Research Briefing | Global

Navigating the next EM currency crisis

Economist

Evghenia Sleptsova
Senior EM Economist
+44(0)20 3910 8022

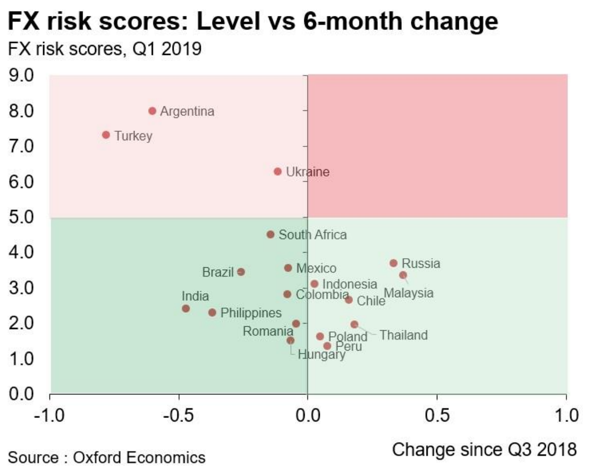
Innes McFee
Managing Director
+44(0)20 3910 8028

Louis Mullen
Assistant Economist
+44(0)20 3910 8134

- **Despite significant adjustments since last year, the Argentinian peso and Turkish lira are still the two currencies most vulnerable to a renewed downturn in market sentiment according to our new FX Risk Tool.**
- **While the Ukrainian hryvnia escaped the market's ire in 2018, it's also at significant risk, scoring close to the beleaguered lira in our framework. Avoiding a large sell-off remains dependent on continued cooperation with the IMF, which in turn hinges on the outcome of the October elections.**
- **South Africa's uncompetitive and structurally rigid economy – both of which the government has failed to address – reinforces its chronic twin deficits, making the rand the next most risky EM currency in our ranking.**
- **While Colombia's peso is often cited as the next victim of a sell-off, we think this fear is overblown and is likely based on a misunderstanding of the country's broader macro fundamentals.**
- **At the opposite end of the spectrum, Asian and CEE currencies are likely to be the most resilient to a change in risk appetite due to these countries' solid external balances and contained inflation pressures.**

Last year was a tough one for emerging markets, with their currencies having lost on average 11% since mid-April 2018 and FX being the worst performing asset class. Although this year's survey data on China suggest the worst has passed, the mounting uncertainty about growth in the US and global trade tensions still pose risks to global market sentiments, and more volatility may well be in store for EM currencies. In this briefing – which is a companion piece to "A new tool for measuring currency risk" - we focus on floating EM currencies. Follow-up research will look at pegged and managed regimes.

Chart 1: Who to watch – FX risk trends across EMs



Despite gradual adjustment, Argentina, Turkey and Ukraine remain most at risk of a currency crisis or a sharp depreciation.

Contact: Evghenia Sleptsova | esleptsova@oxfordeconomics.com

EM currency crises are still a threat

Despite a relatively benign global environment over the past few years, investor sentiment has remained fragile and, as a result, FX crises in emerging markets have continued to occur regularly (**Chart 2**).

While the timing of such crises is difficult to predict, the relative performance of currencies in the event of a sell-off is not, as we noted in August (**Chart 3**). We found other metrics do not have anywhere near the same predictive power in a sell-off. For example, repeating the regression in Chart 3 with credit ratings would yield an r^2 of just 0.5. Our new FX Risk Tool is designed to help clients identify and manage their risks across 166 currencies and spot opportunities in these episodes.

Looking at floating EM currencies, we currently see Argentina, Turkey, Ukraine and South Africa as most at risk of a significant depreciation, and Asian and CEE currencies (CZK, PLN, KRW, HUF, THB and PHP) – as most resilient. For most EMs, though, risks have improved over the past six months, with only Russia, Malaysia and Chile seeing deterioration (**Chart 4 and Annex 1**).

Policy and imbalances are raising risks

Looking at changes in risk profiles, we see internal policy (monetary and/or fiscal policies) as the main drivers of either positive or negative changes across currencies. In some cases, the deterioration stems from higher inflation and rate hikes. As our companion report on the methodology underlying our FX Risk Tool explains, rate hikes can help to stop capital from fleeing in the short term, but also signal higher currency risk. This is why risk scores for Russia are relatively high despite its very strong macro fundamentals, and why its currency is perceived to be higher risk following rate hikes in 2018.

