The possibility that the Federal Reserve (Fed) will taper its securities purchases coupled with the rising interest rates observed in advanced nations during late spring and throughout summer have prompted the currencies of several emerging nations to weaken. The most eloquent examples are the “BRICs” countries (Brazil, India, Indonesia, Turkey and South Africa). Their currencies got a break when interest rates pulled back in September and October, but they still seem to be quite vulnerable. The upswing by rates in late October and early November quickly resulted in further weakening by these currencies.

The mechanics seem fairly clear. Investments in emerging nations become less attractive when returns increase in advanced nations. Investors also fear the effects of a widespread drop in global liquidity when the Fed reduces its purchases. Add to this the underlying problems in several emerging nations, such as weak economic growth and twin deficits (public finances and trade balances).

To offset currency depreciation, some central banks in emerging nations have raised their key rates. The higher overall inflation in these countries also argues for such rate movements, especially since eroding purchasing power can increase currency depreciation. On the other hand, monetary firming harms economic growth, which is not favourable to currency appreciation.

Economic growth will likely have to solidify in emerging nations before we see a drop in sensitivity to interest rate movements. Central banks in these countries will then have more room for action. Investors would also be more motivated to keep their investments in these countries if their economic outlooks were better. This may not change quickly. Among other things, the global economic situation will have to improve in order to support export growth in struggling emerging nations. Countries specializing in natural resources, such as Brazil, would also benefit substantially from a rise by commodities prices.

Implications: As the time draws near for the Fed to reduce its securities purchases, a number of emerging nations’ currencies may remain highly volatile. Even if the Fed waits until spring, some interest rate adjustments will still occur in the coming months. However, currencies will not depreciate as much as they did last summer, as interest rate increases promise to be less dramatic.

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