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The Emerging Market Currency Collapse Can Continue

Economist(s)

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Summary

Over the last few months, emerging market currencies have come under extreme pressure. A more hawkish Fed combined with deteriorating global growth prospects have been the root causes of the widespread selloff across the emerging currency complex. While we have a particularly pessimistic view on emerging market currencies, the depreciation has been more severe than we expected. In our view, this depreciation pressure is likely to continue; however, we have consistently been asked "how much more depreciation can EM currencies experience?"

To offer insight, we updated our emerging market currency vulnerability framework and use the results to gauge the extent of further depreciation. The results are compelling, and suggest that underlying economic fundamentals and local politics are consistent with additional weakness in most developing currencies. There are exceptions, however, and our framework suggests fundamentals are consistent with a modest rebound in the Chilean peso, while the politically driven Colombian peso depreciation has likely run its course.

Emerging Market Currencies Have Become More Vulnerable

As economists, our responsibilities include proactively recognizing where economic fundamentals and local politics are trending in less or more positive directions. Early identification of these developments can help us make timely adjustments to our forecasts and recommend an appropriate course of action for clients exposed to these countries. Over the years, we have developed and refined tools to help us detect these developments. When we are analyzing emerging market currencies, especially when they have come under broad pressure the way they have this year, we tend to update and utilize our Emerging Markets FX Vulnerability framework quite often. Our vulnerability framework gives us a forward looking view into how economies and politics are evolving, and supports our effort to be as early as possible in recognizing changing economic and political conditions. Our framework includes a rolling 1-year ahead current account balance forecast and a forward looking measure of where inflation adjusted interest rate differentials relative to the U.S. could be in 12 months time. In addition, we include foreign exchange reserve adequacy (import cover) and overlay these data with forward looking judgment, as well as a political risk indicator which we also apply judgment to where necessary. We add up these variables to get an overall sense of where local conditions are evolving in each developing country we forecast. Currencies associated with eroding fundamentals and politics are typically more vulnerable and volatile, while currencies with stable politics and relatively strong underlying economics can be more protected in an environment where risk assets are performing particularly poorly.