Chile, Indonesia and Romania are the only countries where widening external imbalances are key drivers of higher risk. Interestingly, banking sectors have played a relatively limited role in either deterioration or improvement in most risk profiles, with the notable exception of Turkey and, to a lesser extent, Argentina and Chile. In Turkey, outstanding credit swelled in the wake of its 2018 currency crisis due to devaluation effects.

Chart 2: Currency crises have been the most common crises recently

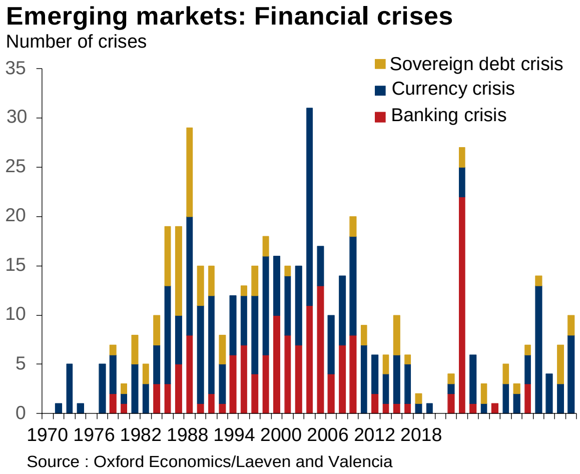


Chart 3: OE FX Risk Tool explained over 80% of TRY-driven depreciation

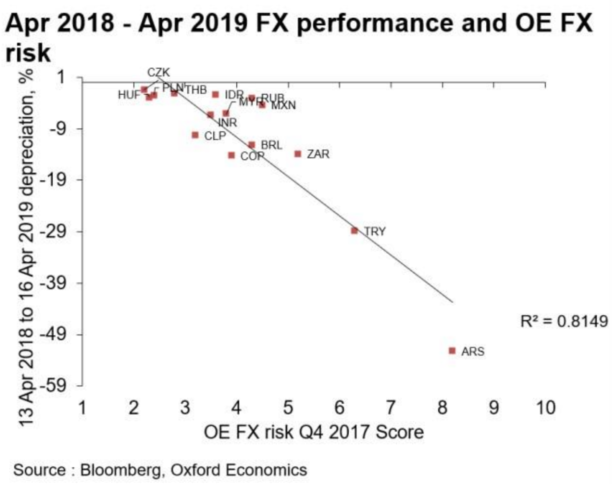
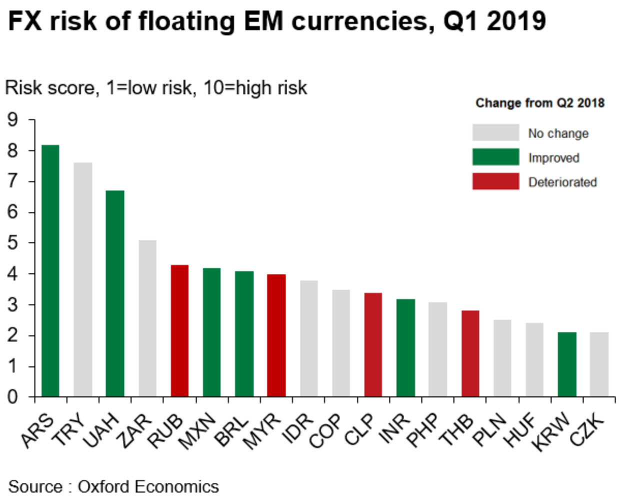


Chart 4: Ranking of FX risk across floating EM currencies



The usual suspects and some new ones

In the wake of corrections in Argentina and Turkey following their respective currency crises last year, these two are still the most vulnerable. In our rankings Argentina scores 8.2 out of 10 and Turkey 7.6 – equivalent to a 70% chance of a currency crisis in the next three years (**Chart 5**). Both continue to suffer from past policy mistakes and new missteps that are preventing the corrections being more effective.

Turkey's external adjustment achieved in H2 2018 has started to reverse amid insufficient credit adjustment, putting renewed pressure on the currency (**Chart 6**). The government's reluctance to accept a lower pace of growth, the central bank's severely dented credibility and the opacity surrounding FX reserve losses have proven damaging for confidence, both domestically and among foreign investors, and may be storing up bigger trouble for TRY down the road.

