BBH Special FX: EM FX Policy Divergence and Differentiation

It is hard to remember a time when FX policy in major EM countries has been so divergent. Some countries are trying to contain currency appreciation, some are purposefully appreciating, some are neutral, while others are fighting the risks of sharp currency depreciation. The level of success for these policies is also very divergent.

Currency warriors:

Brazil leads the ranks here. Just as the market finally took control of the USD/BRL 1.55 trench last week, authorities launched a strong counter attack on derivatives. The war will surely continue and intensify as we head towards the USD/BRL 1.50 Maginot Line. Further macroprudential tightening and purchases by the SWF should be expected. But all they can do is slow down the trend, in our view.

In early May, South Korea threatened to audit banks' FX forward positions and tightened limits on currency derivatives after USD/KRW nearly broke the 1060 level. The won traded around 1080 against the dollar until late June, but it is now testing the key 1050 level. We suspect that the days when Korea was allowing FX appreciation help contain inflation are over. The BoK is likely to become more active in FX intervention and possibly fire some more warning shots against speculators should the won continue to appreciate. The risk-rewards of being long KRW at these levels are much less obvious, despite our broad positive outlook for the region.

Looking at FX reserve data, the South African central bank appears to have become much more passive in spot intervention over the last few months, probably in reaction to rising inflation and pass-through concerns from rand weakness. However, the bank continued to vigorously accumulate forward position, showing its continued commitment to preventing rand appreciation.

Neutrals:

Mexico and India stand out as countries where there is little meaningful intervention in the FX market. Mexican policymakers have endorsed FX appreciation in the past and remain passive FX managers. In contrast with most of its Asian peers, India intervenes only when there are rare specific cases of inflows such as M&A and when inflows are "intervene if the inflows are lumpy and volatile," according to RBI's governor Subbarao.

Since its large announcement of USD purchases in January, the Chilean central bank has been quiet on the FX front even though USD/CLP broke below the 465 level (the level that triggered the January FX measure). We do not think more intervention is imminent. The central bank paused in the last meeting after 475bps of hike, and can use timing and length of any residual tightening to influence the peso.

Willing appreciators:

A handful of EM countries are likely to continue using FX appreciation as a tool to fight headline inflation, including China, Singapore, Indonesia and Russia.

We expect the Chinese yuan to continue to appreciate at a rate of around 5% annualized, despite the underpricing that prevails in CNY NDFs.

Similarly, we think the MAS will continue its tightening policy in its October meeting by adjusting the SGD nominal trade-weighted exchange rate band.

In Indonesia, CPI is trending lower thanks to the BI's implicit policy of allowing the IND to appreciate to help contain inflation. This policy will remain in place for now in our view, especially since the bank is likely to keep rates on hold for the time being. Still, further appreciation will be less emphatic than that observed earlier in the cycle as USD/IND is now below the lower end of the BI's expected trading range for the year at 8500.

Russia is one of the few countries that explicitly endorse FX appreciation as an inflation fighting tool. Unlike the cases of the three countries above, we think that policy is not the most important variable forming the outlook for the RUB – oil prices and capital outflows, for example, are more important in our view. Still, the endorsement of a stronger RUB means that there will be far less headwinds in times of positive sentiment.

<u>Currency Defenders:</u>

Turkey stands out as the only major EM country actively defending its currency against sharp depreciation. Measures so far include the cancelation of USD buying auctions and reduction in FX-reserve requirements for banks. Moreover, CB Governor Basci recently stated that he stands ready to counter further sharp lira depreciation and prevent pass-through to inflation.

Poland, like Russia, has also explicitly endorsed currency appreciation. The government went as far as starting a program of converting EU structural funds (in EUR) into PLN directly in the market. But beyond helping with headline inflation, Polish policymakers are concerned with the value of the PLN given the risks associated with FX-linked debt in the private sector. The same goes for Hungary, where FX-linked debt risks are much more severe. Both countries will likely take action if their currencies depreciate sharply against the EUR and especially CHF – but we are not there yet.

Taking a step back, the recent price action supports our view that EM FX, while vulnerable to negative events in DM, will eventually decouple and rally. But we also note that investors are getting more discerning with regards to EM credits, and believe this will continue given the ongoing uncertain global environment.