

GMV – FX Valuations in the COVID-19 Shock

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- Emerging market currencies have experienced very large depreciations.
- Ordinarily our exchange rate models would be signaling large undervaluations.
- But depth and protracted nature of the COVID-19 shock put us far from ordinary.
- Risk averse markets have become unwilling to fund large EM current account deficits, ...
- a shift that has been ongoing since 2018 and accelerated sharply with the COVID-19 shock.
- Adjusting for this, we find few statistically significant undervaluations in emerging markets.
- The currencies of Argentina, India, Indonesia and South Africa are in overvalued territory.

Emerging market currencies have experienced almost unprecedented declines. In normal circumstances, these depreciations would cause our model to signal large undervaluations across EM. But circumstances are unfortunately far from normal and the protracted nature of the COVID-19 shock means markets may remain disjointed for months to come. Markets had been growing increasingly reluctant to fund outsized current account deficits, something the 2018 sudden stops in Turkey and Argentina underlined forcefully. The COVID-19 shock has now drastically accelerated this process, with increased risk aversion translating into required current account surpluses across EM. In the context of our fair value framework, this means moving our target or equilibrium current account positions further into surplus to reflect what looks to be a semi-permanent shift in risk appetite. As a result, we find that few EM currencies are undervalued in a statistically significant way. Only the Brazilian Real and Chilean Peso come close, in addition to the Korean Won. Our model points to overvaluations for Argentina, where the real effective exchange rate has been appreciating due to high inflation, as well as India, Indonesia and South Africa. At the best of times, FX fair value estimates are subject to great uncertainty and that is especially the case at the current juncture.

Exhibit 1. The Dollar has risen sharply, ...

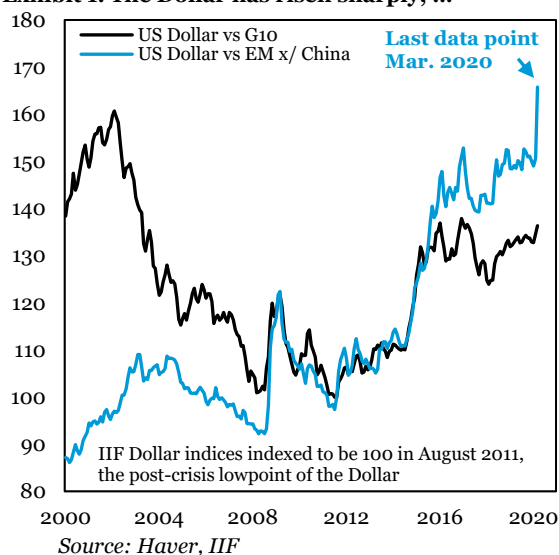
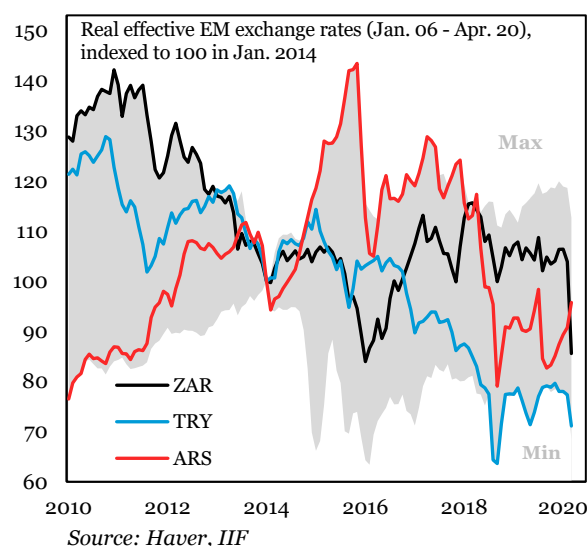


Exhibit 2. ... reflecting many EM devaluations.



