

International Commentary — March 17, 2023

2008 vs. 2023? Emerging Markets Are Better Prepared

Summary

Fifteen years ago—March 2008—new stresses in the global financial system were uncovered. Here we are in March 2023, and new challenges to the global banking system have revealed themselves. New exogenous shocks mean we need to assess vulnerabilities in our sectors, which in this case, are the emerging markets. According to our framework, on balance, vulnerabilities within the emerging markets have lessened since the 2008 Global Financial Crisis. Reduced imbalances can support emerging market currencies should another global banking crisis indeed materialize. While depreciation of emerging market currencies would likely still be significant, improved fundamentals can result in more contained selloffs.

To be clear, we are not forecasting nor implying a repeat of the Global Financial Crisis is imminent. We believe policymakers and regulators will move quickly, and banking sector stresses will be contained and will not result in systemic risks to the global financial system. Under this assumption, we believe emerging currency volatility may stay elevated in the short term; however, we maintain our constructive medium- to long-term outlook for developing currencies, and continue to believe currencies across the emerging markets spectrum can outperform in 2023.

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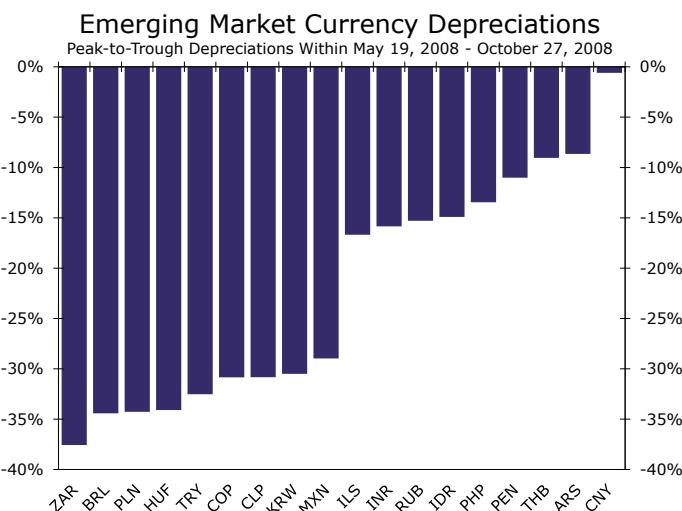
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Another Shock Hits Global Markets

Exactly 15 years ago we were having this same conversation. Bear Stearns collapsed in March 2008, and the company's failure introduced visibility into underlying risks percolating across the global financial system. In the months to follow, these risks materialized and the global financial system nearly came crashing to an end. Here we are, again. Full circle. Different risks, but same conversation. We won't recap the events of the last week. Media headlines have been sufficient. But, what we can do, now that financial stability and banking sector risks are back, is assess vulnerabilities in our sectors. For us, that sector is the global economy. And in this report, the emerging markets. For readers who pay particular attention to our coverage of the emerging markets universe, our FX vulnerability framework should be familiar. Those who do not follow the developing world as closely, our framework is designed to identify economies and currencies at risk should a global shock scenario unfold. Admittedly, we have used this framework quite often over the past few years. Probably more often than we would like. But global economic and financial market shocks have been abundant. U.S.-China trade tensions. Aggressive Fed tightening in 2018. COVID. War in Eastern Europe. A mini "taper tantrum" in 2022. And now, renewed banking sector issues in the U.S. and Europe.