Similarly, Argentina's large rate hikes have helped to temporarily stabilise the situation but have also dampened economic activity. And as the BCRA's unconventional methods (such as keeping the monetary base flat) to stave off inflation are failing, the latest moves to defend the peso through FX interventions and price controls are likely paving the way for another classical currency crisis.

Both Turkey and Argentina demonstrate that once a full-fledged balance of payments crisis breaks out there are no 'good' options to fix the economy. This is particularly true if a country tries to meet mutually incompatible goals at the same time, such as stabilising the exchange rate, supporting growth, reducing inflation and keeping borrowing costs down – even with enormous international assistance, as in Argentina. Failure to take the "bitter pill" of adjustment may result in more painful financial crises, and potentially even the twin or triple whammy of sovereign and/or banking crises, down the line.

The Ukrainian hryvnia (scoring 6.7 or a 47% chance of crisis in 3 years – **Table 1**) was an outlier in the August 2018 sell-off, having lost only 3.8% (against an EM average of 6.5%). But it was only possible due to NBU's interventions ($634m in August and $1.8bn in 2018 as a whole, or about 10% of its reserves before the last IMF tranche was received in November 2018). As a result, hryvnia is now at least 10% overvalued. The presence of the IMF programme and large inflows of remittances equalling £14bn in 2018

Chart 5: Drivers of change in FX risk since Q2 2018

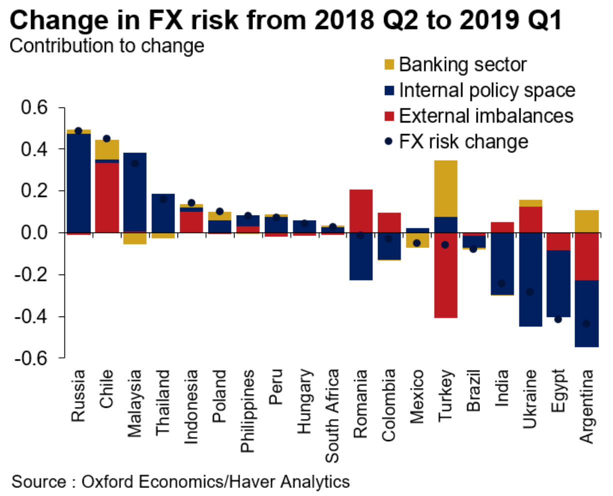


Chart 6: Turkish credit swelled in the wake of the currency crisis

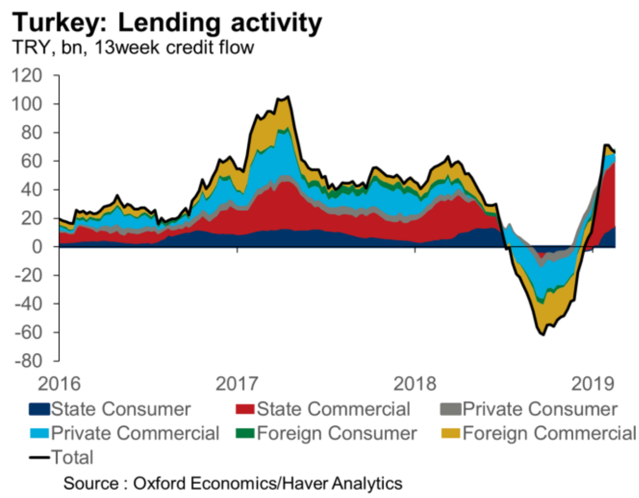


Table 1: Probabilities of a currency crisis by risk score bands

	Probability of a currency crisis in		Sample EM currencies
Risk scores	1 year	3 years	
1-2	5%	17%	
2-3	8%	22%	THB, PLN, HUF, KRW, CZK
3-4	9%	25%	MYR, IDR, COP, CLP, INR, PHP
4-5	11%	34%	RUB, MXN, BRL
5-6	14%	43%	ZAR
6-7	18%	47%	UAH
7-10	37%	71%	ARS, TRY

Note: The probabilities are derived from historical back-testing of the incidence of currency crises across the entire sample of 166 countries (with crisis defined as 3 standard deviations over the previous five-year history).