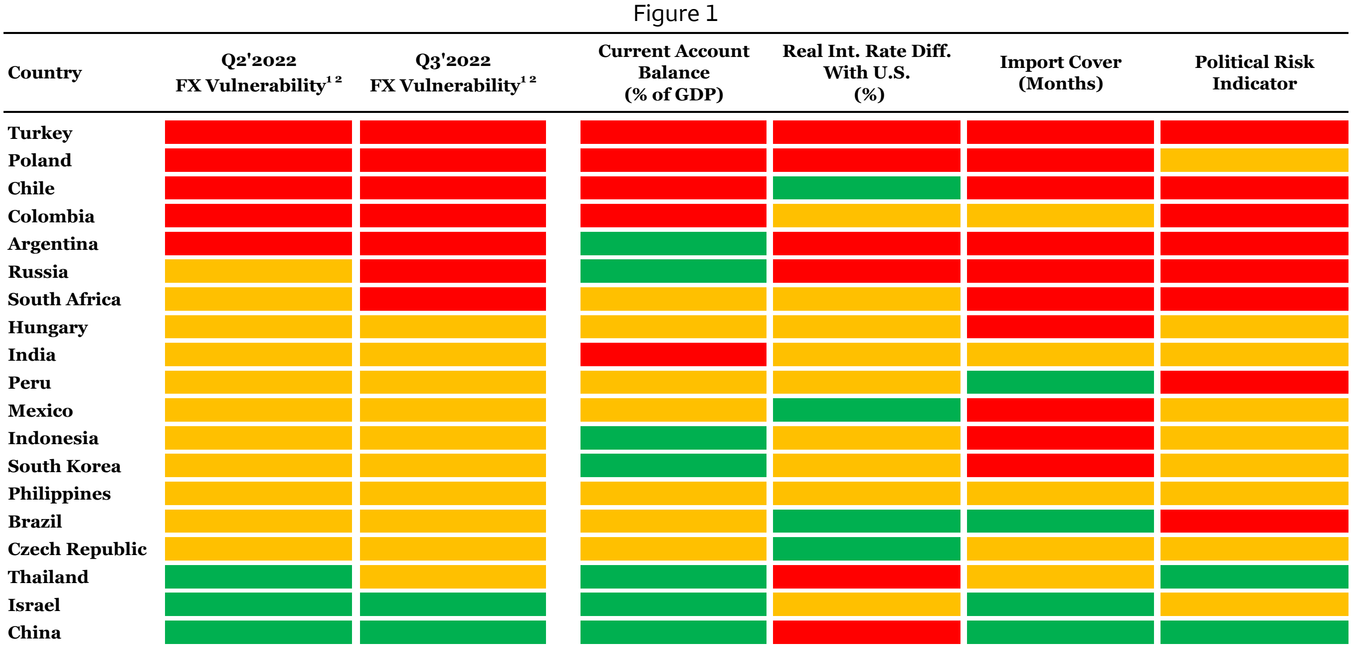
In our view, markets are still in the risk-off environment that has permeated across the globe this year. This global risk off episode is also where our EM FX vulnerability framework works best. In that sense, we updated our vulnerability analysis for Q3-2022 in an effort to assess if and where conditions are evolving, and which currencies could be more or less sensitive. Our latest update reveals interesting conclusions. Our framework suggests that conditions in most countries are stable relative to Q2-2022; however, **our analysis reveals that conditions in certain emerging market countries are evolving in a way where currencies are becoming more vulnerable to market shocks.** To that point, **the Russian ruble and South African rand have become "highly vulnerable" currencies, while conditions in Thailand have deteriorated to the point where the baht is now a "moderately vulnerable" currency** (Figure 1). Including Russia and South Africa, conditions in seven countries have evolved in a way that is consistent with outsized depreciations in their respective currencies over the course of a global risk-off event. Including Thailand, ten currencies now fall into the moderately vulnerable segment, while only Israel and China have currencies our framework identify as having little vulnerability.

The ruble's downgrade comes from a lower real interest rate differential with the United States. Given the ruble's capital controls-driven rally and the downward trajectory of local inflation, the Central Bank of Russia (CBR) has started unwinding emergency policy rate hikes from earlier in the year. Over the last few months, the CBR has lowered its Key Rate 1,050 bps to 9.50%. This aggressive easing comes against higher policy rates in the United States, and has diminished the ruble's yield advantage over the U.S. dollar. While a diminished real interest rate differential is driving the ruble's move into the highly vulnerable segment, a reduced yield benefit of the ruble is combined with elevated political risk amid tensions with Western countries and the conflict in Ukraine. In addition, international sanctions restrict CBR access to a majority of its foreign exchange reserves as well as significantly limit the ability of Russia's sovereign wealth fund to transact and generate liquidity. Historically, more-than-adequate FX reserves and a large sovereign wealth fund have acted as pillars of support for the ruble; however, limited buffers has raised the country risk profile of Russia and contribute to the ruble now being a highly vulnerable currency. As of now, Russia's current account surplus prevents the ruble from being *the most* vulnerable emerging market currency; however, a negative real interest rate differential due to diverging paths for monetary policy between the CBR and the Fed, limited access to buffers and elevated political risk leave the ruble highly sensitive to a large depreciation in times of global market stress.

