QUEEN'S GLOBAL MARKETS

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"Queen's Global Markets (QGM) is a premier undergraduate think-tank dedicated to providing the Queen's student body with knowledge of macroeconomics, capital markets and public policy. QGM aims to provide insights into the complex developments across the globe."

Emerging Markets & Currency Crises

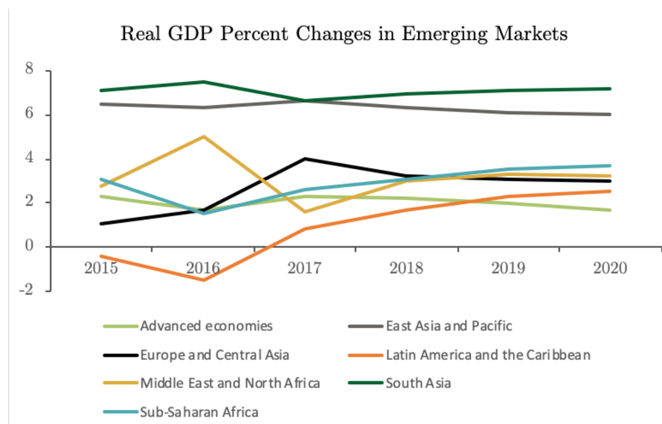
Recently, *Emerging Markets* has been a heavily discussed phenomenon in the world of investing and finance. Although we have witnessed the atrocious volatility of these markets, the potential for high gains continues to attract investors across the globe. This publication will educate on emerging markets, provide in-depth analysis for specific emerging market countries, and delve on certain investor standpoints.

The Story Behind EMs

For countries to develop, a shift occurs from agriculture and raw products to technological advancements and industrialization. An emerging market is characterized as one that is in the process of making this shift. There is no definitive set of emerging market countries, however there is significant consensus regarding prominent players. Brazil, Chile, China, Colombia, Hungary, Indonesia, India, Malaysia, Mexico, Peru, Philippines, Poland, Russia, South Africa, Thailand and Turkey are the ones that the IMF, Morgan Stanley Capital International (MSCI), S&P, the Dow Jones, and the Russell jointly identify as emerging countries. In addition to this core, other institutions have various additional countries that they deem to be emerging, such as Czech Republic and Egypt.

Emerging for a Reason

Data from the World Bank offers a shocking revelation regarding the future of emerging markets. Emerging markets have experienced growth rates approximately double that of advanced economies. It is important to note that all emerging markets and developing economies are not expected to rise at the same rate. For example, India has the highest anticipated growth at over 7% every year, while Russia sits at a meager 1.5% outlook.



A Country-by-Country Case

Perhaps one of the highlighting factors characterizing emerging markets today is currency volatility. Several emerging markets have seen dramatic swings in their respective exchanges caused by varying factors.

Factors Affecting Currencies

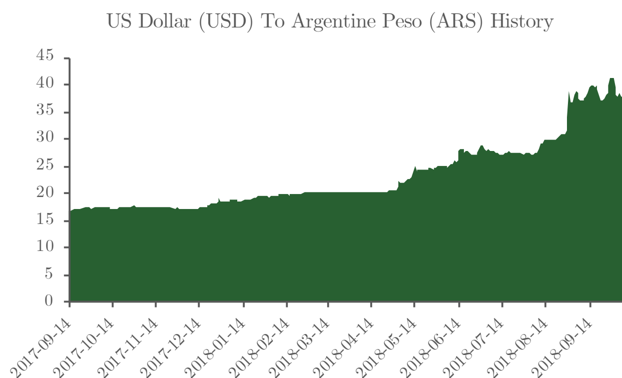
For emerging markets, the inflow and outflow of foreign capital is one of the greatest determinants affecting currency. As the US Federal Reserve continues to raise interest rates, investors are continually moving their capital back to the US to capitalize on higher rates. This outflow of foreign capital decreases demand on emerging market currencies, resulting in lower prices. This relationship can be easily understood through a simple supply-demand model.

Aside from the outflow of foreign currency due to rising US interest rates, there are several other factors leading to many of the currency crises occurring around the world. These factors range from political instability, high government debt, and inflation. To best explain how these factors influence currencies in the real world, several countries offer valuable illustrations.

