EM Squared Emerging markets

Emerging market currencies now far less risky

Improvement reflects quiet revolution in governance and credibility

Steve Johnson 16 HOURS AGO

Emerging and frontier market currencies have become far less risky than during the dark days of the 1980s and 1990s, signifying the quiet progress many countries have made to reform their economic systems.

Diversified baskets of these currencies, including those of crisis-prone states in Africa and Latin America, have also delivered positive real returns in US dollar terms, despite sometimes dramatic collapses.

"Individual EM currency drawdowns are generally less severe now than they used to be," said James Wood-Collins, chief executive of Record Currency Management, which manages $60bn, mostly in currency hedging strategies. He argued that the impact of spillover "contagion" between EM currencies had also declined markedly.

Analysis of a database of 121 emerging and frontier currencies maintained by TCX, a Dutch currency fund, shows a clear pattern of structural improvement.

Between 1987 and 1994, an average of 23.5 per cent of the currencies, which range from the likes of Russia, India and Brazil to Burkina Faso, El Salvador and the Solomon Islands, fell 20 per cent or more against the dollar in nominal terms each year.

This fell to 13.9 per cent of currencies between 1995 and 2002 and tumbled to just 4.1 per cent in the period from 2003 to 2017.

The proportion of currencies crashing 50 per cent or more against the dollar also fell precipitously, from 9.5 per cent a year between 1987 and 1994, to 3.3 per cent in the subsequent eight-year period and just 0.6 per cent since 2003, as depicted in the first chart.

While dramatic collapses still happen with, for instance, the Egyptian pound slumping 57 per cent against the dollar in 2016, the 99 per cent-plus crashes suffered by Nicaragua in 1998, Moldova in 1992, the Democratic Republic of Congo in 1994, Belarus in 2000 and Myanmar in 2012 at least seem to have been consigned to history.

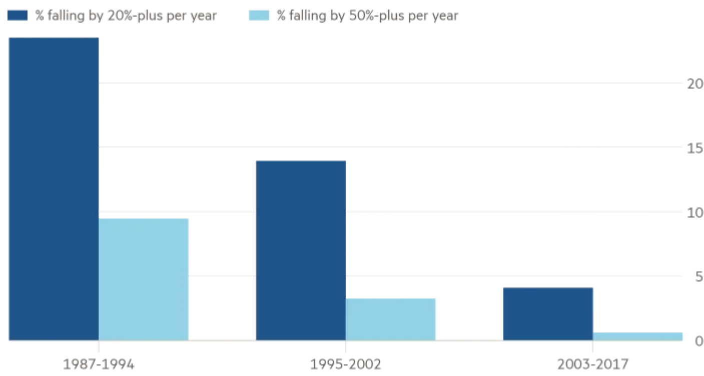
Even when minimising the impact of such outliers the improvement looks stark. Up until the mid-1990s, the 90th percentile of currencies (ie the best of the worst performing 10 per cent) typically lost about 50 per cent of their value each year in nominal terms. Since then the equivalent loss has fallen to about 15 per cent, as shown in the second chart. The 75th percentile mark has also risen solidly, touching zero in good years.

Petra Visser, a manager at FMO, the Dutch development finance institution, who created the TCX database, said one driver of the reduced drawdowns was a generalised move away from fixed to floating-rate currencies across much of the developing world.

Feedback

Risk off

Emerging and frontier market currencies



Sources: TCX, FT calculations
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This means currencies are more likely to fall against the dollar in any given year, but the very large stepped devaluations that occur when fixed currency pegs break — as they do more often than not — have become less commonplace, although this effect did account for the Egyptian pound crash of 2016 and the near-50 per cent slides in the currencies of Azerbaijan and Kazakhstan a year earlier.

Mr Wood-Collins also saw other factors at play. Firstly, a more globalised trading environment "means that international goods arbitrage is both easier and cheaper to do".

"This makes substantial long-term deviations from currency fair values more infrequent, as arbitrage opportunities arising from large exchange rate movements are exploited more quickly," he argued.

Secondly, Mr Wood-Collins believed the trend for emerging market countries to borrow in their own currency, rather than in dollars, "provides some insulation from self-perpetuating currency cycles", making "emerging market currency cycles less volatile".

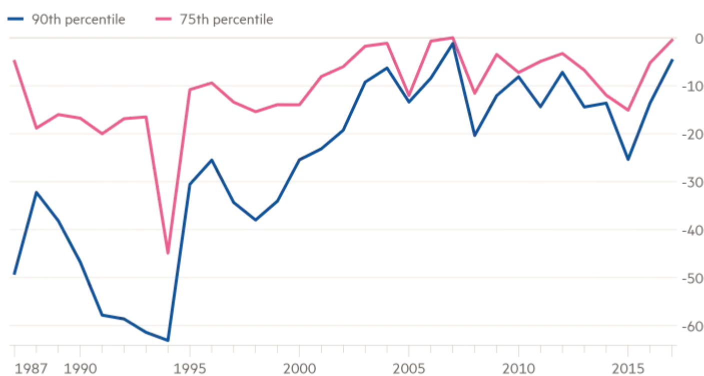
Thirdly, the growth of inflation targeting in the emerging world in the past 20 years has broadly succeeded in reducing inflation. This in turn has led to "more benign exchange rate movements".

