

Nothing stays the same: EM's dramatic external rebalancing

By Jan Dehn

A yet-to-be realised bullish narrative of exit velocity and rate hikes in the US has pushed the US dollar up by nearly 40% against Emerging Markets (EM) currencies since 2011, aided by plentiful QE liquidity from Western central banks.

This surge in the Dollar quickly triggered panic about EM's abilities to cope with the resulting capital outflows, falling commodity prices, higher inflation via FX pass-through and possible FX mismatches on corporate balance sheets.

EM growth did slow in response to these drags, but EM countries have spectacularly failed to implode. There are no widespread defaults or balance of payments crises.

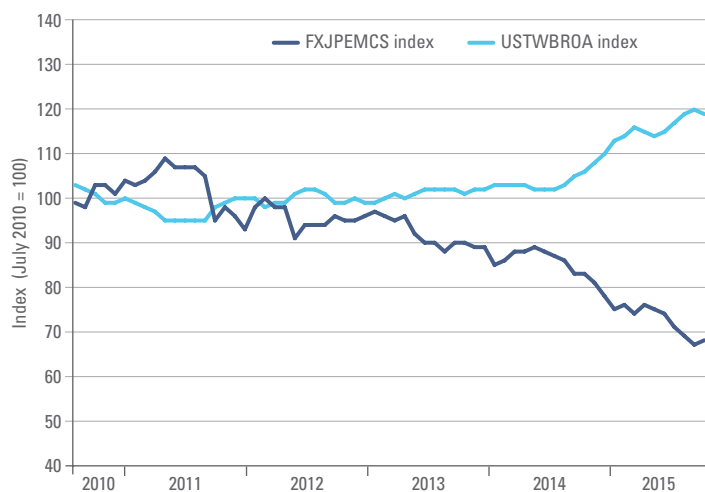
Instead, there is mounting evidence that EM economies have undergone significant adjustment because most EM countries were able to control inflation when their currencies weakened, thus restoring competitiveness. Nowhere is this more evident than in their current account balances.

Exchange rate shock

The US dollar has surged dramatically since the commencement of QE in Q2 2011. Perhaps contrary to economic intuition, printing Dollars has been bullish for the Dollar, because there has been no inflation, so every Dollar printed has been 'real' money. The QE Dollars have exclusively bought Dollar denominated assets in the US and global asset allocators have been quick to jump on the QE band wagon, thus adding dramatically to demand for Dollars.

EM currencies have been on the other end of that trade. Lacking QE sponsorship, their performance has been a near-perfect inverse image of the Dollar (see figure 1). Have EM countries gained external competitiveness on the back of this move in their currencies?

Fig 1: Trade-weighted broad US dollar index and EM currencies



Source: Ashmore, Bloomberg.

Big gains in EM's current account balances

There are good reasons to suspect that current account balances have improved in EM in response to weaker currencies. Yet, there are also three good reasons to expect different response times across EM countries:

1. Currency depreciation can trigger temporary capital outflows due to nervousness or pure speculation on the part of portfolio investors. Short-term volatility can in turn make it harder for the economy to adjust by raising hurdle rates to investment. Incidentally, this is why EM central banks are so fond of maintaining large stocks of FX reserves; reserve cushions give them the means to manage temporary bouts of currency volatility.
2. Current account balances sometimes respond with considerable lags to changes in exchange rates. 'J-curve' effects occur when contractual obligations extend into the future and can create perverse initial responses to currency changes. Response times are also affected factors, such as market efficiency, reforms and credibility.
3. There are typically distributional consequences when resources have to move from one set of sectors to another in response to relative price changes. This can lead to political obstacles to adjustment.