Argentina

The economic issues present in Argentina are deeply rooted in the policy failures of prior governments. Although known as a country for periods of economic depressions, the currency crisis today can be widely attributed to the actions of former president, Cristina Kirchner who led the nation from 2007-2015. During her time, she turned a 2% budget surplus to a 6% budget deficit (OECD, 2017). Along with loose fiscal policy, Argentina's central bank kept interest rates low compared with the country's high inflation rates and was adamant about printing money (The Economist, 2017). Basic economics shows that these policies would result in unsustainable debt, high inflation and eventually a capital flight, a combination which would inevitably lead to a currency crisis. Over the past year, we have seen those exact results in Argentina.

On October 14, 2017, one US dollar traded for 17.34 Argentine Pesos. One year later, one US dollar traded for 36.72 Argentine Pesos. This 112% loss in value of the Peso is resulting in a currency crisis, putting vast pressure on the nation's economy. For Argentina, domestic inflationary pressures are playing a heavy hand in the cause of this crisis. The IMF has calculated Argentina's inflation to be an astounding 25.68% (IMF, 2018). As the Peso becomes less valuable, firms increase prices to accommodate for the decreasing value of the currency. This leads to labourers demanding higher wages, pushing businesses towards raising prices. The vicious cycle of inflation then continues. This problem of inflation is also simultaneously occurring while Argentina is on the verge of a national debt crisis – having recently received a $57 billion IMF bailout (Franck, 2018). With concerns of high debt and inflation having abysmal effects on the economy, foreign capital holders in Argentina have withdrawn their capital, worsening the problem.



After the failures of Argentina's past government, the center-right party of current President Mauricio Macri swept into power in 2015. Under the new President and in response to this crisis, Argentina's central bank has raised interest rates to 60%, the highest of any country in the world (CBC, 2018). The central bank hopes that raising the cost of capital decreases the money supply within the country, tempering inflation. The current federal government is also working towards implementing austerity measures to reduce their fiscal deficits and repay debt in the long term (Squires, 2018). They are hoping this sheds the perception of Argentina being an unreliable home for foreign capital while simultaneously creating a stable business climate.

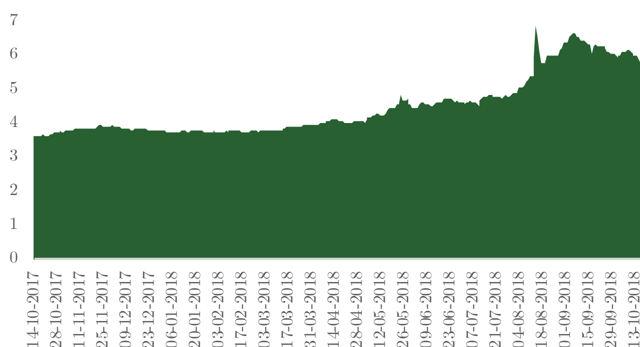
Turkey

Albeit similar to Argentina, the Turkish currency crisis is quite unique. It entails all the typical causes of a currency crisis like inflation, high debt levels, and fleeing of foreign capital, but also adds the factor of political misbehaviour by the government. The Turkish economy for over a decade was seen as a miracle, given its strong performance with a 328% increase in real GDP from 2000 – 2016 (World Bank, 2017). Many attest this strong economic performance to smart and strategic economic development led by Erdogan's government, mostly funded by foreign-currency debt (Lee, 2018). However, this debt-funded growth has now begun to catch up with Turkey's government as a currency crisis looms. The country stands at a high 53.3% GDP-to-debt ratio as of 2017 (CEIC, 2017). Along with the debt crisis, Turkey faces an overheated economy in which inflation reached a staggering 24.5% in September 2018 (Pitel, 2018).

Government efforts to combat inflation have been futile, as raising interest rates would counter Erdogan's plan in driving continued economic growth. In a speech on the campaign trail, Erdogan stated: "If my people say continue on this path in the elections, I say I will emerge with victory in the fight against this curse of interest rates" (Edwards, 2018). Although the Turkish central bank has been defiant in Erdogan's request for lower interest rates, markets have started to question the central bank's independence from a lurking authoritarian government (Blitz, 2018).

