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Financial Markets

Emerging markets: An uncertain route adjustment

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Following a bonanza year in 2017, this year looks like becoming a year of losses for emerging financial markets. Since the beginning of the year these countries' currencies have depreciated on average by close to 13%, their stock exchanges have fallen by 10% and their risk premiums have increased by nearly 100 basis points. Following the renewal of tensions in August, the big question is: Are we on the verge of a crisis in emerging markets?

To answer this question, we need to step back and see the picture in perspective. On the one hand, it is important to stress that, unlike previous episodes, the appearance of tensions should have been no great surprise, since the process of monetary normalisation, which is in full swing in the US, with other central banks gradually following suit, was announced in advance and marks an inflection point for markets in general and emerging markets in particular, since they clear benefited from the abundant liquidity and cheap financing.

That said, the exact timing of this inflection point was as usual unpredictable. The trigger for the first upset in the emerging markets, in the spring, was the surprising appreciation of the dollar which, combined with the uptick in US interest rates, led to a change of sentiment: appetite for emerging markets gave way to increased risk aversion, investors adjusted their exposure to these countries and in the end there was a correction in asset prices, especially currencies. Given that the basic concern is ability to service their (external) debt, the impact has not been uniform across the board: on the contrary, there has been clear differentiation. Thus countries such as Argentina and Turkey, considered more vulnerable in view of their large external financing requirements, are suffering very abrupt adjustments, whereas the bulk of emerging markets are experiencing orderly price adjustments – we might even say necessary adjustments, given for example the risk premiums and bearing in mind that we were starting out from a situation of complacency in the markets.

In August there was a second wave of turbulence, with similar characteristics to those of the springtime bout in that the epicentre was once again in these two countries. But with some differentiating features. Firstly, the extreme nature of the tensions, which in both cases reached their highest points since the international financial crisis, and the fact that risk premiums soared well above the equilibrium levels (reflecting market over-reaction). Secondly, we are starting to see some contagion, possibly fuelled by factors of a technical nature. And thirdly, the turbulent spell, while not extreme, is showing signs of being persistent, which will have an effect on activity and may also feed back into negative expectations.

It is not easy to know how this episode will end, but there are reasons to think it may have some way to go yet. We are expecting new rate hikes from the Federal Reserve, the next one at the end of this month, and there are bound to be more. The uncertainty about trade policy does not seem likely to clear up any time soon. This is a very significant aspect for China, because it may be a destabilising factor, now that the authorities have succeeded in halting the depreciation of the currency and capital flight. And we are also watching closely to see how systemic economies such as Brazil develop with the upcoming elections in October.

Although they have increase, tensions for the emerging markets as a whole are currently less than they were in the crisis episodes originating in China in mid-2015 and early 2016. High frequency data of investors’ re-routing of funds do not point to a sudden stop in flows to emerging markets. And for the majority of countries in the region the increase in the risk premium remains contained and in line with their fundamentals. But the bout of turbulence has not ended, and the expectations channel is crucial. We shall remain on the alert.

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