– factors that are not captured in our framework – provide a significant cushion to the currency. But this cushion may well disappear should the October elections install a new government that fails to renew cooperation with the IMF, or if an external demand shock reduces the flow of remittances.

South Africa's rand is the next most vulnerable among floating EM currencies, scoring 5.1/10 on our tool, which indicates about 40% probability of a currency crisis in the next three years. South Africa remains the only major emerging market that has avoided a balance of payments crisis in the past five years. The country's lingering structural rigidities and uncompetitive economy mean that it is stuck in a low growth trap, preventing it from narrowing the twin deficits of about 4% of GDP each (the widest among major EM) and improve its reserve coverage. With upcoming elections unlikely to bring about a major policy break-through, the volatile (and prone to overshooting) ZAR will remain one of the most vulnerable EM currencies.

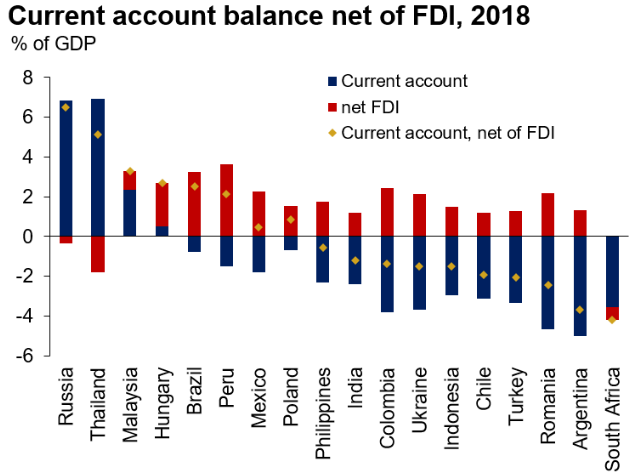
Colombia is misunderstood

The Colombian peso is often quoted as the next in line for a sell-off (e.g. here or here) and, indeed, it was the fourth worst performing currency since the EM sell-off last year. The drivers of this performance are most likely Colombia's relatively wide current account deficit, which stood at 3.8% in 2018 (up from 3.3% in 2017) and its high dependence on oil prices. Yet we believe that looking at the current account without considering how it is funded can be misleading. Taking into account FDI, only 1.4% of GDP in the current account deficit needs to be covered by portfolio flows (**Chart 7**). In the meantime, Colombia's structurally low inflation is an important strength that reduces any domestic pressure on the currency. We therefore see COP as medium risk, scoring 3.6/10.

Asia and CEE currencies are the most resilient

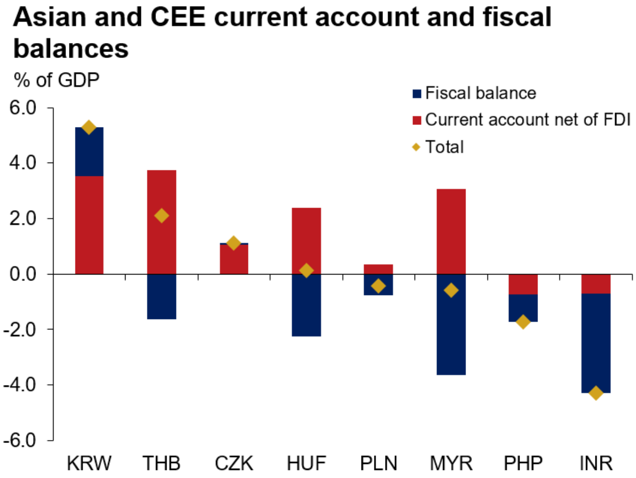
Asian and CEE currencies appear at the lower end of our risk ranking. Large overall external debt burdens and low reserve coverage in Hungary and Poland do not make their currencies more vulnerable in our view, as these are offset by their balanced or positive current account positions and contained inflation. Asian currencies benefit from a combination of either low inflation and low interest rate differential (Malaysia, Thailand), or very low short-term external debt (India, Philippines). South Korea, Thailand and Malaysia also stand out for their high and positive current accounts (**Chart 8**).

Chart 7: Current account balances and their financing



Source : Oxford Economics / Haver Analytics

Chart 8: Solid twin balances support Asian and CEE currencies



Source : Haver Analytics