It seems like emerging market (EM) currencies are down a lot. Is this a big move by historical standards?

A few currencies, such as the Turkish lira and the Argentine peso, have fallen a lot, but the move in the basket has not been particularly large, even when compared to the drop a few years ago. One or two currencies such as the Colombian peso are actually up on the year. It’s best to just look at the chart.

Why are some currencies under pressure? What has been driving the fall in EM currencies?

Most economists would point to policy in the U.S. The Fed has been raising rates and slowly reducing its balance sheet. This is putting pressure on countries that have to fund current account deficits. The more vulnerable currencies, those in countries with current account deficits or political uncertainty, have been getting hit since investors can move into U.S. dollars and earn positive returns on their cash. The fact that the U.S. dollar is up against many developed currencies hasn’t helped.

But the Fed has been moving slowly; its balance sheet reduction is no surprise. Why does it matter?

As the Reserve Bank of India Governor Urjit Patel pointed out in an FT editorial, the balance sheet contraction has been expected, but the tax plan is leading to higher U.S. deficits and more Treasury issuance than most analysts had forecast a year ago. We’ve previously argued that the Fed balance sheet contraction is roughly the equivalent of issuing longer-term bonds. The combination of the Fed and the Treasury has added a lot to the supply of bonds. It may be causing what Governor Patel describes as a dollar shortage in the world.

Would you say that this Fed and Treasury combination has created a double impact and caused double the Van Dammage?
No one in their right mind would say that. Let’s try to do one Q&A without a Jean-Claude Van Damme question.

Didn’t Patel’s predecessor, Raghuram Rajan, claim that Fed policy was too loose? Now Patel is complaining about tightening? [2]

Yes, it seems no one’s ever happy with U.S. monetary policy. To be fair, Rajan argued that low rates would be reversed at some point in the future and that would be painful.

Will the Fed take the EM currency concerns into account in its monetary policy?

The Fed does take international events into account, but Fed members have been clear that they set monetary policy based on U.S. conditions. It is unlikely this has reached the level where it will have a significant effect on the U.S. economy, so it shouldn’t change Fed policy at this point.

How have EM central banks reacted?

The RBI showed they weren’t all talk (or print on the editorial page) and responded with a surprise rate hike. [3] Brazil held off on cutting rates. [4] Turkey raised rates sharply and reformed the way it conducts monetary policy. [5] More generally, it has resulted in tighter monetary policy across EM countries. Higher rates could be viewed as an attempt to become more attractive for dollar funding. Higher domestic rates can also make it more expensive to short EM currencies. [6] Countries in which there are questions about their central bank independence or credibility have underperformed as investors have doubted their ability to react.

This does not seem like a crisis yet. But it brings up the question: why do we get EM crises?

There seems to be a fairly simple pattern. EM countries get large inflows of foreign capital which causes economic booms. Then foreign investors stop getting the returns they want and pull their money out. This can be destabilizing, particularly if the countries have become dependent on foreign investment.

How are conditions different now from times when there were crises?

For one thing, commodity prices are up on the year. [7] Past EM crises, including 1998, have been associated with lower commodity prices. The relationship makes sense because many EM countries, such as Colombia and South Africa, are exporters. Also, China has emerged as a large buyer of goods from other EM countries. China’s economy seems to be holding up pretty well, which could boost the economies of other EM countries. If China starts to crack or commodities prices fall, it could be a bad sign for EM currencies.

The Brazilian real is down. Isn’t the Brazilian real a commodity currency? Doesn’t that prove your whole point wrong, smart guy?

Brazil exports a lot of agricultural commodities, and those have lagged some of the other commodities. [8] Brazil is a small net exporter of oil, but the rise in energy prices has caused some political problems which have outweighed other economic benefits. Part of the Brazil economic liberalization plan was to reduce diesel subsidies. As a result, truckers facing higher fuel costs went on strike. This hurt the economy and led to a reversal of the policy. This, combined with concerns about the upcoming election, has been the likely driver of the real depreciation.

