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The Causes of Currency Turmoil in the Emerging Economies

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Despite unprecedented high debt levels in major developed economies, their economic outlook remains generally sunny. It is especially so with the United States which is enjoying almost full employment[1] and higher gross domestic product (GDP) growth than before. However for many emerging economies (EMEs) and developing countries as a whole, the downward pressure has been mounting and the fragility and vulnerabilities of their economies have once again become more evident. Currency turmoil in Argentina made the country return to the International Monetary Fund (IMF) for financial support. Currently, the currency crisis in Turkey is still playing out. Developing countries including Brazil, China, Viet Nam, Colombia, Indonesia, Pakistan and South Africa are all struggling with currency depreciation pressures to varying degrees. Many commentators put the blame of the dramatic currency depreciations of Turkey and Argentina squarely on the countries themselves and consider their problems completely self-inflicted. However, to be objective, though their problems do reflect the economic imbalances of these countries, the flaws in the current international financial system and external shocks also have their fair share in pushing these economies off the cliff. It is important to bear in mind that, in a globalized environment, the world economy would also feel the pain of the sufferings in the emerging economies. If disinflationary headwind gets stronger and drags these economies into recession, the sunny sky in the developed world would at least turn overcast, if not worse.

External factors contributing to EME currency turmoils

One important factor for the boom and bust cycles of the world economy including the currency crises is the inherent weakness or a structural flaw of the international monetary system, namely the heavy reliance on the US dollar as the dominant international reserve currency. Foreign debt is mostly denominated in dollars and international trade is predominantly undertaken in dollars and priced in dollars, oil for example. As a result, the

Abstract

Many emerging economies and developing countries are facing strong economic headwinds. Currency depreciation pressure is mounting for some countries. Argentina and Turkey are coping with currency crises, massive capital outflows and hyperinflation. To say their crises are completely self-inflicted is not correct. The exogenous shocks have played an important role. Other emerging economies and developing countries as a whole should be vigilant and try to defend their currencies and maintain financial stability. It is also high time to try to fix the flaws in the international financial system.

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De nombreux pays émergents et en développement sont en proie à d'importantes difficultés économiques. La monnaie de certains pays subit de plus en plus de pressions à la baisse. L'Argentine et la Turquie font face à une crise des changes, à la fuite massive des capitaux et à l'hyperinflation. Il est faux de dire que ces pays sont les seuls et uniques responsables des crises qui les affectent ; les perturbations externes y ont fortement contribué. Les pays émergents et en développement en général devraient être vigilants et s'efforcer de défendre leur monnaie et de maintenir la stabilité financière. En outre, il est grand temps de s'employer à corriger les lacunes du système financier international.

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Muchos países emergentes y en desarrollo hacen frente a importantes factores económicos adversos. En algunos países aumenta la tendencia a la depreciación de la moneda. La Argentina y Turquía afrontan crisis monetarias, salidas masivas de capital e hiperinflación. Decir que sus crisis son totalmente autoinfligidas es equivocado, pues las perturbaciones exógenas han desempeñado un papel importante. Los países emergentes y en desarrollo en general deberían estar alerta, procurar proteger sus monedas y mantener la estabilidad financiera. También es hora de intentar corregir las deficiencias del sistema financiero internacional.

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United States Federal Reserve's supply of liquidity and its policies affect the business cycle of the world economy even though much of the dollar lending is outside the US banking system proper, namely controlled by financial institutions outside the United States. A large amount of international US dollar balance sheets outside the US rely more on short-term wholesale instruments including interbank deposits, commercial paper, and certificates of deposits. These financial instruments are highly volatile and very responsive to US monetary policies.[2]

Michael Hudson used the term "monetary hegemony" in his book *Super Imperialism*,[3] to describe the pivotal role of the US dollar on the global financial system and how peripheral developing countries of the financial system have been at the mercy of the dollar cycle.[4]

Because of this phenomenon, the appreciation and depreciation of the dollar and the increase and decrease of the interest rates by the US Federal Reserve would have important ramifications on other economies, in particular the economies with various fragilities. Some economists consider the current financial system as a "non-system"[5] influenced heavily by a "hegemonic currency."[6]

The flaw in the international financial system has been further exacerbated with financial innovations in recent decades, which further encouraged risk taking behavior as innovations and computerization have sped up the flow of hot money and also reduced the costs to investors in times of banking and financial crises.[7]