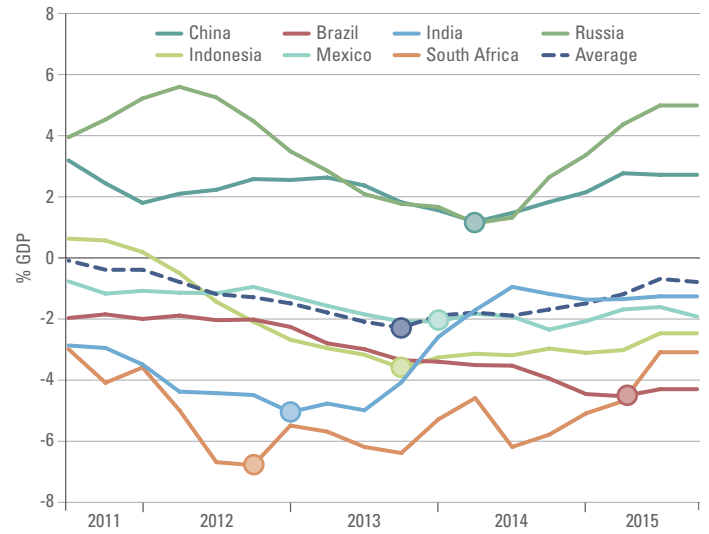
The implication of these differences across countries is that it can be highly misleading to gauge the responsiveness of current accounts to single externally generated nominal exchange rate shocks by comparing across two fixed points in time when dealing with a large sample of heterogeneous countries.

This is illustrated in figure 2, which shows the path of current account balances for seven large EM countries. The large dots denote where each country's current account balance turned since QE began.¹ On average, the current accounts in the sample 'turned' some 2¼ years after the start of QE, but variation across the sample is considerable. South Africa's current account turned as early as September 2012, while Brazil's external balance only appears to have troughed in March 2015.

To take explicit account of these very different response times, we measure the improvement in current accounts across our sample from each country's respective turning point. This approach explicitly recognises that each country may adjust at different speeds.

EM economies have undergone significant adjustment – most countries have controlled their inflation when their currencies weakened so they have been able to restore competitiveness

Fig 2: Current account balances



Source: Ashmore, Bloomberg.

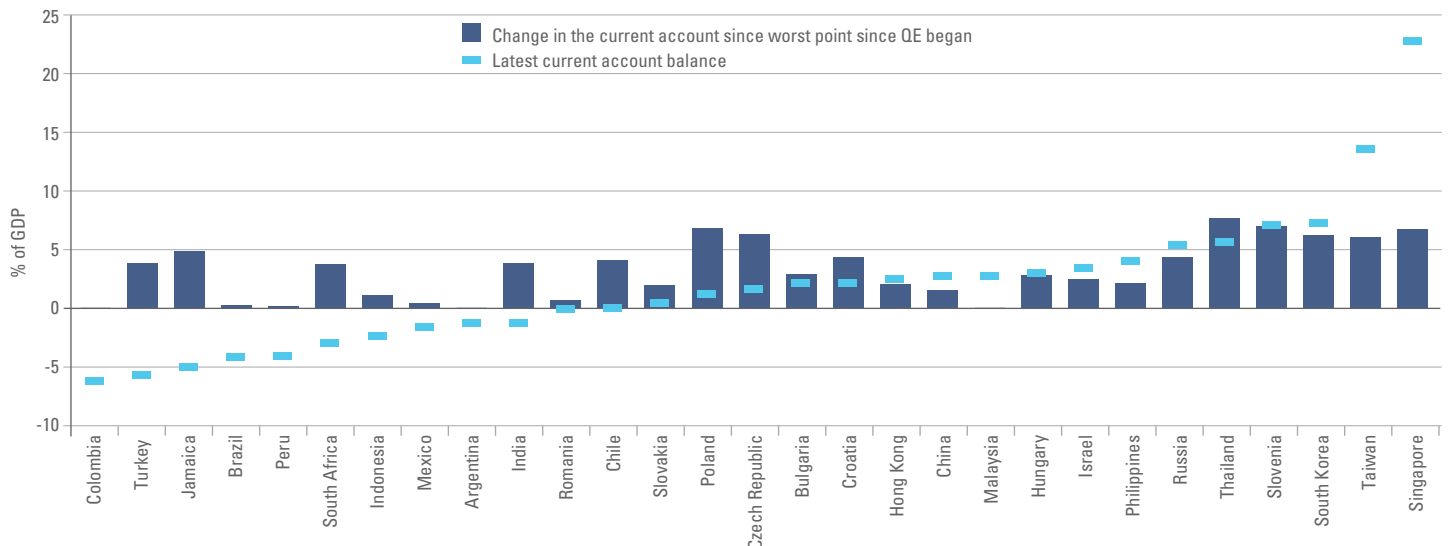
Dramatic improvements

We found that on average, the improvement in current account balances across a sample of 29 of the most widely traded EM countries has been very substantial at 3.2% of GDP.² There is obviously considerable variety across the sample, but it is telling that even at the median – which is less sensitive to outliers – the cumulative improvement in the current account balances of the sample has still been a very meaningful 1.8% of GDP.