For the South African rand, we expect the current account surplus to flip into deficit, which is behind the currency's shift into the highly vulnerable segment. With the risk of global recession rising, demand for commodities is likely to ease over the medium term. In fact, we have seen these dynamics play out over the last few weeks as copper prices have plummeted and oil prices have dropped below $100 per barrel on recession risks. Given South Africa is a major commodity exporter, particularly of precious metals and agriculture products, lower demand should result in metals and agriculture prices softening over the medium term. As commodity prices come down, South Africa's current account balance should move out of surplus and into modest deficit. A current account deficit will likely be matched by persistent elevated political risk stemming from insufficient governance controls and little momentum behind implementing a much-needed reform agenda. In addition, the South African Reserve Bank (SARB) has inadequate FX reserves and may struggle to defend the value of the rand in times of extreme volatility. SARB is also likely to maintain only a slim positive real interest rate differential against the United States as policymakers have taken a more gradual approach to interest rate hikes relative to the Fed, while local inflation is likely to continue to trend higher. Altogether, fragile fundamentals and elevated political risks have resulted in the rand returning to a highly vulnerable currency susceptible to a large depreciation in a global risk off scenario.

And in Thailand, **the baht's move to moderately vulnerable is driven by the currency now being associated with a negative real interest differential**. Bank of Thailand (BOT) policymakers have been an outlier to the higher interest rate trend. Despite inflation trending toward levels last seen during the 2008-2009 Global Financial Crisis and the Asian Financial Crisis of the late 1990's, BOT policymakers have maintained a view that current inflation is only temporary. With a view that price pressures are transitory, the BOT has resisted raising interest rates or engaging in operations consistent with tighter monetary policy. With local inflation spiking, BOT policymakers on hold, and the Fed lifting policy rates quickly, real interest rate differentials have moved into negative territory and are now a source of potential stress on the baht. Aside from diverging paths for monetary policy between the BOT and Fed, underlying fundamentals in Thailand are actually quite strong. The country is likely to maintain a healthy current account surplus of around 1.5% of GDP in 2023, while BOT FX reserves are likely to remain adequate going forward. On the political side, local protests touched off over the last few years in response to COVID-related lockdowns; however, demonstrations did little to disrupt Thailand's political structure, policymaking abilities or governance controls. In that sense, we believe political risk in Thailand is low, and political stability should act as a source of support for the baht in times of global market stress. In aggregate, our framework identifies the economic and political mix in Thailand as consistent with a currency that can now come under more pressure than previously.

Figure 1



[1] Red indicates "Highly vulnerable", Orange indicates "Moderately vulnerable", Green indicates "No vulnerability"

[2] Highly vulnerable represents 15%-20% depreciation, Moderately vulnerable represents 10-15% depreciation, No vulnerability represents 0-10% depreciation

Source: IMF, Bloomberg Finance L.P., Marsh and Wells Fargo Economics

Vulnerabilities Suggest More EM FX Depreciation...With A Few Outliers

Our vulnerability framework is certainly helpful in identifying at-risk currencies; however, we can also use our analysis as a valuation metric to get a sense of how much each currency can depreciate. In that sense, we ran our vulnerability analysis ahead of prior global risk-off episodes (i.e. 2013 Taper Tantrum, 2018 Hawkish Fed, COVID-19 etc.) to gauge how much currencies in each segment of our framework could depreciate. On average, we found that highly vulnerable currencies can depreciate between

15%-20% over the entire course of the selloff. We also found that moderately vulnerable currencies can experience a 10%-15% depreciation, while low vulnerability currencies can see a more contained selloff of up to 10%. In this context, currencies in Figure 1 ranging from the Turkish lira to the South African rand can come under the most depreciation pressure and could sell off up to 20% in a global risk off episode. Currencies in our moderately vulnerable segment from the Hungarian forint to the Thai baht could see up to a 15% depreciation, while the Israeli shekel and Chinese renminbi could see more minor depreciations of up to just 10%.