Erdogan's government has not helped itself in solving the crisis by engaging in a geopolitical fight with the United States over an imprisoned pastor, Andrew Brunson. Detained two years ago, the American pastor was imprisoned for espionage over alleged support of the 2016 Turkish coup (Levenson, 2018). Until recently, Turkey had been determined in sending an explicit message of defiance to the US through the pastor's captivity. A change of course occurred after significant sanctions were levied by the US Administration (Aliaga, 2018). Although the issue was solved, it significantly contributed to the devaluation of the Turkish Lira. The event left markets unconvinced of Erdogan's ability to lead a stable government.

The overall debt, inflation, concerns over the central bank's independence, and political mismanagement have caused foreign currency holders to panic and withdraw their capital away from the Turkish economy. Capital outflows have resulted in a major currency crisis with the Turkish Lira entering free-fall over the last year. On October 14, 2017, one US dollar traded at a stable 3.63 Turkish Liras. Forward a year, one US dollar buys 5.87 Turkish Liras, a 61.71% loss in value. It is highly anticipated the Lira will continue in a downward slide as political and economic uncertainty continue to accelerate.



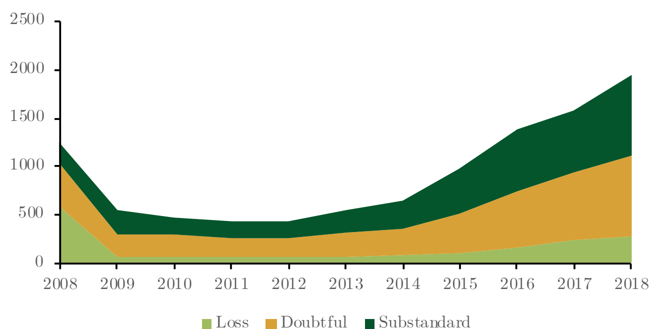
China

Recently China has posted third-quarter GDP growth year-on-year of 6.5%, lower than analysts' expectations and the weakest quarterly growth since early 2009. The cooldown of the Chinese economy, coupled with the increasing geopolitical tension and uncertainty arising from China's stand-

off with the US, have seen the renminbi fall to decade-low levels.

In addition to the currency fall, China faces a concerning debt situation with state-controlled banks lending atrocious amounts of capital to state-controlled firms. Non-performing loans at China's state-controlled banks currently total 1.5 trillion yuan, but this number could be 14 times higher due to the concealed values of the true figures.

A non-performing loan is defined as an obligation in which the debtor has not made the proper scheduled payment for a specified period, which is usually 90 days for commercial banking loans.



An economist at Nomura compares China's current situation to the Great Recession: "The situation revolving around these [wealth-management products] is similar to the residential mortgage-backed securities problem in the US that eventually triggered the collapse of Lehman Brothers and the global financial crisis," Kiuchi said.

In addition to the trade impasse and the severe debt situation, there are also various underlying factors that have stunted China's growth. Some of those prominent factors include: companies defaulting bonds at higher rates, lower consumer spending and retail sales, reduction in infrastructure spending, and a stock market that has fallen 15% this year.

Takeaways

The cases of Turkey, Argentina, and China clearly illustrate the effects of government actions and policies on the economy and currency values. Although it may not always be the case, this proves it is not only external factors such as rising US interest rates which can cause currency devaluation, but also internal factors of economic mismanagement. What we can learn from the examples of Argentina and Turkey is that fiscal responsibility, inflationary control, and government stability go a long way in ensuring countries do not face economic hardships.

Servicing Debt

As discussed, rising debt levels have had major impacts in causing currency crises. However, the relationship goes both ways. A currency crisis can have a devastating effect on debt levels and the repayment process. This all becomes dependent on the denomination of country's debt. If a country's debt is denominated in a foreign currency and the value of the home currency falls, it immediately becomes harder to service their debts. This is because it suddenly takes more currency to pay back the same amount of debt due to the loss in value of the currency. Take Argentina as an example. One year ago it took Argentina 17.34 Pesos to pay off a single dollar of US debt. As of October 14th, 2018 it takes 36.72 Pesos to pay off a single dollar of US debt. This makes countries with high amounts of debt denominated in foreign currency very vulnerable to currency crises. Unfortunately for Argentina, 70% of their debt is in foreign currency, making debt repayment a much more difficult task due to their currency devaluation over the past year (Rizzi, 2018).