Ninety percent of the countries in the sample have improved their current account balances since Q2 2011. The 26 'improvers' in the sample have seen their current account balances improve by 3.6% of GDP on average (2.2% of GDP at the median). One fifth of countries in this sub-sample swung from deficit to surplus status over the relatively short period in question. Figure 3 illustrates the change in current account balances along with the levels achieved by Q3 2015.

Only three countries in the sample – Argentina, Malaysia and Colombia – have not yet recorded any improvement in their current account balances, despite, in each case, much weaker currencies. But even here there are reasons to believe that fundamental adjustment is coming. For example, all three countries have experienced significant real effective exchange rate depreciation, particularly since the Taper Tantrum two years ago. Malaysia, which runs a substantial current account surplus, has seen its real effective exchange rate (REER) depreciate by 10% in the past two years, while Colombia's REER has fallen by a whopping 32% over the same period. Argentina's real exchange rate has also depreciated a significant 25%. This means that all three countries are sitting on 'unrealised gains' in external competitiveness that could be actualised in the quarters ahead provided that they keep inflation under control. Only in the case of Argentina do we worry that price stability may not be achieved.

Fig 3: Improvement in current account balances: 29 EM countries, Q2 2011 to today



Source: Bloomberg, Ashmore.

¹ Q2 2011.

² Colombia, Turkey, Jamaica, Brazil, Peru, South Africa, Indonesia, Mexico, Argentina, India, Romania, Chile, Slovakia, Poland, Czech Republic, Bulgaria, Croatia, Hong Kong, China, Malaysia, Hungary, Israel, Philippines, Russia, Thailand, Slovenia, South Korea, Taiwan and Singapore.

Improvement in spite of commodities

EM's current account performance is particularly impressive, because it has taken place in spite of rather than because of changes in commodity prices. Figure 4 plots current accounts versus the Thomson Reuters/Core Commodity CRB Commodity Price Index, aka DXY Index in Bloomberg code.

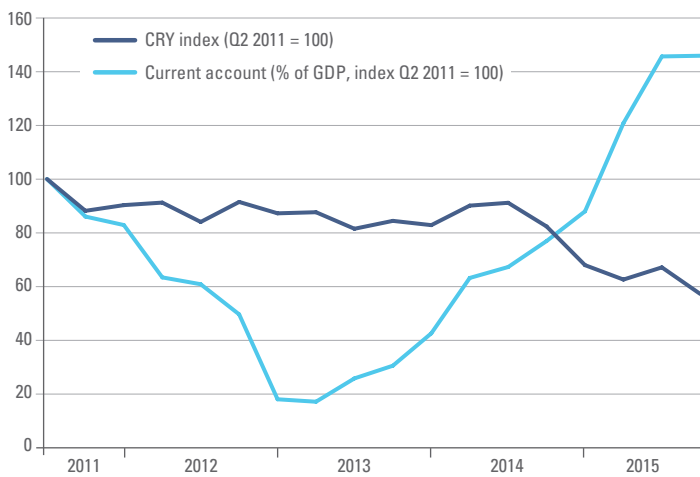
It is clear that while commodity prices have fallen steadily throughout the sample period current account balances have staged a sharp recovery mid-sample. The result is an overall correlation between the two series of -0.59.

This result carries over to terms of trade as well. Many EM countries import commodities as well as export them, so

country-specific indices of commodity terms of trade are arguably better gauges of the potential impact of commodities on EM current account balances than a simple broad commodity price index.