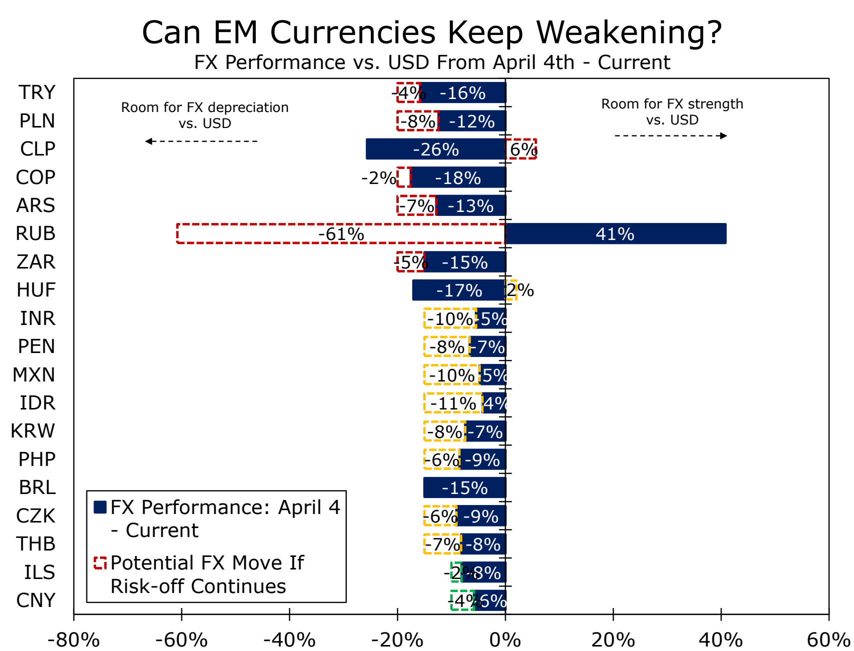
As mentioned, **we believe the global risk-off sentiment across global financial markets could continue**. Our U.S. economics team forecasts the Fed will tighten monetary policy more than markets are currently priced for, while we believe global GDP growth will be much slower than consensus forecasts. Should the Fed indeed become more hawkish and markets reprice Fed interest rate expectations, and global growth decelerates as we expect, risk sentiment could soften further and downward pressure on risk assets could persist. As of now, this is our base case scenario under which we forecast emerging market currencies. With these assumptions in mind, we believe the selloff emerging market currencies have experienced is set to continue going forward. However, the question of "how much further could the EM FX selloff go?" has become top of mind and a theme that has appeared numerous times in client conversations. To provide insight into how much more EM currencies can weaken, we can use our FX vulnerability framework and potential devaluation ranges, and compare these possible ranges to the actual depreciations emerging market currencies have experienced over the course of the latest downturn.

Broadly speaking, our vulnerability table's assessment of underlying economic fundamentals and political conditions suggest **the emerging market currency selloff may have room to run**. In many cases, despite global equities in bear market territory and the risk of a global recession elevated, currencies have yet to approach the upper bound of their segment's potential depreciation range (Figure 2). For example, our framework identifies the Turkish lira as the most vulnerable emerging market currency and susceptible to as much as a 20% depreciation. Since the beginning of April, the currency has depreciated 16%, which means **the lira can still weaken another 4%**. Same can be said for the Polish zloty, another highly vulnerable currency that could sell off as much as 20% over the course of the downturn. Since early April, the zloty has weakened 12% against the U.S. dollar, meaning economic fundamentals and local politics suggest **the Polish zloty could experience another 8% depreciation**. Many currencies, particularly currencies our framework identifies as moderately vulnerable, have yet to approach the upper bound of their potential depreciation ranges. In that context, our framework suggests the **Indonesian rupiah can weaken another 11% and the Indian rupee another 10%**. Both of these countries are exposed to higher commodity prices, while Bank Indonesia has also avoided tightening monetary policy and the Reserve Bank of India has been somewhat slow to raise interest rates. In our view, around 10% downside in each currency does not seem out of the question in the current global and local landscape. Currencies such as the Mexican peso, Korean won, Peruvian sol and Thai baht our framework identifies as potentially having more depreciation ahead of them. Given Thailand's shift to a moderately vulnerable currency amid the BOT's hesitant outlook on monetary policy, **another 7% selloff in the baht could materialize**. Even our low vulnerability currencies could be at risk of depreciation. Our analysis suggests **the Israeli shekel could weaken another 2%**, while the **Chinese renminbi could depreciate another 4%**.