The major tool for containing and managing the 2007/2008 global financial crisis was a decade of monetary expansion by major developed countries via zero or negative interest rates and the quantitative easing (QE). These policies have led to an astronomical increase of the supply of international liquidity in dollars and Euros and much of them have not been invested in productive sectors but became speculative capital outflows to emerging and even low income developing countries. As the source countries of the financial crisis were the developed economies and the transmission of contagion would take time, most developing countries at the beginning of the crisis still enjoyed decent economic growth and their interest rates were higher than those in the mature economies. Yield-seeking investors face no incentives to park money in developed countries with ultra-low interest rates. Risk appetite increases during the dollar cycle. Investors dramatically increased their exposure via various forms in emerging markets and even low income developing countries without giving sufficient attention to credit risks. The flood of capital into developing countries included direct purchases from primary and secondary debt markets as well as portfolio investment and foreign direct investment (FDI).

Carry trade, borrowing money in countries with low interest rates and investing in currencies with high interest rates, was rampant and the amount was massive. Though there is no good data available, McCauley, McGuire and Sushko (2015)[8] estimated that between the beginning of 2010 to September 2014, the outstanding USD-denominated debt of non-banks located outside the United States increased by more than $3 trillion reaching $9.2 trillion. The interest rate in emerging economies was around 3% higher than that in the United States. Owing to lack of foreign exchange control mechanisms including both capital-account management and interventions on foreign exchange markets, such kind of flood of foreign capital within a short period of time would lead to inflation, create credit boom and overheating in real-estate and household consumption, sowing seeds for a banking and currency crisis as what happened in Turkey and Argentina. The unwinding of carry trade has contributed to the drying up of capital to some countries, leading to gaps for financing current account deficits and rolling over of debt. Such gaps could be either temporary or structural, therefore leading to increasing imbalances, vulnerabilities and fragilities of the economies down the road.

Yield seeking hot money is extremely foot loose and highly risk aversive. Back in 2013, when there was the talk of normalization, the so-called "taper tantrum"[9] manifested and led to a sharp sell-off in equities, bonds and other financial assets in emerging markets, which put downward pressure on EMEs' currencies. Some Asian and Latin American currencies as well as the South African rand all depreciated by large margins. The taper tantrum led to the request for better communication and coordination among governments regarding monetary policies and measures. This, together with other economic reasons, was followed by a more gradual normalization process. The US Federal Open Market Committee (FOMC) continued to wind down the asset purchase programme in 2013 and declined to zero over 2014,[10] which means there was a reduction of injection of liquidity to the market. In December 2015, the FOMC began the gradual normalization of interest rates which has been continuing this year. With a higher interest rate, the dollar has become even stronger making debt servicing in emerging economies and developing countries more costly. Meanwhile, the reaction of investors to the US hike of interest rates as well as strong economic recovery in the US from the crisis is to withdraw capital from EMEs and to park the money in the US which is considered as a safe haven with higher returns. The emerging economies are facing a double whammy, namely higher debt servicing cost owing to a stronger dollar and a fast drain of international liquidity as well as an outflow of capital. For countries with good economic fundamentals, they have to cope with liquidity drought. For countries which rely heavily on external borrowing in foreign currencies and suffer from a lack of steady flow of revenues, this kind of exogenous tightening of financial conditions has proven to be disastrous, amounting to a "sudden stop".

While withdrawal of liquidity, a strong dollar and hikes of Fed interest rates make debt servicing more cost-

ly, it is difficult to liquidate bonds in foreign currency and local currencies held by foreigners owing to heavy discounts in the market. As holders get stuck with bonds, they have greater urge to sell EMEs' currencies, leading to faster currency devaluation in these economies.

Looking back at the recent history of financial crises in the world, one can easily remember the Russian crisis in 1994, the Asian financial crisis in 1997-1998 and the Argentinian debt crisis of 2001, all of which broke out at the wake of dollar appreciation phase.[11] All went through dramatic currency depreciations and fast and massive outflow of capital.

Bad things never come alone. There are other external shocks which also have the effect of triggering an outflow of capital. Risk aversion is intense at the time of financial tightening. Reactions to bad news tend to be exaggerated.

The current trade tension is one example. It is not just among major countries. The US tariff retaliation on steel and aluminium has affected many countries. For Turkey, the US President's approval of the doubling of tariffs on Turkish steel and aluminium following the detention of American pastor Andrew Brunson became the last straw that breaks the camel's back and made the already declining Turkish lira face a dramatic sharp fall. U.S. anti-dumping measures against Vietnam's exports of fish fillets also contributed to the decline of its currency in July 2018.