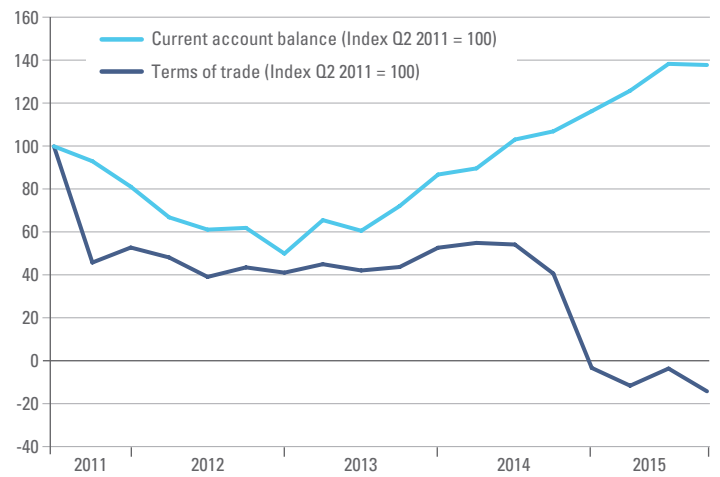
Figure 5 shows EM current account balances and commodity terms indices for 22 EM countries. Clearly, the inverse relationship between terms of trade and current account balances is equally emphatic here, underlining, once more, that the notion that EM investing is a commodity play is simply non-sense. The result also strongly supports the conclusion that recent improvement in EM current account balances is mainly due to improving competitiveness on the back of lower nominal exchange rates.

Fig 4: Commodity prices and current account balances in EM



Sources: Ashmore, Bloomberg.

Fig 5: Current account balances and commodity terms of trade



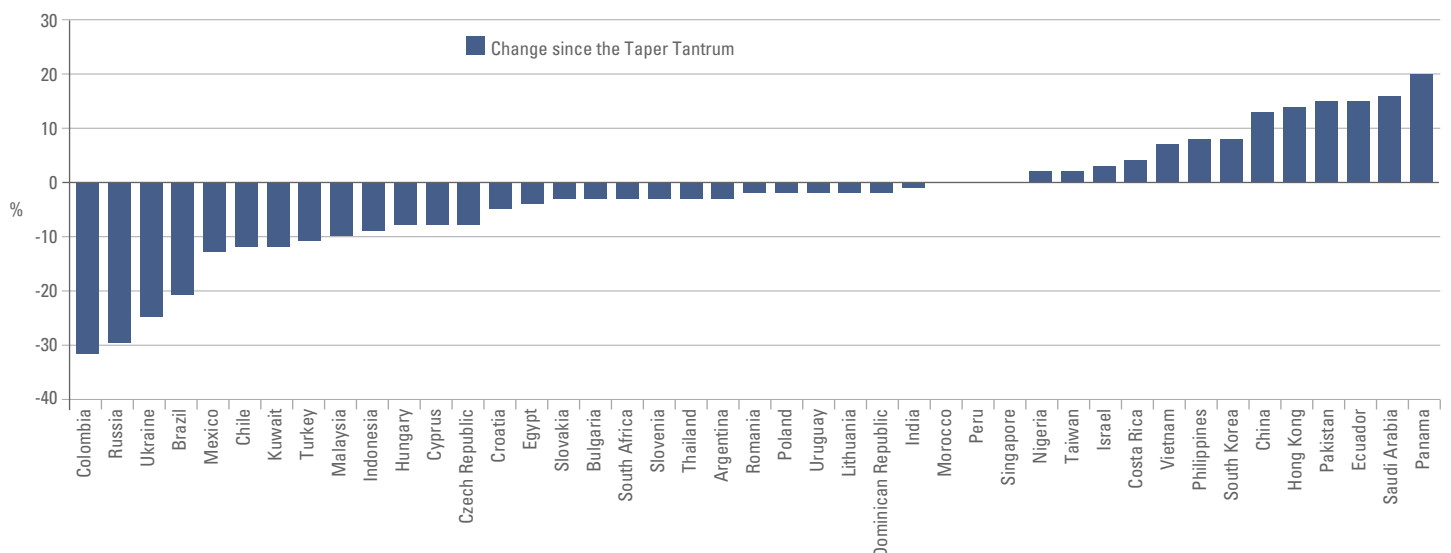
Sources: Ashmore, Bloomberg.

Real depreciation

The bulk of EM countries – more than 2/3 of the sample – have realised significant real depreciation during the US dollar rally of the last few years. The most depreciated real exchange rates are in South America – Colombia, Brazil, Mexico and Chile – but Russia, Ukraine, Turkey, Indonesia and Hungary have also eked out significant competitiveness advantages due to weaker currencies.