There are, however, currencies our framework identify as overshooting their depreciation range and may be oversold. In the highly vulnerable segment, our analysis reveals **the Chilean peso may be oversold at current levels**. In fairness, the Chilean peso has rightfully come under pressure. Copper prices have dropped significantly, and given Chile's reliance on copper, the drop in prices has spilled over onto the currency. In addition, Central Bank of Chile policymakers have underwhelmed markets on multiple occasions when it comes to monetary policy. Not long ago, the central bank signaled the end of its tightening cycle may be approaching despite the Fed picking up the pace of rate hikes. While policymakers kept raising policy rates, forward guidance continued to suggest the pace of rate hikes would slow going forward, leading to sharp peso depreciation. As depreciation pressure mounted, policymakers have resisted any form of FX intervention, and as of now, seem unwilling to use FX reserves to support the currency. This combination has the Chilean peso in free-fall and hitting new lows against the greenback on a daily basis. However, we believe the currency is oversold and now misaligned with country fundamentals. From a technical perspective, we believe market participants will notice this imbalance and the peso can recover. In addition, we believe the recent selloff will force Central Bank of Chile policymakers to raise policy rates more aggressively and extend the tightening cycle, as well as intervene in FX markets and defend the currency. As policymakers step up policy tightening and intervention efforts, the currency can rebound back toward the upper bound of its potential depreciation range. In that sense, **we believe the Chilean peso can rally 6% in the short-term**. Similar dynamics exist for the Hungarian forint. **We believe the forint can experience a modest 3% recovery** against the dollar in the short-term as the currency now appears oversold. Hungary's central bank is one of the more hawkish institutions in the emerging markets, which we believe will ultimately be the driving force behind the modest short-term recovery in the currency.

We also wish to highlight a few takeaways for certain currencies that have been under the microscope lately. We mentioned the Russian ruble earlier and how the currency is now considered highly vulnerable in our framework. But, given the ongoing conflict in Ukraine, Russia's isolation from the global economy as well as the sovereign defaulting on its debt obligations, the path of the ruble is closely scrutinized. According to our framework, underlying fundamentals and political risk suggest the currency should be significantly weaker than where it is trading today. In fact, **our vulnerability framework suggests the ruble should be around 60% weaker relative to current levels**. **However, with capital controls and other ruble-supportive policies still in place, this type of ruble depreciation is unlikely**. We believe the ruble will weaken going forward as CBR policymakers ease monetary policy; however, this depreciation should be gradual as currency controls are likely to remain in place. Only until capital controls and other policies designed to stabilize the ruble are lifted should the currency experience the selloff our analysis suggests is consistent with current conditions in Russia. In Colombia, the peso has hit all-time lows against the U.S. dollar as political risks related to the election of Gustavo Petro and lower oil prices hover over the economy. According to our model, **the Colombian peso has likely bottomed out and has experienced the full extent of the currency's short-term depreciation**. Qualitatively, we agree with our framework's conclusion as we believe Petro will moderate his stance on his radical policy platform. In that sense, the currency has likely stabilized, and in our view, the Colombian peso is unlikely to reach another record low in the near-term. And finally, the Brazilian real has been exceptionally volatile the last few years; however, **our framework suggests the Brazilian currency, for the time being, is trading at fair value and is aligned with economic and political fundamentals**. Over the course of the current global market downturn, the Brazilian real has sold off 15%, equivalent to the upper bound of the moderately vulnerable potential depreciation range. We believe the currency will hover around current levels in the short-term, with the currency possibly gathering depreciation momentum as we approach the presidential election in October.

Figure 2



Source: Bloomberg Finance L.P. and Wells Fargo Economics

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