Global Macro Views – Updating our EM FX Fair Values

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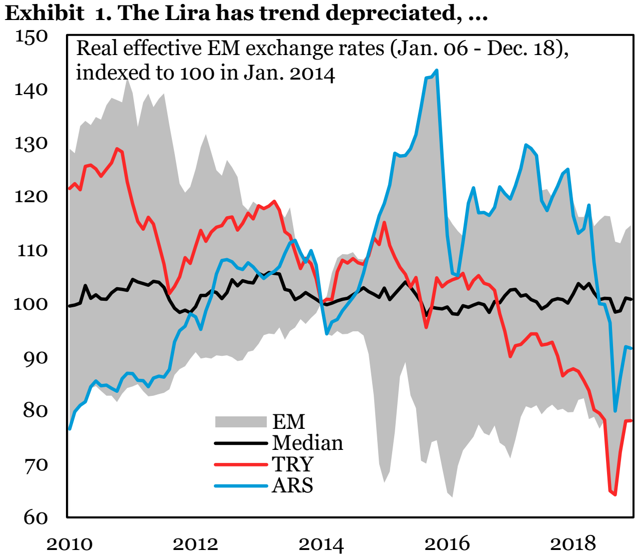
- We unveiled our EM FX valuation framework about one year ago, …
- which proved an invaluable guide in navigating the EM sell-off in 2018.
- This ***Global Macro Views*** updates our fair value estimates for EM FX, …
- incorporating large exchange rate, current account and activity moves.
- Argentina's Peso and the Turkish Lira are only mildly expensive here, …
- while India, Indonesia and South Africa remain overvalued in FX terms.
- EM Asia continues to be significantly undervalued, including China.

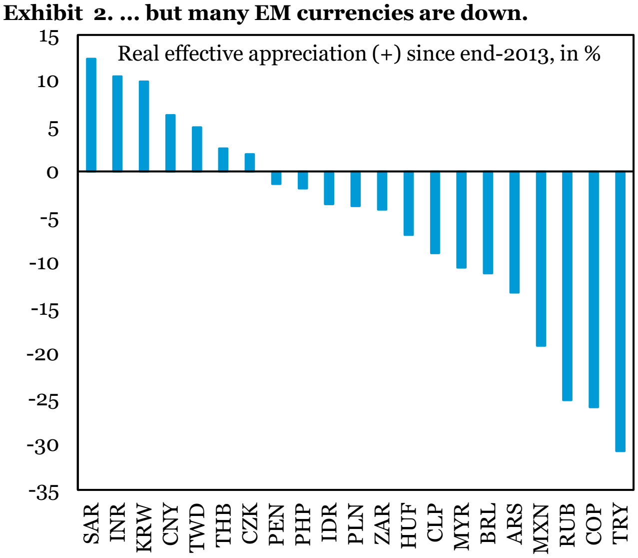
We unveiled our EM FX valuation framework a year ago, which maps current account imbalances into needed real exchange rate adjustment. At the time, large and rising current account deficits in Argentina and Turkey mapped into substantial overvaluations – around 15 percent – and both currencies fell sharply during 2018. Our valuation framework ended up being a central guidepost in a turbulent year, helping us shift constructive on EM in September, at the peak of the EM sell-off. This ***Global Macro Views*** continues a broad update to our framework, which began last week with a look at current account adjustment in Argentina and Turkey. We update our overall framework for large moves in real exchange rates, current accounts and activity that have unfolded over the past 12 months. The Argentinian Peso and Turkish Lira are only somewhat overvalued here, while India, Indonesia and South Africa remain expensive. EM Asia continues to be significantly undervalued, including China's RMB.

Exhibit 1. The Lira has trend depreciated, …



Source: Haver, IIF

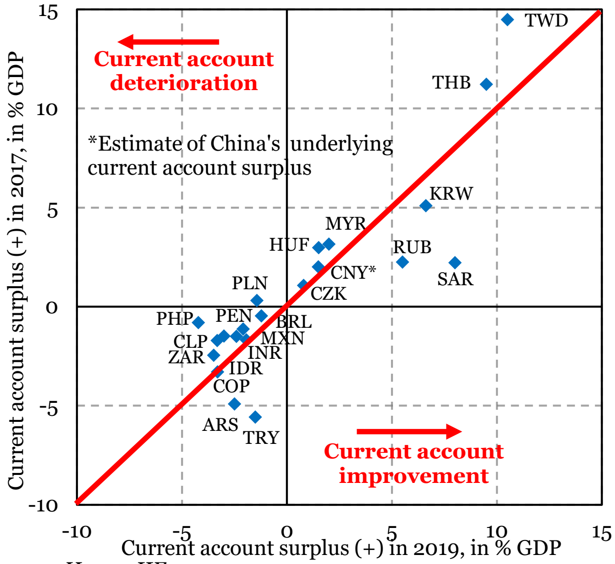
Exhibit 2. … but many EM currencies are down.