Figure 6 summarises the changes in REERs over the sample (negative numbers denote REER depreciation, i.e. gains in external competitiveness) based on a sample of real effective exchange rates for 44 EM countries.

Fig 6: Real effective exchange rates



Source: Ashmore, Bloomberg, BIS.

Clearly, not all EM countries have benefited from a stronger US dollar. For example, the US dollar rally sharply appreciated the real exchange rates in countries whose currencies are fixed or pegged to the US dollar or otherwise track the Greenback, including China, Hong Kong, Saudi Arabia, Singapore and the UAE. Many of these countries can handle real appreciation, because they run significant external surpluses, but other Dollar based countries such as Costa Rica, Ecuador and Panama now face serious competitiveness challenges.

Oil exporters with pegged or fixed exchange rates also face challenging times. The only way these countries can adjust to lower oil prices is to reduce domestic demand. Some, such as Saudi Arabia, have room to do this in a smooth fashion by running temporary large fiscal deficits on account of very low starting levels of public debt.

Others have remained in denial, refusing to adjust resulting in dramatic real effective exchange rate appreciation. The most appreciated real exchange rate of them all is that of Venezuela, whose REER is up 211% since the Taper Tantrum (not shown in figure 6, because Venezuela's appreciation dwarfs all other countries).

The bulk of EM countries – more than two thirds of the sample – have realised significant real depreciation during the US dollar rally of the last few years

One can also discern a group of 'low beta' EM countries, such as Israel, South Korea and Taiwan that have had less currency depreciation in the face of the USD rally than other EM countries, though they have typically also benefitted from positive terms of trade shocks by virtue of being commodity importers.

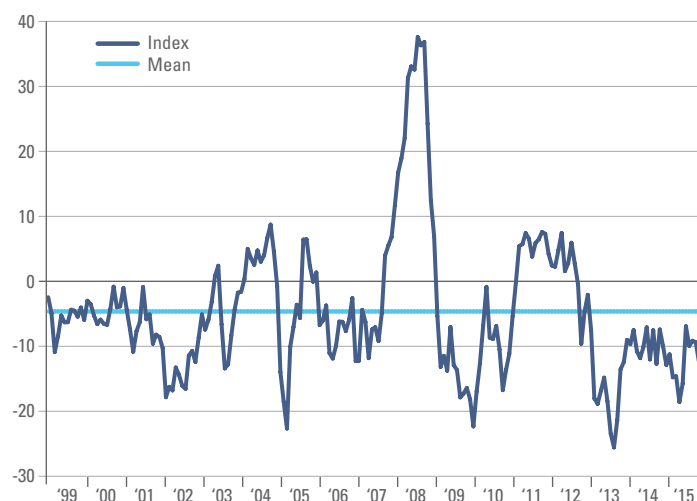
As an aside, the REERs of the UK and United States are now 20% more appreciated than before QE began. The Eurozone countries and Japan have benefitted from weaker currencies. Within developed economies, the pressure is clearly mounting in the US.

Price stability

The fact that so many EM countries have achieved considerable REER depreciation suggests that they have maintained inflation discipline in the face of currency weakness. This is indeed the case.

The Citibank's inflation surprise index for EM countries shows that inflation continues to surprise to the downside in EM (see figure 7). This testifies to the credibility of most EM central banks as inflation-targeters. As always, there are many and important exceptions. Inflation has emerged as a problem in countries that have deliberately undermined central bank credibility, such as Argentina, Brazil and Venezuela. Others, such as Russia and Colombia, have also seen inflation rise, but mainly due to exceptionally large nominal exchange rate shocks that have temporarily pushed up inflation in a mechanical fashion, but in these countries we expect the inflationary impulse to be strictly temporary, because their central banks remain highly credible, in our view.

Fig 7: EM inflation surprise index



Source: Citibank, Ashmore, Bloomberg.

Conclusion

EM countries have successfully weathered a US dollar storm over the past few years. Spreads have steadily widened over the period as investors have chased QE sponsored opportunities in developed markets. But rather than blow up most EM countries adjusted and hence sowed the seeds for future performance. Domestic demand has slowed, while exports have become more competitive. Overall, current accounts have improved significantly as EM countries were able to maintain inflation discipline despite weaker currencies. The meaningful improvements in EM current accounts suggest that EM may soon begin to accumulate reserves again, particularly if capital account flows stabilise.

