

FOCUS · Emerging currencies: where they are and where they are going

Between 1st July 2014 and 31 December 2015 the emerging currencies lost heavily against the dollar. The rouble's value fell by 53%, the Brazilian real by 45%, the Colombian peso by 41%, the Argentine peso by 37% and the South African rand by 31%. Although these are the five emerging currencies recording the largest depreciation, the emerging currencies on the whole tended to lose value. The J. P. Morgan emerging market currency index (a basket of 10 benchmark currencies) shows a decline of 26% for this period which was also accompanied by increased volatility. Although this movement had been reversed to some extent up to June this year (the aforementioned basket appreciated by 4.1%), volatility is still high and the ground lost is far from being regained.

Given this situation, we need to ask whether, after these fluctuations, the emerging currencies are still some distance from their equilibrium exchange rate (i.e. the exchange rate that corresponds to their underlying macroeconomic fundamentals). If we compare the most recent real effective exchange rate (REER) with the equilibrium rate estimated by the IMF, it can be seen that the aforementioned episode has led to almost all the emerging currencies being clearly undervalued.¹ The gap between the REER and the equilibrium rate is strongly negative (with differences in the order of 30%) in South Africa, Russia, Malaysia and Mexico, and somewhat less marked in Brazil and Poland. However, Turkey and India would only be slightly overvalued.

Based on this situation, how are the emerging currencies likely to perform in the coming years? In order to answer this question we need to look at two groups of factors that will probably affect these currencies; global factors and those of a more idiosyncratic nature. With regard to the former, at present we can identify three major conditioning factors influencing the emerging economies as a whole. Firstly, the emerging currencies will be affected by the financial repercussions of the Brexit. In the days following the British referendum these currencies have seen widespread depreciation, this being particularly severe in the case of the South African rand, the Polish zloty, the Hungarian forint, the Argentine peso and the Romanian leu.

A second global conditioning factor has been in effect for some time now and is likely to continue, namely the impact on emerging currencies of the monetary policy normalisation carried out by the US Federal Reserve (Fed).

During the widespread depreciation of the emerging currencies in 2014-2015, some of the most virulent episodes of depreciation coincided with moments when the market expected US interest rate hikes in the near future. But in addition to acting as a temporary catalyst, expectations of US monetary normalisation have also placed quite a constant pressure on the emerging currencies and this is likely to intensify once the Fed's current inaction gives way, surely at the end of the year, to renewed hikes in the reference interest rate.

Lastly, a third global factor which has recently tended to push down the value of the emerging currencies is related to decisions to devalue the yuan, especially when these have coincided with macroeconomic data that suggest China's soft landing may be veering towards a relatively uncontrolled slowdown in activity. As is the case with the other two global conditioning factors already mentioned, we believe that China will continue to be a source of risk over the coming months, keeping a lid on the value of the emerging currencies.

These global conditioning factors will have more or less impact at a national level depending on the specific situation of each emerging market. Two relevant vulnerabilities can be observed in particular: the presence of macroeconomic imbalances and the political uncertainty faced by some of these countries. Regarding the former of these blocks of local factors, the most worrying due to its nature is the excessive dependence on external financing. In this respect Turkey, South Africa and Brazil particularly stand out as a result of their current account deficit, countries in which the situation is further complicated by a clearly inflationary trend. Brazil, moreover, is also facing the threat of alarmingly imbalanced public accounts. The political source of risk is relevant in countries such as Russia (in this case of a geopolitical nature) and Brazil (due to its recent institutional situation, complicating the country's governability and economic policymaking).

Uncertainty regarding the Brexit, the Fed and China is unlikely to dissipate appreciably or quickly. Neither do the more fragile emerging countries seem able to earn their right to leave the danger zone thanks to appreciable macroeconomic adjustments or favourable turnarounds in their political situation. Unfortunately all this makes up a context that is ripe for further episodes of depreciation among the emerging currencies, probably as a result of relatively unselective dynamics based on increasing global risk aversion.

1. The REER is an index that takes into account bilateral nominal exchange rates and the relative variation in national prices compared with the price of trading partners, weighted by the share of each trading partner in the total international trade of the country in question.