Source: Haver, IIF

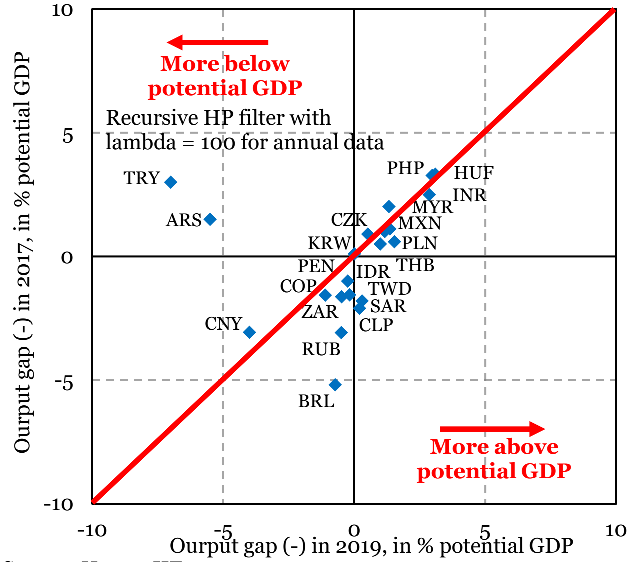
At the heart of our FX valuation model is an estimate for the underlying current account, which is cyclically adjusted by closing domestic and foreign output gaps. As readers of our work will know, we are skeptics of prevailing estimates of slack, which tend to steer too much towards realized levels of GDP, as opposed to where activity "could" be. We estimate potential GDP recursively, to avoid look-ahead bias, and use a smoothing parameter of 100 for annual data, so potential departs more from actual GDP than is standard. We use standard trade elasticities to simulate the effects of closing domestic and trade-weighted foreign output gaps and feed through lagged effects from real exchange rate changes over the past 3 years. Exhibit 1 shows the range of moves in real exchange rates over the last 10 years, highlighting the trend decline in the Turkish Lira. Exhibit 2 shows that most real exchange rate changes have been negative since 2014, consistent with the idea that a gradual withdrawal of monetary policy accommodation in the G-3 is a structural headwind for EM currencies. Exhibit 3 shows current accounts in 2017 (vertical) versus 2019 (horizontal), showing that large current account deficits in Turkey and Argentina shrunk significantly. Exhibit 4 shows that these current account adjustments come at the expense of activity, with output gaps moving to be substantially negative this year in both countries.

Exhibit 3. Current account imbalances are less, ...



Source: Haver, IIF

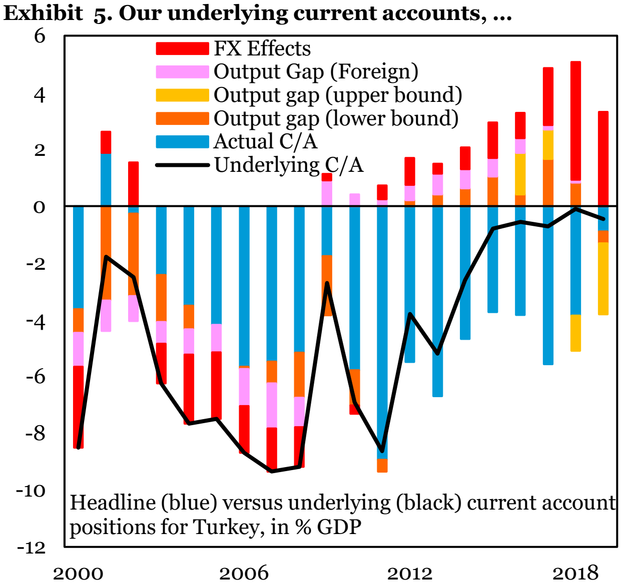
Exhibit 4. ... at the expense of rising output gaps.



Source: Haver, IIF

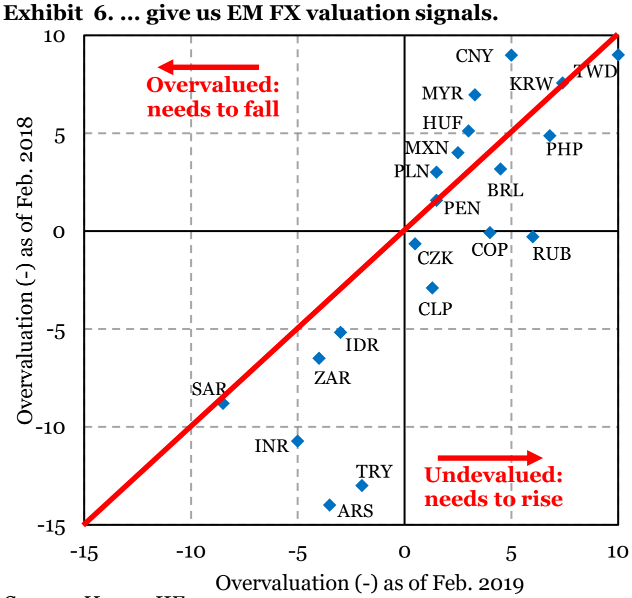
Exhibit 5 shows how these different adjustments to the current account (blue) play out for Turkey. We estimate that the underlying, cyclically adjusted current account (black) is stable around -1.0 percent of GDP, with offsetting forces from past Lira depreciation (red) and rising output gaps (yellow). Exhibit 6 shows the end-result across countries, with Turkey and Argentina only somewhat overvalued (horizontal), in contrast to 15 percent overvaluations a year ago (vertical). India, Indonesia and South Africa continue to be overvalued, while many EM Asia currencies, including China, remain undervalued.

Exhibit 5. Our underlying current accounts, ...



Source: Haver, IIF

Exhibit 6. ... give us EM FX valuation signals.



Source: Haver, IIF