On a broader fundamental level, EM countries should not have weaker currencies. The recent weakness in EM FX is once again turning EM countries into net exporters, which implies that developed economies must consume more. This in turn implies wider external deficits and more debt in developed economies, which only increase the global imbalances.

The US dollar rally of the past few years is one of the unintended consequences of QE and it is ultimately unsustainable. The sustainable path forward is one involving weaker QE currencies, so that the heavily indebted money-printing developed economies can export and inflate their way back to health. EM's real challenge – which still lies ahead – remains one of coping with eventual currency appreciation, not depreciation.

How does nominal depreciation affect the current account?

Nominal exchange rate depreciation should improve the current account by altering relative prices in favour of export sectors and away from domestic demand-led sectors. Additionally, a weaker currency can induce a supply-side shift within the tradable sector that encourages the production of domestic import substitutes and exportables. Overall, the result should be a stronger current account.

This outcome, however, hinges on a number of other factors. Most importantly, countries must ensure they keep inflation under control to prevent the gains from nominal currency depreciation being eroded away by higher prices. This critical relationship between nominal exchange rates and inflation can be summarised into a single measure called the real effective exchange rate (REER). A depreciation of the REER denotes improving competitiveness, which occurs when nominal exchange rates depreciate faster than home prices rise. REER appreciation happens when currencies appreciate faster than domestic prices, given foreign prices.

Mathematically:

$$REER = \frac{\text{Nominal ER} \times (\text{Tradable Home Prices} + \text{Non-Tradable Home Prices})}{\text{Foreign Prices}}$$

In practice, many other factors beyond inflation determine the evolution of the REER and therefore current account balances. They include terms of trade, reforms, labour market flexibility, capital account policies, fiscal and monetary policies, credibility of policy makers, etc. All these factors will in some way or other potentially influence how industries in countries experiencing currency depreciation are able to realise gains in competitiveness vis-à-vis competitors in similar sectors in other countries. In short, the relationship between the current account and nominal exchange rates is an empirical question.

Contact

Head office

Ashmore Investment Management Limited

61 Aldwych, London WC2B 4AE

T: +44 (0)20 3077 6000

[@AshmoreEM](#)

www.ashmoregroup.com

Beijing

T: +86 10 5764 2601

Bogota

T: +57 1 347 0649

Jakarta

T: +6221 2953 9000

Istanbul

T: +90 212 349 40 00

Mumbai

T: +91 22 6608 0000

New York

T: +1 212 661 0061

Riyadh

T: +966 11 483 9100

Singapore

T: +65 6580 8288

Tokyo

T: +81 03 6860 3777

Washington

T: +1 703 243 8800

Other locations

Shanghai

Bloomberg page

Ashmore <GO>

Fund prices

www.ashmoregroup.com

Bloomberg

FT.com

Reuters

S&P

Lipper

No part of this article may be reproduced in any form, or referred to in any other publication, without the written permission of Ashmore Investment Management Limited © 2015.

Important information: This document is issued by Ashmore Investment Management Limited ('Ashmore') which is authorised and regulated by the UK Financial Conduct Authority and which is also, registered under the U.S. Investment Advisors Act. The information and any opinions contained in this document have been compiled in good faith, but no representation or warranty, express or implied, is made as to their accuracy, completeness or correctness. Save to the extent (if any) that exclusion of liability is prohibited by any applicable law or regulation, Ashmore and its respective officers, employees, representatives and agents expressly advise that they shall not be liable in any respect whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) out of or in connection with the contents of or any omissions from this document. This document does not constitute an offer to sell, purchase, subscribe for or otherwise invest in units or shares of any Fund referred to in this document. The value of any investment in any such Fund may fall as well as rise and investors may not get back the amount originally invested. Past performance is not a reliable indicator of future results. All prospective investors must obtain a copy of the final Scheme Particulars or (if applicable) other offering document relating to the relevant Fund prior to making any decision to invest in any such Fund. This document does not constitute and may not be relied upon as constituting any form of investment advice and prospective investors are advised to ensure that they obtain appropriate independent professional advice before making any investment in any such Fund. Funds are distributed in the United States by Ashmore Investment Management (US) Corporation, a registered broker-dealer and member of FINRA and SIPC.