Turkey, on the other hand, is in a slightly better position with foreign debt making up nearly 57% of their overall national debt (Republic of Turkey - Ministry of Treasury and Finance, 2018). How these countries will service their debt and whether they will require the involvement of international entities is a question that must be addressed.

The Role of the IMF

The International Monetary Fund (IMF) is an international organization headquartered in Washington, D.C., consisting of "189 countries working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable

economic growth, and reduce poverty around the world" (IMF, 2018).

Formed in 1945 at the Bretton Woods Conference primarily by the ideas of Harry Dexter White and John Maynard Keynes it came into formal existence in 1944 with 29 member countries and the goal of reconstructing the international payment system. It now plays a central role in the management of balance of payments difficulties and international financial crises. Countries contribute funds to a pool through a quota system from which nations experiencing balance of payments problems can borrow money. As of 2016, the fund had about US$666 billion.

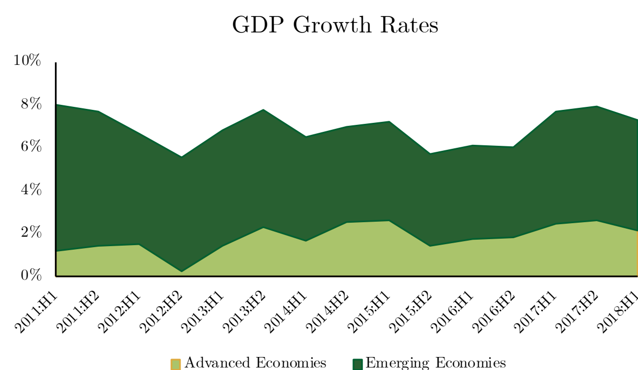
The financial stress afflicting emerging market economies has dominated discussions at the IMF and World Bank annual meetings, rekindling memories of the 1990s, when the fund was forced to intervene, in some cases very controversially, to stem crises in Asia and Latin America. This year, the IMF has already agreed to its biggest bailout package in history, a US$57 billion loan for Argentina, and is considering a request from Pakistan for a loan — estimated at US$7 billion.

"There are a range of countries that are beginning to see stress," said Thomas Bernes, a former Canadian and IMF official who is a fellow at the Centre for International Governance Innovation, a think-tank. "People are nervous." IMF officials have repeatedly said they do not see any evidence of contagion in emerging markets and investors are differentiating between countries that had made policy blunders and those that have been more virtuous.

This means that any market turmoil could be contained and the IMF's role would remain circumscribed. Optimists point to the fact that, since the 1990s, many emerging market countries are in a stronger position, having allowed their currencies to float and having bolstered their foreign exchange reserves. "This can be seen as a type of 'never again' fund in terms of going to the IMF for financial help," said Paul Gruenwald, global chief economist at S&P Global Ratings.

Investing in Emerging Markets

Since Donald Trump's election, bond yields have increased, sending asset prices in emerging markets down. President Trump's protectionist trade policies have worried foreign trading partners, especially those in emerging economies. His desires to modify or withdraw from NAFTA, TPP, and offshoring activities presented a threat that put smiles on the faces of many emerging market detractors. In recent years, emerging markets have gone through high-profile political risks. These have been exemplified through Russia's invasion of Ukraine, the Philippine 'war on drugs', a successful coup in Thailand in 2014 where Prime Minister Yingluck was impeached and the senate was dissolved, and a failed coup d'état against Turkish President Recep Erdogan in 2016. Developed economies now continue their competitive drive for technological advancements and products, leaving a void in the mainstream production market. This vacuum is quickly being replaced with exports from emerging economies. Emerging countries increased exports 4.6% in the first half of 2017 year-over-year. These exports are driving demand for production and furthering the favourable divergence of emerging markets GDP as a percentage of the global share. The difference in GDP growth rates currently is approximately 3% per annum. Even though emerging markets have been recovering from commodity price shocks in the past, they have managed to sustain GDP growth which collectively triumphs advanced economies.



