OBSERVATION

TD Economics

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EMERGING MARKETS: CUT BY THE SAME SCISSORS, BUT NOT FROM THE SAME CLOTH

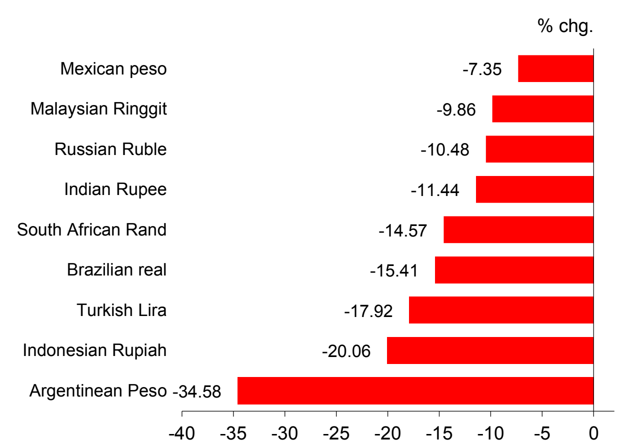
Highlights

- EM assets and currencies have been under pressure since last May, when Fed Chairman Bernanke's anticipation of Fed tapering triggered a tightening in global financial conditions. Financial volatility escalated in recent weeks, engulfing those EMs with more serious imbalances.
- In the last few days, several EM central banks raised their interest rates to stem the precipitous decline of their currencies.
- However, not all EMs are the same. The recent sharp devaluation of the Argentinean peso has less to do with external factors such as Fed tapering, and more to do with years of blatant macroeconomic mismanagement.
- Still, this country does offer a cautionary tale of how poor policies and delayed adjustments can put a country between the rock and a hard place.

The beginning of 2014 has been rough for many emerging markets. EM assets and currencies have been under pressure since last May, when Fed Chairman Bernanke's anticipation of Fed tapering triggered a tightening in global financial conditions. However, other factors such as a deceleration of trend economic growth in China, weaker commodity prices, and a subpar recovery amongst developed economies have also played a role. Heightened investor jitters to emerging markets in recent weeks reflects this less favorable backdrop, and the period of adjustment for many EMs will persist for some time due to the imbalances they have accumulated after years of ample global liquidity. EMs will also have to deal with maturing credit cycles. This combination of factors will prove challenging and will undoubtedly weigh on economic growth. Recent interest rate hikes by central banks in Turkey, India, and South Africa in response to the precipitous decline of their currencies illustrate this need to adjust. Brazil was ahead of pack in trying to address its imbalances, with the central bank having raised interest rates by 325 basis points since April of last year.

Many of these countries share similar characteristics (e.g., stubbornly high inflation stemming from supply bottlenecks and years of robust credit growth, insufficient infrastructure spending, distortive subsidies and price controls, fiscal and external imbalances, etc.), but they come in different shades. Some will have

EM CURRENCIES TUMBLED AFTER BERNANKE ANTICIPATED TAPERING LAST MAY



Source: Bloomberg, TD Economics. Change since May 21, 2013

Martin Schwerdtfeger, Senior Economist

more policy room than others, and will be more nimble to react and adjust. Among those that will have a harder time, Argentina is the poster child. The recent sharp devaluation of the Argentinean peso has less to do with external elements such as Fed tapering, and more to do with years of blatant macroeconomic mismanagement. Although there isn't an EM that truly parallels the self-inflicted challenges now facing Argentina, this country does offer a cautionary tale of how poor policies and delayed adjustments can put a country between a rock and a hard place.