Another external shock is the rising fuel prices. 2017 alone saw an increase of almost 70% in global oil prices. For countries like Argentina and Turkey which are oil importers, this has worsened the inflation pressure, weakened economic growth and the current account, thus further destabilized the currencies. It is worth noting that high oil prices used to be a negative factor for the US economy. This time, the negative impact is much less for the dollar as the US has a much lower reliance on oil because of the American shale oil revolution. It was 91% self-sufficient in energy in 2016.[12]

All these negative external factors combined have formed a very strong headwind to the emerging economies, leading to violent volatility in the equity market and foreign exchange market.

Domestic factors leading to currency turmoil/crisis

However, with the same negative externalities, some developing countries have proved to be more resilient than others because of their solid economic fundamentals. If countries have relatively large foreign reserves or current account surplus to cover higher cost for servicing dollar-denominated debt, these countries would be in a much better position to defend their economies against market volatilities. If they have already been suffering from current account deficits and relying on constant inflows of capital or direct borrowing from primary markets to roll over their debts, the monetary tightening in the US would lead to very fast re-appraisal of risks of these countries and a sudden change of investor sentiments. As a result, these countries would see themselves land in trouble and large portfolio outflows and greater external imbalances follow.

An examination of economic fundamentals of Turkey and Argentina would reveal clearly why it would be so challenging for them to defend their currencies. Though the IMF's article IV consultation with Turkey[13] had a positive tone, it revealed that Lira depreciation started from November 2016. There are various problems with its economic fundamentals including a widening current account deficit about 5% of its GDP, a high inflation rate of 12% in 2017, increasing fiscal deficit, overheating of the economy and difficulty to cope with high oil prices. Debt denominated in dollars amount to an equivalent of about 40% of the bank asset of Turkey. Foreign holdings of central government debt securities almost doubled between 2010 and 2013.[14][15] Statistical evidence suggests that large current account deficits would normally lead to crisis. For Turkey, it has relied on borrowing to cover its current account deficit as well as fiscal deficit. It also suffered from high household and corporate debt. However, its foreign exchange reserve is limited. This shows very clearly the economic vulnerability of Turkey. It relies on borrowing more external debt to cover its various needs, yet it has no asset to match the debt roll over cost - no increase of trade surplus, no earnings, no increasing productivity. Thus once liquidity stops to flow in when investors are on a risk aversion mode, currency would depreciate and debt servicing burden would be further increased. The Turkish banking sector would be in deep trouble in the current situation.

Like Turkey, Argentina had a large trade deficit, fast increasing public debts with 80% denominated in dollars, and soaring inflation. In order to service external debt, the government floated $16 billion worth of dollar-denominated sovereign bonds in April 2016, mainly for the purpose of paying off holdout creditors from the 2001 default. In June 2017, Argentina sold $2.75 billion of dollar-denominated century bonds. Even with this amount of liquidity in hand, investors did not have confidence in Argentina to service the debt when the US Fed started to increase interest rates and tighten money supply. It is public knowledge that a great deal of the borrowed fund has not gone to real investment but into financial assets as well as to pay back hedge funds. The Peso started to decline and capital outflow increased at the same time that the US normalization process sped up. The central bank has repeatedly raised interest rates to stem capital outflows and falling currency, reaching a punitive 60%. To defend the currency, the central bank spent $4.3 billion of foreign exchange reserves in just one week in May 2018. In June 2018, Argentina agreed a standby arrangement worth $50bn over three years with the IMF to boost market confidence.

Policy recommendations

Even though currency crises are painful for developing countries, it does not mean that normalization of interest rates in the developed countries should not take place. The expansionary monetary policies for the past decade have created many imbalances in the world economy and it is also a way of kicking the ball down the road making a future financial crisis bigger in size and more painful for economies and their populations. However, it is important to point out that the current international financial system needs to go through badly needed reforms, without which, developing countries would suffer most because of their weak capacity and fragile economic structure and lack of financial sophistication in dealing with tidal capital inflows and outflows as well as international liquidity supply cycles. Even though many developing countries are better prepared this time, quite a number of developing countries are still under tremendous pressure with financial tightening. The crash of more currencies from emerging markets would be disastrous for the world economy.

