Economic News

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INTERNATIONAL

Emerging market currencies barely react to rising bond yields

The current increase in bond yields recalls the episode in spring 2013. Then, the yield increase was particularly pronounced in the United States in anticipation of the end of the Federal Reserve's (Fed) asset purchases program. Among the effects, it had reversed capital flows and had strongly depreciated emerging market currencies, generating a lot of incertainty.

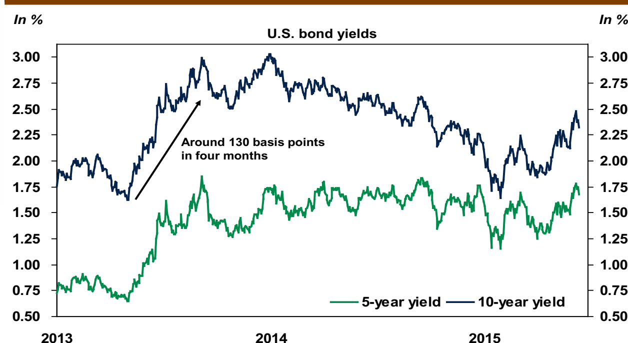
History does not seem to want to repeat itself today. This may be due to the fact that bond yields are not up as much as in 2013, while the U.S. 10-year yield had advanced around 130 basis points in four months (graph 1). Since January's low, the rise in the 10-year yield is only around 80 basis points and the advance is even less for shorter maturities.

While it is true that investments in emerging markets become less attractive as returns increase in advanced markets, that is not the sole determinant the exchange rates. In 2013, investors feared the effects of the Fed concluding its asset purchases. Today, massive purchases by the Bank of Japan and the European Central Bank are staving off such fears.

We must also look at where we are coming from. In 2013, weak economic growth and the existence of double deficits (public finances and trade balances) in several emerging countries heightened pressure on currencies and the situation has not improved much since. Furthermore, emerging market currencies have never returned to pre-2013 bond yield increase levels (graph 2), which may diminish the potential for additional depreciation. The widespread vigour of the U.S. dollar is probably an explanation, but persistent weakness in economic and financial variables likely contributed to keeping several emerging market currencies soft. The Indian exchange rate did better, with India experiencing economic growth that accelerated to 7.2% in 2014 and a current account deficit narrowing to 1.4% of GDP.

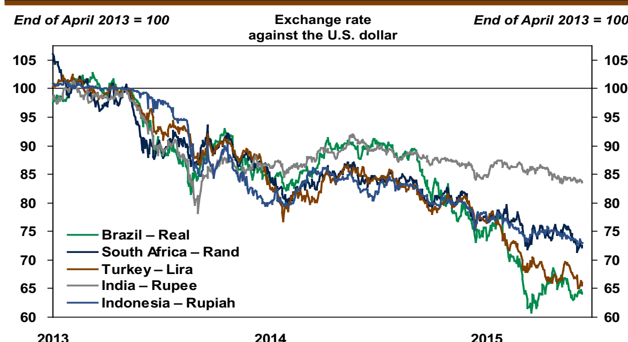
Implications: The fact the emerging market currencies are barely reacting to the current increase in bond yields is good news. This particularly lowers the risk of financial instability in these countries and, by extension, in the world. Nonetheless, it is possible that the currencies will react more strongly when the shorter maturities start showing more significant yield increases. Finally, the persistence of economic and financial problems in emerging countries remains a concern.

Graph 1 – Increase in bond yields is not as drastic and not yet as high as in 2013



Sources: Bloomberg and Desjardins, Economic Studies

Graph 2 – Several emerging currencies hard hit in 2013 have remained very depressed



Sources: Bloomberg and Desjardins, Economic Studies

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