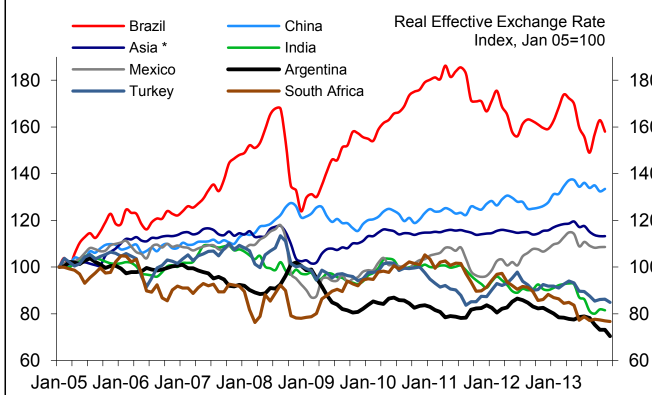
The sharp depreciation of the Argentine peso has been long in the making

In the aftermath of the 2001/2002 debt default and currency crisis, the boom in commodity prices fueled a strong rebound from the 4-year long recession that had hammered the country. Argentinean exports roared, boosting the country's current account, and subsequently, its FX reserves. The latter went from US$9 billion in July 2002 to US$50.5 billion in April 2008. In turn, the economic recovery that took hold in 2003, in combination with the debt default and the 2005 debt restructuring, led to a significant improvement in fiscal accounts.

Encouraged by such fiscal abundance, the Kirchner administration ramped-up fiscal spending. For example, they subsidized utility tariffs, fuel prices, and transportation costs to secure popular support and to contain looming inflation. However, because they put caps on domestic prices, private fixed investment spending did not keep up with the pace of real GDP growth, which averaged 8.5% during 2003-08. This eventually caused supply bottlenecks, and consequently fed into inflationary pressures. In the energy sector in particular, lack of fixed investments caused the country to shift from being a net energy exporter to a net importer. And, given that the government insisted on subsidizing fuel and electricity prices to keep popular support, the subsidies' bill grew, putting pressure on the fiscal budget.

When the commodities boom stalled in 2008, the government began a series of arbitrary policy actions to make up for the decelerating fiscal revenues. The first measure was a re-nationalization of private pension funds. Once under government control, the administration forced the national pension administrator to contribute to financing the fiscal deficit. Second, it raised export tariffs on the agricultural sector, which ended up causing a revolt within the sector and the resignation of the country's Vice-President. These measures hindered foreign direct investment (FDI) and

SOME EMs CURRENCY DEPRECIATIONS DID NOT KEEP UP WITH INFLATION



Source: Bloomberg, TD Economics. Values above 100 represent REER appreciation vis-à-vis January 2005. * includes Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Thailand, and Taiwan. GDP-weighted.

portfolio investment inflows, a trend that was exacerbated by the global recession. As a result, FX reserves failed to make any further material gains, hovering around US$50 billion for the next several years, with a peak of US$52.5 billion in January 2011.

To further complicate matters, around 2007, the government had intervened the National Statistics Institute and began manipulating official inflation figures. Actual inflation has been in a range of 22% to 28% for the past six years, although official figures reported a third of that rate. Rampant inflation caused a continued appreciation of the real exchange rate and reduced the competitiveness of Argentinean products. This has progressively eroded the trade balance, which has also been under pressure due to the increasing in energy imports. Given that the government was determined not to recognize and tackle rising inflation, it did not allow the Argentinean peso to devalue in tandem with the increase in domestic prices. This made the U.S. dollar artificially cheap in Argentinean pesos terms. In a country with a long history of high/hyper inflation episodes, collective memory indicated just one thing: buy USD, run away from Argentinean pesos.

In mid-2011, as FX reserves began to contract, the government introduced restrictions to the purchase of U.S. dollars. This made matters worse, as inflows of FX reserves declined because economic agents feared they would not be able to make transfers out of the country if they needed to do so. In April 2012, fiscal accounts were under mounting pressure due to the subsidies policies. The government decided to expropriate Spanish energy company Repsol of its shareholdings of YPF, the largest local energy company. This sent a clear signal: the government would rather infringe on property rights before revising its policy agenda. Speculation began to build about a potential mandatory conversion of foreign currency-denominated private bank deposits into domestic currency deposits. The private sector accelerated its demand of foreign currency and began to withdraw its savings from banks. Bank deposits denominated in U.S. dollars dropped from US$16 billion in mid-2011 to US$9 billion in August 2012.