For developing countries, it is most important to improve economic balances and enhance resilience. Current account deficits and fiscal deficits must be lowered to a safe level which can withstand capital reversals. Naturally, national capacity should be developed to screen and curb speculative capital inflow as well as to develop policies to put inflow of capital into productive use. Capacity to undertake debt management need to be strengthened so that large maturity and currency mismatches can be avoided and contingent liabilities would not get out of hand.

Massive capital flows because of sudden changes of risk assessments by investors have created havoc in developing countries. The imposition of the Tobin tax or other policy measures should be considered to curb the magnitude and speed of speculative capital flows. Improved policy coordination among not only developed countries but also with developing countries is necessary.

To fight against the trade protectionism triggered by the US and to support multilateralism is vital for maintaining financial market stability, as many developing countries are relying on trade to gain revenue for covering their foreign capital needs.

The reform of the international financial system is not an easy process; however it is high time for the international community to put this firmly on the agenda. The discussion about the Special Drawing Rights has somehow faded into the background while the problems of relying on the dollar have been further exacerbated. While public debt has exploded since the global financial crisis, the world still does not have a sovereign debt resolution mechanism. With the developing countries playing a more important role in the global economy, their representation in the multilateral financial institutions has not been fully reflecting the changing economic landscape. The list can get longer. Yet, history has proven that even to address one problem would be a daunting job. Nevertheless, it is high time to have some concrete outcome on this vital front. Some commentators have lamented that the world has wasted the global financial crisis as an opportunity to introduce significant changes, but if something can be achieved a decade later, it is still better late than never.

Endnotes:

[1] Jerome H. Powell, US Federal Reserve Chairman, “Monetary Policy in a Changing Economy,” statement at Changing Market Structure and Implications for Monetary Policy symposium, 24 August 2018. Available from https://www.federalreserve.gov/newsevents/speech/powell20180824a.htm?from=groupmessage&isappinstalled=0.

[2] John Caparusso, Yingyuan Chen et al., “An Imbalance in Global Banks’ Dollar Funding,” IMF Blog, 12 June 2018. Available from https://blogs.imf.org/2018/06/12/an-imbalance-in-global-banks-dollar-funding/.

[3] Michael Hudson, *Super imperialism: The Origin and Fundamentals of U.S. World Dominance*, 2nd ed. (London, UK, Pluto Press, 2003).

[4] Referring to the cycle of the change in the dollar’s exchange value which affects the economic performance of the economies in the rest of the world.

[5] José Antonio Ocampo, *Resetting the International Monetary (Non)System* (Oxford University Press, 2017).

[6] D. Fields and M. Vernengo, “Hegemonic Currencies during the Crisis: The Dollar versus the Euro in a Cartalist Perspective,” Levy Economics Institute Working Paper No. 666 (April 2011).

[7] Cristina Fuentes-Albero, “Financial Frictions, Financial Shocks, and Aggregate Volatility,” Finance and Economics Discussion Series 2018-054 (Washington, Board of Governors of the Federal Reserve System, 2018).

[8] R. N. McCauley, P. McGuire, and V. Sushko, “Global dollar credit: links to US monetary policy and leverage,” BIS Working Paper No. 483 (April 2015).

[9] In 2013, Federal Reserve Chairman Ben Bernanke announced the Fed’s intention to reduce injecting more liquidity to the market leading to massive panic in the global financial market. Investors quickly withdrew funds from the bond market which increased bond yields dramatically. This was named by many economists as “taper tantrum”.

[10] Jerome H. Powell, US Federal Reserve Chairman, “Monetary Policy in a Changing Economy,” statement at Changing Market Structure and Implications for Monetary Policy symposium, 24 August 2018. Available from https://www.federalreserve.gov/newsevents/speech/powell20180824a.htm?from=groupmessage&isappinstalled=0.

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[12] U.S. Energy Information Administration, "U.S. Energy Facts Explained," 19 May 2017. Available from https://www.eia.gov/energyexplained/?page=us_energy_home.

[13] IMF, “Turkey 2018 Article IV consultation,” IMF Country Report No.18/110 (April 2018).

[14] Yılmaz Akyüz, *Playing with Fire* (Oxford University Press, 2017).

[15] IMF, "Turkey: IMF Executive Board Concludes 2018 Article IV Consultation," Press Release No. 18/152, 30 April 2018. Available from https://www.imf.org/en/News/Articles/2018/04/30/pr18152-turkey-imf-executive-board-concludes-2018-article-iv-consultation.

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