Bridge Over Troubled Waters

While returns on bonds in the developed world are increasing, yields are still inferior compared with yields provided on debt and equity in emerging markets. Smart investors are immigrating their capital to take advantage of risk-adjusted investments. Intelligent bond opportunities exist, such as the hedge funds that capitalized on impaired Argentinian debt for roughly 20 cents on the dollar in 2001. The new government last year settled and paid ten times the price paid in 2001. Furthermore, for the first time in three years, all BRICS countries grew simultaneously. While emerging markets have not, and most likely will not, replicate the growth they realized from 2003-2006, they are still growing at an impressively consistent rate. Hitherto, 21 of the 24 countries in the MSCI emerging markets index have reported year-end GDP figures, all of which have seen year-over-year growth. Following this, the MSCI index took the lead and currencies point in the right direction. The capital markets are racing, and if growth can keep up while commodity prices stabilize, many economies will concrete their position as global providers of goods and services.

Be Wary of Sentiment, Stick to Fundamentals

Investor sentiment varies so often that it is more useful to look at fundamentals and leave enthusiasm aside. The Economist famously published three contradictory cover photos focusing on the projected emergence, demise, and stabilization of Brazil. Price-to-Earnings ratio discounts relative to the S&P 500 are approaching levels that were encountered during the 2003-2006 boom, and investors should take notice. On a monthly basis over the last 20 years, there have been 61 instances where the valuation gap between the MSCI Emerging Markets Index and the S&P 500 has been as large as it currently is. In past occasions, emerging markets have outperformed US stocks over a five year period. According to the analysts at WisdomTree, emerging markets delivered an average five-year annual return of 18.7% versus a much smaller average annual return of 3.9% for the S&P 500. In times of historically low interest rates around the world, many investors are hungry for income. Dividend stocks paying yields above 3% are far more abundant in emerging markets than in other regions, and this could drive yield-hungry investors to emerging markets in search for dividend opportunities. Importantly, investors in emerging markets are not only being exposed to equity prices. Fluctuations in currency rates can have a huge impact on overall returns when investing on a global scale. According to estimates from JPMorgan, emerging markets currencies are historically undervalued in comparison to the U.S. dollar, which could be an additional return driver for investors in emerging markets going forward. Emerging markets have reached a point where they have been through the peaks and troughs and are now on a stable path to dominance. Investors should put home bias aside and realize that the real room for growth doesn't lie in the FANGS, but in the BRICS.

Investor Opinions

Short-term? Maybe. Long-term? Definitely.

During an interview, the CEO of Strategic Wealth Partners, Mark Tepper spoke about the emerging markets landscape. In the short-run he states that emerging markets are "volatile due to the strong dollar, trade tensions, and debt concerns that is all working against them". Tepper then goes on to say that you have to own them. Tepper, like many other investors believe the rise of the middle class in emerging market countries, and the amount of growth that they are going to continue to achieve by becoming increasingly consumer driven will result in long-term value.

Another supporter of emerging markets is Wealth Management Head at Morgan Stanley, Lisa Shalett. She acknowledges that so far 2018 has been a year for decreased stock prices in emerging markets, but you should still stay in them - capital spending is strong and the prices of commodities are going up. When companies spend capital, this leads more supply parts and raw materials from emerging markets. Emerging markets are often tied with commodities as they export large quantities of them. When commodity prices rise, this will have a correlation with the growth of that country.

As always, where there is chance for high return, there must be some high risk associated with the investment. Emerging markets are no exception to this rule.

Investing in emerging markets requires you to purchase into the local currency. This in itself presents a significant risk, as previously discussed.

However, much of the risk associated with investing in emerging markets lies in the environment in which you invest. Generally speaking emerging markets are not as sophisticated as advanced economies. This means investors are likely to expose themselves to increased chances of bankruptcy through weak audits, less rigorous insider trading restrictions, and weak corporate governance where upper management has greater power than the shareholders do.

The last risk involves liquidity, and this is especially relevant if you are seeking a shorter term investment. Emerging markets do not present the same ease of purchasing and selling investments as developed markets do.

A Bouncing Ball

As *Emerging Markets* continue to be heavily discussed in the world of investing and finance, uncertainty remains. The cases of several prominent emerging markets clearly illustrate the atrocious volatility that stems from this uncertainty.

Emerging markets have seen periods of tremendous ascent and descent. Whether emerging markets have reached their apex is a question that likely has no answer. Perhaps what is certain is that emerging markets will continue their cycle, making timing the most important element in this investment decision.

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