Is uncertainty about U.S. trade policy and tariffs having any effect?

Probably. If a country’s exports are disrupted, it could hurt its currency. The Mexican peso has been very sensitive to the ups and downs in NAFTA negotiations.

Does the label EM even make sense anymore?

EM countries are very diverse; it’s difficult to find a common economic characteristic. In fact there is a lot of disagreement as to which countries should be called EM. That may be why we are seeing so much dispersion in their returns. The only commonality they may have is that if things do get bad, investors could sell them all indiscriminately. Such is the blunt financial logic of panic.

You are ending on such a down note.

Folks aren’t panicking now. Also, the Colombian peso is up so far this year.

What We Are Watching

FOMC Meeting (Wednesday) The Federal Reserve is tasked with a dual mandate of full employment and price stability, and appears to be achieving success on both fronts. [9] As a result, the Fed has been gradually raising rates, and recent communications suggest the committee will likely announce another increase in its target range for the Fed Funds rate (to 1.75%-2%) at this month’s meeting. [10] While market participants appear confident in the outcome of the June meeting, there are a few major questions that are likely to shape market reaction on Wednesday. The Summary of Economic Projections (SEP) published in March showed a nearly even split on the committee between those expecting four total hikes in 2018 and those expecting three. If the SEP indicates that some participants have shifted their forecast to four hikes, it could cause markets to price in a more rapid pace of tightening moving forward. The committee may also choose to modify the post-meeting statement to acknowledge that rates are moving closer to a neutral setting. Finally, markets will be looking for a possible adjustment to the interest rate paid on excess reserves (IOER) aimed at preventing overnight rates from moving above the target range. Depending on where the committee lands on these questions, Wednesday could be an eventful day for U.S. fixed
European Central Bank Meeting (Thursday) As part of its effort to provide stimulus to the eurozone economy, the European Central Bank (ECB) has been buying large quantities of government bonds since 2015. According to its most recent guidance, these purchases “are intended to run until the end of September 2018, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim.” [11] A key question for eurozone markets in recent months has been whether the ECB will allow the purchase program to come to an end in September or will extend it (likely at a reduced pace) to December or even into 2019. This decision has implications not only for longer-term bond yields, but also for the pricing of short-term rates, as the ECB has stated it will not hike rates until “well past the horizon of our net asset purchases.” Until recently, it had seemed that the ECB might delay a decision until July, as lackluster growth numbers and rising political uncertainty in Italy have clouded the outlook. However, a speech this week by ECB Executive Board member Peter Praet, considered an influential centrist on the Governing Council, appeared to lay the groundwork for imminent announcement of an exit plan. [12] If the ECB announces that asset purchases will end in September, it would likely lead to a selloff in domestic fixed income and a rally in the euro. A more gradual tapering of asset purchases would likely be seen as more favorable for bonds and more negative for the currency.

[6] In non-deliverable currencies this relationship is not as direct, but there still tends to be some relationship between carry and currency returns anyway.
[7] As of 6/6/18, the S&P GSCI Spot Index is up 6.5% YTD. Source: Bloomberg.
[8] Brazil is a meaningful exporter of soybeans and sugar. Looking at GSCI spot returns as of 6/6/18 soybeans are up only 3.4% YTD and sugar is down 19.5% YTD. Source: Bloomberg.
[9] According to the Bureau of Labor Statistics, the unemployment rate has fallen to just 3.8%, the best level since 2000, and readings could soon reach levels not seen since the 1960s. Per Bureau of Economic Analysis data, the Fed’s preferred measure of inflation, the PCE Deflator, rose 2% YoY in April, exactly matching the central bank’s target (although readings excluding food and energy remain a bit lower).
[10] For example, the minutes of the May FOMC meeting stated that “most participants judged that if incoming information broadly confirmed their current economic outlook, it would likely soon be appropriate for the Committee to take another step in removing policy accommodation.
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