COFACE ALERT

2014 : a year of volatile emerging market exchange rates

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WHAT? Since the devaluation of the Argentinean peso announced the 24/01/2014, another round of sharp depreciation of major emerging currencies has occurred. 3 currencies have been especially hard hit: Since 1st of January, Turkish Lira (TRL) lost 6.4% vs. the USD; the South African Rand 5.9% and the Russian Rubble 5.4%. Brazilian real, Mexican peso and the Philippines peso have also been impacted, but to a lesser extent (at around -2.5%).

WHY? ***Several factors are at work to explain this loss of confidence towards emerging markets***:

- **The rebalancing of risks and changes in the US monetary policy.** With strong recovery in the US (2.4% in 2014 Coface forecast) and ending of recession in the Euro zone (+0.9% in 2014), risks are on a downward trends in advanced economies. The US fed has confirmed the tapering (to reduce the volume of assets bought). US long term rates have begun to increase steadily to reach 2.8% (lowest point = 1.4% reached in mid-2012).

External factors trigger the outflow, but the most significant engines are domestic:

- **Slowdown of growth due to structural supply constraints**. Average emerging market growth in 2013 and 2014 will be in the 4-5% range instead of 6-7% in the previous decade. While domestic consumption has slowed because of high household debt and/or increasing political risks, it is mostly fixed investment that is slumping, due to structural factors such as the lack of skilled labour and inefficient infrastructures. Russia has been especially hit with 3 consecutive quarters of negative fixed investment in 2013.

- **Deteriorating current account balances:** with constrained domestic supply, final demand feeds imports which lead to deteriorating external balances. In some important cases (South Africa, Brazil, Turkey), the current account deficit is financed by volatile flows. In China and Russia, external surpluses are shrinking. Despite the revival of exports to Europe, in 2014, current account deficits will diminish only slightly in Turkey, South Africa or India and even deteriorate in the case of Brazil.

- **Political uncertainties:** after several episodes of tensions since 2013 (Brazil, Turkey, Thailand, Ukraine and Turkey again), 2014 is a major election year in emerging countries. Electoral period can be the theatre of renewed tensions. Furthermore, electoral process may prove unable to ease tensions. Uncertainties about the political scenarios feed the volatility of exchange rates, especially if the capital flows are of speculative nature. **The case of Turkey is especially sensitive** since the ongoing tensions within the ruling party (AKP) make the political picture of 2014 highly uncertain (municipal elections in March, presidential in August). Political fights may also limit the efficiency of macro policies. In some cases, central bank moves seem not to be supported by governments.

RISKS? **Despite fragile exchange rates, emerging markets are not back to the 1990's, but corporate external debt is at risk.**

- **Monetary policies are reactive but it may be not enough**: The Reserve Bank of India has increased its policy rates to 8% (28/01), after a clear shift to inflation targeting since September 2013. The central bank of Turkey massively increased its rates 29/01, with its overnight rate reaching 12% (+ 425 bp!). The move was followed by the Reserve Bank of South Africa 29/01 with a hike of rate of 50 bp, now at 5.5%. ***Central banks do react*** but ***1/*** lack of coordination of emerging central banks may be interpreted as panic moves and therefore fuel lack of confidence; ***2/*** might negatively impact growth (Turkish GDP growth is revised down to under 3% for 2014), ***3/*** can only be a partial answer in a context of political uncertainties. After the meeting of the CB of Turkey, the TRL fell again…

- **Systemic emerging risk has diminished.** Emerging economies are more able to resist to exchange rate volatility. Sovereign risk is generally low, foreign reserves are high, banks are sound. ***Systemic actors such as government and banks are not (or less and less) exchange rate-sensitive***. Mr. Erdogan or Ms. Rousseff do not need the external support of the IMF. At this stage, "no sudden stop recessions" or "sovereign crisis" are expected.

- **While systemic risk (sovereign and banking) is trending down, corporate credit risk is rising.** Corporate vulnerability has to be watched, especially for those with currency mismatch. 2 countries require special attention:

- In Turkey: In the 3Q 2013, **FX** liabilities of the corporate sector reached 255 bln USD (31% of GDP), of which 34.3 bn is short-termed. Half of total stock is due to domestic banks, mostly in construction-real estate and energy sectors.

- In Russia: end-2013, corporate **external** debt reached 438 bn USD (21% of GDP) and is concentrated in major Russian energy entities.

PS: external = due to non-resident lenders; FX = denominated in foreign currency

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