This is because, in (efficient market) theory at least, the nominal change in a bilateral exchange rate should be the inverse of the interest rate differential between the two countries, so the total return for both participants in a forex trade is zero. Thus, the smaller interest rate differential that is likely to result from a lower inflation rate in the emerging world should be accompanied by a smaller nominal currency depreciation.

"On average, over countries and over time, in theory, and also in practice, the interest rate [differential] compensates for the depreciation. The interest rate is basically forward looking," said Ms Visser.

Safer space

Nominal return v dollar of 75th and 90th percentile of EM currencies, per year (%)



Source: TCX
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Feedback

Othman Boukrami, head of trading at TCX — which was set up by 22 development finance institutions and microfinance vehicles with the Dutch and German governments in 2007, to pool the risk of currencies for which there are no long-term hedging products — agrees this interest rate parity theory broadly holds, at least over extended periods.

"Most of the studies are done on a 10 years-plus basis, where it holds. Over a two to three-year period, where most of our work is done, it definitely doesn't hold," Mr Boukrami said. "On average

we are right, but year on year we can have huge volatility on the p & l [profit and loss account]. This volatility is why this business is not done in the private sector or by DFIs."

Ms Visser said the "political and economic backdrop" in emerging markets makes predictions (as to the correct interest rate that will balance the likely nominal devaluation) "much more difficult than for the dollar", rendering volatility inevitable.

To the extent that there is a pattern that cuts through this chaos, though, it appears to be one that benefits those holding diversified baskets of EM currencies.

"Generally we find that the spot decline isn't enough to offset the interest rate differential, so the total return tends to be positive," said Mr Wood-Collins.

A similar tendency is typically found even within developed market currencies, with higher-yielding ones delivering positive total returns, a puzzle known as the forward rate bias.

Mr Boukrami said TCX had found this "carry trade" premium as well, with its portfolio delivering annualised returns of 1-1.5 per cent since inception in January 2008, despite its first year, which coincided with the global financial crisis, being the worst year for EM currencies since 2000.

"There were big issues because of that, then we made solid gains until the oil crisis of 2014-15 when we lost quite a bit of money" on the currencies of oil exporters such as Nigeria, Azerbaijan and Kazakhstan, Mr Boukrami added. A recovery in 2016-17 was followed by losses again last year as the dollar rallied across the board.

Mr Wood-Collins said "a lot of people see [the carry return] as a risk premium", even if "opinion sometimes slightly differs as to what the risk is that you are getting paid for".

"Our view is that the risk transfer that is going on is the risk of funding current account deficits," he added. "There is a need to find external investors to hold assets in these currencies to finance the deficit."

This view tallies with the fact that the currencies of developed world countries with persistent current account deficits, such as Australia, New Zealand and the UK "tend to offer higher long-term inflation-adjusted exchange rates" than surplus countries such as Japan and Switzerland, Mr Wood-Collins said.

On top of that a separate theory, the Balassa-Samuelson effect, backed up by a solid body of evidence, suggests EM currencies should, broadly, deliver positive total returns vis-à-vis their developed world peers, assuming developing countries enjoy stronger real income growth.

One might think that the decreased volatility of EM currencies, combined with both theory and practice suggesting they deliver real gains (albeit with a lowish Sharpe ratio, or risk-adjusted return), should encourage intrepid private sector investors into the asset class, rendering the likes of TCX unnecessary.

Recommended

This is even more so if Mr Wood-Collins is correct in his assertion that the contagion risk between EM currencies has fallen in the past decade with, say, idiosyncratic currency crises in Argentina and Turkey last year not infecting all EMs, as was often the case in the past, such as during the global financial crisis and the Asian, Russian and Latin American crises of the 1990s.

This lack of contagion should damp the volatility of a basket of EM and frontier currencies, even if their individual volatilities remain high.

Mr Boukrami saw some signs of private investors being willing to dip their toes in the frontier currencies TCX specialises in. It has issued bonds in currencies such as the Georgian lari, Uzbek som, Ukrainian hryvnia, Myanmar kyat, Tanzanian shilling and Honduran lempira, although the buyers are often ethically minded "impact investors" keen to support the work of TCX's parent DFIs.

Nevertheless, he argued it was not necessarily the case that carrying the risk of such currencies was now less problematic than in the past. While perceived risk may have fallen, so has the carry, meaning that the risk/return trade-off has not necessarily improved.

Mr Wood-Collins said there were "a whole lot of issues around liquidity that make people nervous", such as the difficulty of exiting positions without moving the market "or even at all".

"The late 1990s to early 2000s was a period of success with EM currency strategies, but dollar strength eroded enthusiasm," he added. "We run portfolios but I don't think they are in the mainstream category."

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