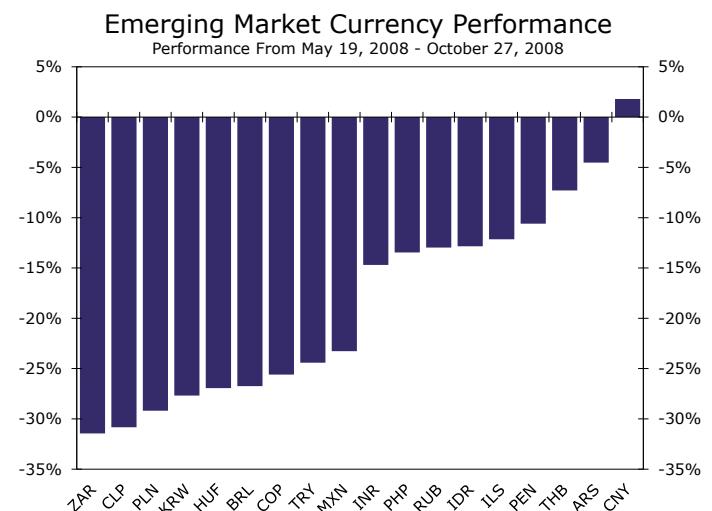
Now that another exogenous shock scenario is here, we updated our FX vulnerability framework to provide guidance on potential depreciations EM currencies could experience if current conditions worsen. While we are updating our framework in the context of the latest banking sector stresses, we are not forecasting nor implying a global financial sector meltdown. In fact, our assumption is that banking sector challenges can, and will, be contained and a repeat of the 2008-2009 Global Financial Crisis is not imminent. This is our assumption; however, stress testing and planning for a worst case scenario is an exercise that corporates and investors should undertake. Our framework, in this case, is designed to support that process. Our analysis suggests that EM currencies have become less vulnerable over the past 15 years. Current account balances have shifted toward a less robust surplus and deficit; however, foreign exchange reserve balances have improved since the Global Financial Crisis (GFC) and interest rate differentials are now more supportive of emerging currencies. In our view, local political risk has broadly risen since the GFC, with select exceptions, as unorthodox policymaking frameworks have been implemented in multiple countries. But in aggregate, our framework suggests the positive evolution of fundamentals should lead to less overall currency depreciation in 2023 relative to the GFC, which is a good thing, because the EM currency selloffs in 2008 were some of the most extreme on record. Over the course of the emerging equity downturn—which we measure from mid-May 2008 to the end of October 2008—on a peak-to-trough basis within that period, certain currencies sold off over and around 35% (Figure 1). Over the full May-October time period, depreciations were slightly less sharp, but still significant. Select currencies weakened over 25%, with the South African rand and Chilean peso dropping over 30% (Figure 2).

Figure 1



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

Figure 2



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

Vulnerabilities Were Plentiful Pre-Global Financial Crisis...

If we ran our vulnerability framework ahead of the GFC, the analysis would have had success predicting many of the currencies that underperformed as well as the currencies that were more insulated. To that point, a pre-Global Financial Crisis version of our framework identified currencies, such as the Hungarian forint, Turkish lira, South African rand, Chilean peso and Polish zloty (among others), as most vulnerable and the currencies susceptible to selloffs of at least 20% during the Global Financial Crisis downturn ([Figure 3](#)). These currencies, along with other “highly vulnerable” currencies identified by our framework, certainly underperformed in 2008. In fairness, our framework identified the Mexican peso and Brazilian real as moderately vulnerable currencies, which we define as susceptible to depreciations between 10%-20%. Both currencies sold off more than our framework’s target range, which we could argue left each currency oversold and offered buying opportunities, but nevertheless our model missed a chunk of the MXN and BRL selloff in 2008. Our framework would have been more effective identifying currencies that were more protected from the risk-off sentiment. In that sense, our analysis suggested fundamentals in Israel, Russia, Thailand, India and Peru were strong enough to result in more contained depreciations. Indeed, currencies associated with these countries did not face the same depreciation pressures as highly vulnerable currencies. Perhaps most intriguing, our vulnerability table identified the Chinese renminbi and Argentine peso as currencies most insulated from global market stresses. Fundamentals in China were relatively strong leading into the GFC, which can explain the renminbi’s haven appeal, and while Argentina was still muddling through conditions associated with sovereign default years earlier, a current account surplus, a positive real interest rate differential with the United States, and sufficient FX reserves provided protection to Argentina’s currency. Our framework’s “low vulnerability” currencies performed well during the Global Financial Crisis, with the Argentine peso selloff more contained than peer EM currencies, while the renminbi outperformed substantially compared to most other emerging currencies.

Figure 3

Country	Global Financial Crisis FX Vulnerability ^{1,2}	Current Account Balance (% of GDP)	Real Int. Rate Diff. With U.S. (%)	Import Cover (Months)	Political Risk Indicator
Hungary	Red	Red	Red	Red	Red
Turkey	Red	Red	Red	Red	Red
South Africa	Red	Green	Red	Red	Green
Chile	Red	Green	Red	Red	Red
Poland	Red	Red	Red	Red	Green
South Korea	Yellow	Yellow	Red	Yellow	Red
Indonesia	Red	Green	Red	Red	Red
Colombia	Red	Red	Red	Yellow	Yellow
Philippines	Red	Green	Red	Red	Red
Mexico	Yellow	Yellow	Yellow	Red	Yellow
Brazil	Yellow	Yellow	Yellow	Green	Red
Israel	Yellow	Green	Red	Red	Green
Russia	Yellow	Green	Red	Green	Red
Thailand	Yellow	Green	Red	Yellow	Yellow
India	Yellow	Yellow	Red	Green	Green
Peru	Yellow	Green	Red	Green	Yellow
Argentina	Green	Green	Green	Green	Red
China	Green	Green	Red	Green	Green

