Economist Insights

EM: exposing markets

Some emerging markets have found themselves wobbling in recent weeks, following a long period of hitching themselves to the loose monetary policy of the Federal Reserve. They face the choice of hanging on (by raising rates) or letting go (allowing their currency to depreciate) but neither of these options will be pain-free.

Joshua McCallum
Senior Fixed Income Economist
UBS Global Asset Management
joshua.mccallum@ubs.com

Gianluca Moretti
Fixed Income Economist
UBS Global Asset Management
gianluca.moretti@ubs.com

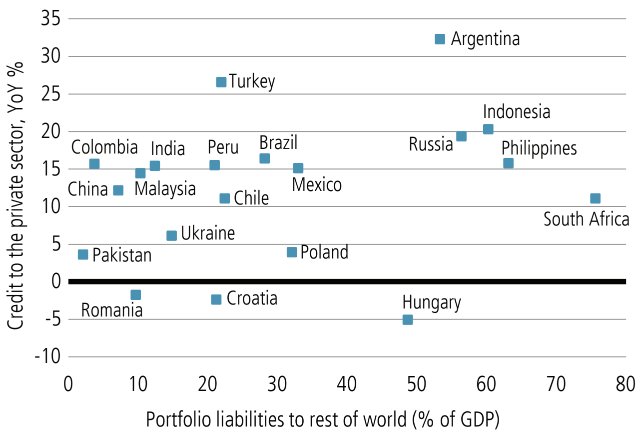
When you are riding a bicycle or skateboard, there is no more worrying feeling than the wobble that tells you the wheels are starting to come loose. And if you are holding onto the back of a rapidly moving car while it happens, it is likely to be downright terrifying. This highly unadvisable manoeuvre, known as "skitching", is a pretty good analogy for the situation that some emerging markets (EM) have found themselves in over the last few weeks, following a long period of hitching themselves to the loose monetary policy of the Federal Reserve and other developed market central banks (see *Economist Insights* "Skitching", 9 September 2013).

Some EM that took advantage of the massive global liquidity provided by quantitative easing (QE) policies got a big boost from capital inflows as investors, squeezed out of treasuries, followed their search for yield into EM. Cheap external financing allows a country to run a current account deficit – the rest of the world lends you money so that you can spend more than you earn. This can be fun for a while (just look at the US from 2003-2007) but often ends in tears (as the US found out in 2008). Cheap external financing and a current account deficit generally mean loose financial conditions, which means rapid credit growth. Once monetary conditions tighten, and assets in developed markets start to look more attractive, investors may head for the exit.

The most exposed countries are those with a high level of reliance on external portfolio flows (foreigners buying their equities and bonds). Even if this inward flow is matched by outwards flows (domestic investors investing abroad) the risk remains – in the event of a crisis foreigners will take their money out and domestic investors will leave their money overseas and likely send the rest of their money after it. The most exposed countries on this basis are familiar: Argentina, Indonesia, Russia, South Africa (see chart 1). Turkey and Brazil are also exposed.

Chart 1: The wheels come off

Credit growth YoY and portfolio liabilities (debt and equity) to the rest of the world as a share of GDP, %



Source: IMF International Financial Statistics, UBS Global Asset Management
Note: Dates of most recently available data vary by country.

Just as with skitching, when things are looking wobbly an exposed EM can choose to hang on or let go. Neither of these options are particularly appealing. Let go of the car and you will slow down, but it is easy to fall off before you do. Hold on and the danger is that the car could either speed up (making things worse) or even slow down quickly (causing a crash). An EM central bank facing capital flight can either try to hold on to it by raising rates, or let go and allow the currency to depreciate as capital flows out. There is no easy way out, but as economists never tire of saying, there is no such thing as a free lunch.

Hiking rates to try to retain foreign capital (by paying them more) and maintain the exchange rates is a policy with a long (and inglorious) history. The pressures of the Asian crisis in 1997 were largely built up by fixed exchange rates, and several countries did themselves huge amounts of damage by trying to maintain their exchange rates in the face of huge outflows. Higher rates hurt domestic demand and are especially dangerous if there has been a credit bubble. Eventually those countries capitulated and let their currencies depreciate.

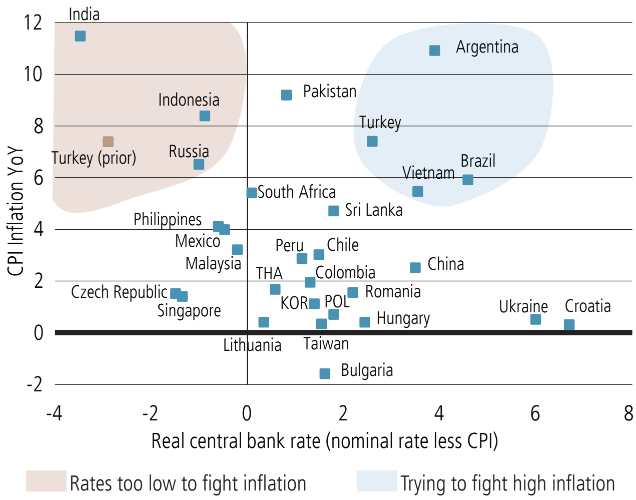
For a few exposed EM, a response of hiking rates may be sensible; but only because it would be sensible for their own economy. For example, India has very high inflation – well above the central bank rate (see chart 2). As a general rule of thumb, if you want to get inflation down you will need to have your central bank rate higher than the inflation rate (i.e., a positive real rate). Before Turkey doubled its interest rate last week (although the actual impact is probably about half the headline number), its monetary policy looked far too loose to control inflation. While *some* hiking was justified, the doubling of headline rates looks like panic; and catching up so quickly is dangerous, especially when the unemployment rate is already trending upwards. Over-aggressive tightening to avoid external depreciation may simply result in even more painful domestic deprecation in the form of lower output and falling prices.

An alternative way to maintain the exchange rate is to use your foreign reserves to buy your own currency. This tends to be a losing game when faced with sustained capital flight – Argentina has been throwing its foreign reserves at the market but has been unable to stop the slide in its currency. Many countries in Asia have huge foreign exchange reserves and consequently have been far less affected by the panic. Some like China and Korea have such big reserves that the markets are unwilling to test them. Nonetheless, despite their better fundamentals, currencies for many Asian EM have been caught up in the recent volatility.

Given the costs, choosing to let go of the currency and allow a depreciation ultimately makes sense – after all, a lower currency makes you more competitive. The adjustment period can be very painful though, and if there is a panic in the capital flight there could be enough disruption to damage the economy. Even without the panic, a depreciating currency will generate inflation. After the Fed announced tapering last year and EM currencies started to sell off, Indonesia was one country that did not attempt to stand in the way of currency depreciation. Now that this is translating into higher inflation through import prices, Bank Indonesia has had to raise rates to combat inflation.

Chart 2: Wiggle room

Most recent CPI inflation reading and real central bank policy rate (nominal rate less CPI inflation), %



Source: Bloomberg Finance LP, UBS Global Asset Management
Note: Dates of most recently available data vary by country. KOR = South Korea, THA = Thailand, POL = Poland

For investors in EM, the greatest fear has to be that there is a panic as everyone tries to be the first out of the door. Such panics can become self-fulfilling, creating problems far worse than are justified by the economic fundamentals. Some of the investors into EM in recent years are new to EM, having only invested there because returns were so low at home in developed markets. Such investors are most likely to panic, and when they do so they sell the whole benchmark. So far the larger institutional investors have remained calm, but if they joined the panic the impact could spread to EM that are not really risky. To the savvy investors, that could create the best buying opportunity in EM for years.