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EMERGING MARKETS

Will the calm on the currency markets last?

Gregor Eder
Phone +49.69.24431-3358
gregor.eder@allianz.com
Allianz SE
https://www.allianz.com/economic-research/en

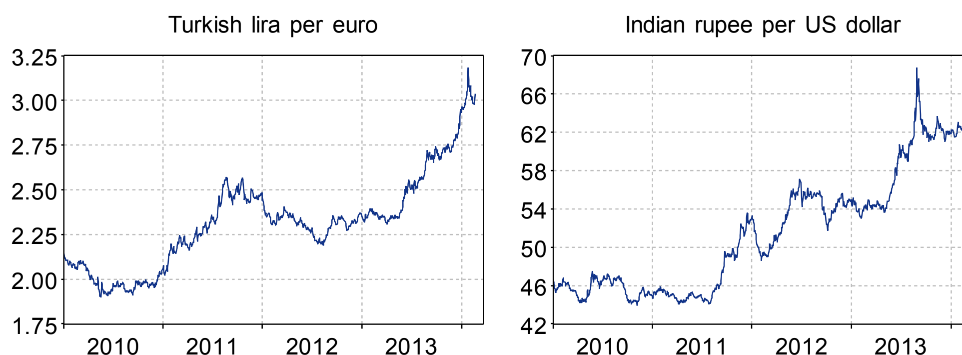
After the currencies of numerous emerging markets had come under substantial downward pressure in late January, the situation has since eased appreciably. In countries like Turkey, for example, resolute action by the central bank has succeeded in stabilizing the domestic currency and offsetting at least some of the recent losses.

In January it was the combination of several factors that triggered an abrupt withdrawal of capital from the emerging markets. At the latest since the US Fed's announcement in December 2013 that it would gradually rein in its bond-purchasing program this year, it was clear that the period of ultra-loose monetary policy would at least slowly come to an end, rendering investments in industrial countries increasingly attractive and investments in emerging markets less attractive. So at the very moment that financial markets were reweighting risks, worries about the economic outlook in individual emerging markets came to a head. Fears of a marked slowdown in the Chinese economy and the massive slide of the Argentine peso against the US dollar were ultimately "the straw that broke the camel's back" at the end of January. Currencies such as the Turkish lira and the Russian ruble came under massive pressure.

How long the renewed calm on the currency markets can last remains to be seen. A renewed abrupt outflow of capital from the emerging markets is by all means possible given that the overall picture has not changed substantially compared with early 2014: the monetary policy exit will come sooner or later – in Europe too. In addition, considerable macroeconomic imbalances still exist in a number of emerging markets which cannot be eliminated overnight. On top

of this comes the tense domestic political situation in countries such as the Ukraine and Thailand.

The extent to which the reduction of macroeconomic dislocations can render a country more resilient is demonstrated by India: until well into 2013 India suffered from a yawning current account deficit. This in combination with weak growth and stubbornly high inflation exposed the Indian currency to massive selling pressure in 2013. Over the course of the year the rupee tumbled 11% against the US dollar. In recent quarters, however, the imbalances in India have eased appreciably: the current account deficit is shriveling fast and inflation is falling. This was doubtless one of the main factors why the Indian currency proved relatively stable amid the turbulence seen in January. The example of India illustrates that the financial markets differentiate between the individual economies. This was evident during the currency turmoil in late January and is likely to be the case in the event of a renewed wave of selling. After years of expansionary monetary policy by the Fed, bemoaned by many emerging markets, the key now is to adapt to normalization. Not all countries will navigate this transition equally well.



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