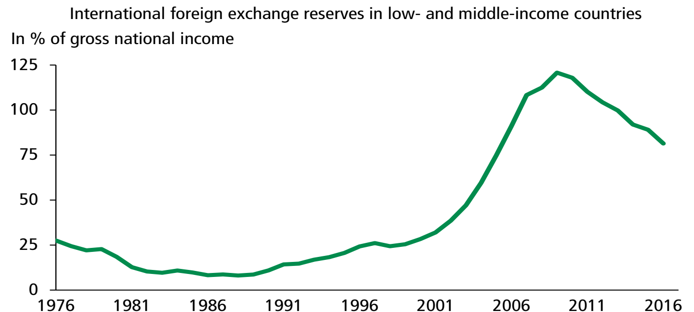
Another aspect that sets today's situation apart from the situation in the 1990s is the level of international foreign exchange reserves. After the financial crisis, many emerging countries accumulated substantial reserves to offset another potential shock. These reserves can be used to intervene in the foreign exchange market. They can limit interest rate increases and offset capital outflows. While these reserves have shrunk since 2009, they nonetheless remain high in comparison to 1990s levels (graph 10).

GRAPH 9
The weight of external debt is lower today than in the 1990s



Sources: World Bank and Desjardins, Economic Studies

GRAPH 10
Although they have been declining for the past few years, international foreign exchange reserves are still high



Sources: World Bank and Desjardins, Economic Studies

No Reason to Panic, but Caution Is Advised

The volatility of emerging country currencies may raise some concerns. Currency movements that are too large can destabilize economies by increasing the weight of external debt, accelerating inflation and sometimes requiring sizeable interest rate hikes. For the time being, excluding Venezuela and Argentina, currency movements are still small compared to what has already been observed in previous crises, such as the one that hit many Asian countries in 1997 and 1998.

Caution is still advised, however. The international climate has become less favourable for many emerging countries. Interest rate increases will make financing more difficult, particularly for the most heavily indebted countries. Higher oil prices risk spiking already high inflation in some countries. Lastly, rising protectionism could become very problematic. It is already a major source of volatility for the Mexican peso. China, which accounts for 18% of global GDP, might encounter significant challenges if there is an escalation in trade barriers. The volatility of the Chinese yuan would probably be higher in such a scenario.

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