¹ Red indicates “Highly vulnerable”, Orange indicates “Moderately vulnerable”, Green indicates “No vulnerability”

² Highly vulnerable represents >20% depreciation, Moderately vulnerable represents 10-20% depreciation, No vulnerability represents 0-10% depreciation

Source: Wells Fargo Economics

...But, Reduced Imbalances Can Support EM FX in Another Banking Crisis

As mentioned, according to our model, since 2008 emerging market currencies have become less vulnerable to global market shocks and risk-off scenarios. On balance, our framework suggests that countries, with only one exception, have gravitated toward containing vulnerabilities rather than letting imbalances build ([Figure 4](#)). As far as the countries that have become less sensitive to market shocks, all are located in Asia. South Korea, Philippines and Indonesia have improved fundamentals to the point where our framework no longer considers their respective currencies to be “highly vulnerable,” but rather “moderately vulnerable.” In South Korea’s case, the won is less sensitive as a current account surplus is expected for this year, and while foreign exchange reserve coverage has lessened, in our view political risk has diminished over the past 15 years. As for the Philippines, the shift to a less vulnerable currency is driven by a more robust foreign exchange reserve stockpile and diminished political risk. While the Philippine current account is expected to end 2023 in deficit—a deterioration from the GFC era—political risk has eased significantly. And in Indonesia, we believe local political developments are no longer a potential source of stress on the currency, an improvement in political dynamics since the GFC. In addition, real interest rate differentials relative to the U.S. are now supportive of the rupiah compared to 2008 Bank Indonesia-Fed monetary policy settings. If the current situation were to become more similar to the GFC, we would nonetheless expect less significant depreciation pressure to be placed on the Korean won, Philippine peso and Indonesian rupiah than during that previous episode. To quantify that statement, our framework suggests “moderately vulnerable” currencies can depreciate between 10%-20%, rather than the over 20% expected depreciation for “highly vulnerable” currencies. On the other hand, Argentina’s fundamentals have deteriorated sharply since 2008. So much so, that the peso went from being one of the more insulated currencies in a global risk-off scenario to one of the most vulnerable. Hyperinflation is at the core of Argentina’s issues; however, challenges run much deeper. And while our framework suggests a sizable peso depreciation in another shock scenario, strict capital controls may contain any peso selloff. However, an explicit peso devaluation cannot be ruled out as foreign exchange reserves are limited despite IMF support and an FX swap line with China. Average daily depreciation combined with a devaluation could result in peso depreciation of over 20% in a banking crisis scenario.

Figure 4

Country	Global Financial Crisis FX Vulnerability ^{1,2}	Q1'2023 FX Vulnerability ^{1,2}	Current Account Balance (% of GDP)	Real Int. Rate Diff. With U.S. (%)	Import Cover (Months)	Political Risk Indicator
Turkey	Red	Red	Red	Red	Red	Red
Argentina	Green	Red	Yellow	Red	Red	Red
Hungary	Red	Red	Red	Red	Red	Yellow
Poland	Red	Red	Red	Red	Red	Yellow
Chile	Red	Red	Red	Yellow	Red	Red
Colombia	Red	Red	Red	Yellow	Yellow	Red
South Africa	Red	Red	Yellow	Yellow	Red	Red
Russia	Yellow	Yellow	Green	Yellow	Red	Red
South Korea	Red	Yellow	Green	Red	Red	Yellow
Philippines	Red	Yellow	Red	Red	Yellow	Green
India	Yellow	Yellow	Red	Yellow	Red	Yellow
Mexico	Yellow	Yellow	Yellow	Yellow	Red	Yellow
Peru	Yellow	Yellow	Yellow	Yellow	Green	Red
Israel	Yellow	Yellow	Green	Red	Green	Red
Brazil	Yellow	Yellow	Yellow	Green	Green	Red
Indonesia	Red	Yellow	Green	Yellow	Red	Green
Thailand	Yellow	Yellow	Green	Red	Yellow	Green
China	Green	Green	Green	Yellow	Green	Yellow