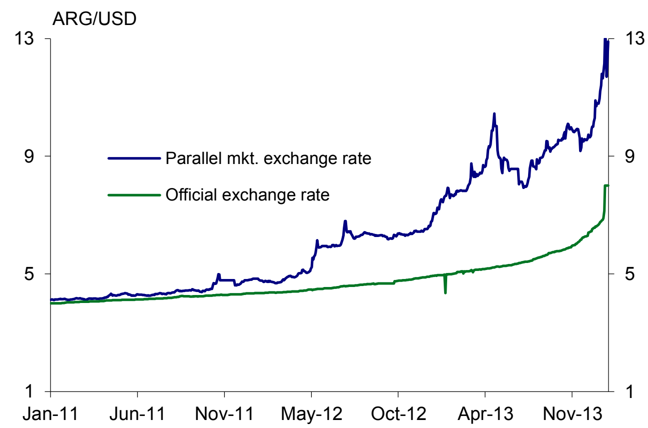
As if this wasn't enough implementation of poor policy, in 2012 the government also forced a modification of the Central Bank's founding act, which gave the current administration more discretionary power to influence the central bank's actions. This paved the way for the country's Treasury to place a significant amount of non-marketable sovereign debt securities with the central bank to finance growing fiscal spending. Central bank holdings of such Treasury bills increased from 13.1% of its total assets in January 2008 to 39.6% as of last week. Given that the central bank did not sterilize this monetization of the fiscal deficit, the monetary base grew at an astounding pace. This, in combination with the massive decline in foreign exchange reserves of the last two years has driven the ratio of M0 to FX reserves from 67% to 184% over the same period.

The alarming deterioration of the central bank's balance sheet and a barrage of administrative measures to suppress domestic access to U.S. dollars have deterred capital inflows, driving a wedge between the parallel and official foreign exchange rates. As the drain in foreign exchange reserves intensified, last week it became clear that the central bank would be unable to defend the administered peg of the Argentinean peso to the U.S. dollar, so it let the official foreign exchange rate escalate, which triggered the spike in the parallel foreign exchange rate (see accompanying chart).

What is the way out for Argentina?

The only way to prevent a continued depreciation of the Argentinean peso and an acceleration of inflation is to anchor inflationary expectations. Any policy mix aiming for that goal must include rationalizing fiscal spending and halting its financing via central bank monetization. At the onset, this would cause the economic deceleration to deepen, as private sector spending would be slow to fill the void left by public spending. Therefore, a major challenge resides in how to galvanize public trust in a new policy plan to defuse inflationary expectation and be able to gradually remove restrictions on FX transactions. The track record of the current administration would certainly not help. In all likelihood, it is too late for this government to regain any credibility. Furthermore, because the country still has not solved its outstanding disputes with foreign creditors dating back to the 2002 debt default, it has very limited access to global financial markets. This reduces the policy options to manage the adjustment. Hence, in the short term, economic conditions in Argentina are posed to get worse before they can get better.

FURTHER WEAKENING SEEMS INEVITABLE FOR ARGENTINEAN PESO



Source: La Nacion On-line, TD Economics

Final remarks

Is Argentina a bellwether for all EMs? To the extent that Argentina shares some of its traits with many of the other EMs that are currently under market scrutiny, one might be tempted to take Argentina's woes as harbingers of what might be awaiting the others. However, Argentina represents an extreme case of macroeconomic mismanagement. And, although its problems might be adding to negative sentiment over the risk of investing in other EM markets, they are a product of Argentina's insistence in implementing policies that have repeatedly backfired. Investors will differentiate between developing economies. An escalation of Argentina's sufferings should have modest international impact beyond adding color to news headlines. The bottom line is that Argentina is a cautionary tale for other EMs to put their house in order before they run out of options, but certainly is not the benchmark from which to judge them.

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