¹ Red indicates “Highly vulnerable”, Orange indicates “Moderately vulnerable”, Green indicates “No vulnerability”

² Highly vulnerable represents >20% depreciation, Moderately vulnerable represents 10-20% depreciation, No vulnerability represents 0-10% depreciation

Source: Wells Fargo Economics

Aside from those currencies explicitly mentioned above, FX vulnerabilities have not shifted significantly since the GFC. Many of the currencies our framework identified as highly vulnerable in 2008 are still highly vulnerable in 2023. Fundamentals in countries such as Turkey, Hungary, Poland and Chile have not improved leaving these currencies most sensitive to quick changes in investor sentiment and capital flows. While the ranking of the most highly vulnerable currencies has changed slightly, many of the same currencies that experienced sharp depreciation pressures in 2008 would likely come

under a similar degree of stress today should the global financial system be at risk. In the Q1'2023 FX vulnerability column, all currencies highlighted in red we would expect to sell off over 20% should the health of the global banking system be tested in more strenuous circumstances. The same takeaway can be made for moderately vulnerable currencies. Currencies our framework identified as moderately vulnerable in 2008 remain moderately sensitive today, and any depreciation pressure that forms on the emerging market currency complex would likely be more subdued for the currencies in this segment. Our model also still suggests underlying economic and political fundamentals in China are strong and stable enough to support the renminbi in times of global distress. The renminbi is the only "no vulnerability" currency our framework identifies, and at most, could experience depreciation of up to 10%.

Uncertainties Are Rising; However, the EM FX Outlook Is Unchanged

We write this report to signal that risks to the outlook for emerging market currencies are rising. Banking sector stresses are worrisome enough, but together with a global economy on the brink of recession and central banks maintaining a hawkish stance on monetary policy, risks are starting to mount and gather momentum for emerging currencies. For the past few months, emerging currencies have been resilient; however, now that risks are starting to build this resiliency is being tested. Over the past week, emerging market currency volatility has spiked, and with the banking sector outlook less-than-certain, this volatility could persist in the short term. With that said, despite the uncertainties involved, we are assuming that current challenges in the banking system will be contained and spillovers will not result in systemic risks to the global financial system. Recent central bank and regulator action supports this assumption, and with the 2008-2009 crisis playbook available and institutions' ability to develop new crisis management tools, unless something drastic occurs, we will maintain this assumption when forecasting and developing the medium- to longer-term outlook for emerging market currencies. In that sense, we believe the recent bout of volatility will subside in the coming days/weeks. While economic activity may slow further as a result of the latest developments, we believe financial markets will recover and risk sentiment will stabilize. Under this assumption, we are not changing our outlook for emerging market currencies. In the very short term, we would not be surprised to see the U.S. dollar strengthen on safe-haven characteristics amid shaky market sentiment and for EM currencies to broadly soften.

However, longer term, we continue to believe the U.S. dollar can weaken over the course of 2023 and into 2024, which could mean stronger developing market currencies going forward. This broad greenback depreciation will still come from, in our view, GDP growth differentials that support foreign currencies and a Federal Reserve that will eventually signal an aggressive easing cycle in the coming quarters as the U.S. economy falls into recession. In addition, we believe yield and carry opportunities will attract capital flows toward the emerging markets, which can act as a tailwind to EM FX for the remainder of this year and in 2024. This has been our outlook for some time, and while sporadic bouts of volatility may exist over the longer term, overall we remain constructive on emerging market currencies as an asset class. In fact, we continue to believe that in 2023, emerging market currencies can outperform G10 peers, and a fair amount of this outperformance will come from currencies associated with sound underlying fundamentals and stable politics. In that sense, we favor currencies such as the Mexican peso and currencies in emerging Asia. We also believe the Brazilian real and Chilean peso can outperform this year on attractive yield opportunities, and political risk that should stabilize going forward. And in the EMEA region, we continue to believe the Israeli shekel is oversold. While local political risk is concerning, ultimately we believe strong fundamentals, the likelihood of Bank of Israel FX intervention, and optimism around judicial reform policies being watered down or not implemented can spark a relief rally in the currency. In our view, recent depreciation across the emerging market currency spectrum represents buying opportunities for investors and attractive levels for corporates with developing currency expense exposures.

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