The Dollar has risen sharply versus emerging markets, reflecting unprecedented capital outflows that are akin to a systemic [sudden stop](#) for EM (Exhibit 1). We flagged significant overvaluation of South Africa's Rand in our last [valuation](#) update in [November](#), but EM currencies have been falling much more broadly (Exhibit 2), with many exchange rates at or near all-time lows in real effective terms (Exhibit 3). In the context of our valuation model, these large depreciations are pushing our estimates for underlying current account positions – adjusting for domestic and foreign output gaps as well as lagged depreciation effects – sharply into surplus and, in normal circumstances, would signal substantial undervaluations. However, circumstances are far from normal and the protracted nature of the COVID-19 shock means markets may remain disjointed for some time. In our model, this means that the target or equilibrium current account is moving further into surplus, something that the 2018 sudden stop in Turkey and Argentina illustrated forcefully, with both no longer able to run current account deficits (Exhibit 4). This same shock is now hitting EM on a much broader scale and forcing countries with even small current account deficits into surplus. Ordinarily, we ignore changes in risk appetite in our fair value assessments, given that they can quickly reverse and are difficult to model. This time is different. We take the unusual step of shifting our target or equilibrium current account balances into bigger surplus pretty much across EM.

Exhibit 3. EM currencies are down sharply, ...

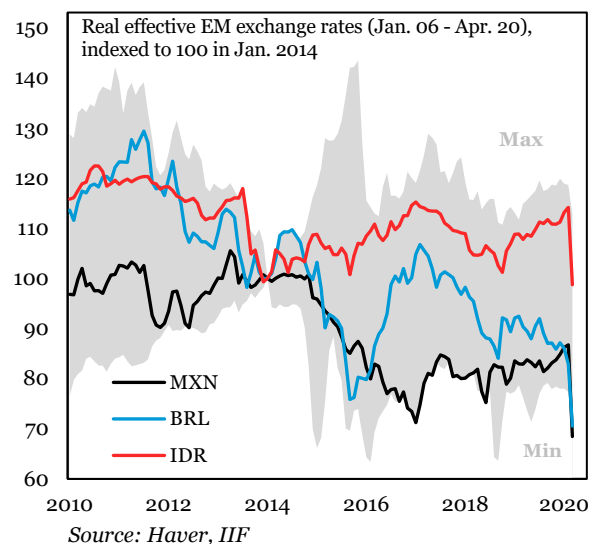


Exhibit 4. ... in a “systemic” sudden stop.

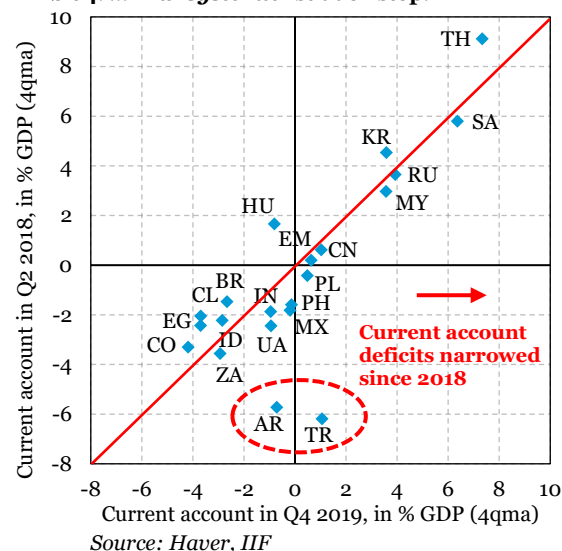


Exhibit 5 shows key [inputs](#) into our updated exchange rate valuations. Column (1) is our projected current account for 2020. Columns (2) and (3) give domestic and trade-weighted foreign output gaps, respectively. Column (4) gives the cumulative change in the real effective exchange rate since 2016. Columns (5) - (8) then show the contributions of these different things (in percent of GDP) to our estimate of cyclically- and FX-adjusted current accounts, which are in column (8). Column (10) gives our target or equilibrium current account positions, which we have shifted further into surplus as a result of the COVID-19 shock. Column (9) gives these equilibrium balances from the IMF where those are published, a good guidepost to where these equilibrium balances would be without the COVID-19 shock. Column (11) gives our undervaluation (+) or overvaluation (-) estimates, which are the change in the real effective exchange rate needed to bring the underlying current account in column (8) to target in column (10). We find few statistically significant undervaluations across EM. Only Brazil, Chile and South Korea come close. At the same time, there are overvaluations in Argentina, India, Indonesia and South Africa.

Exhibit 5. FEER Valuation Model for EM & G10 Currencies: Model Inputs and Estimated Misalignments for 2020

	(1) C/A (% GDP)	(2) YGAP (% GDP)	(3) YGAP* (% GDP)	(4) REER (% 2015)	(5) YGAP (% GDP)	(6) YGAP* (% GDP)	(7) REER (% GDP)	(8) C/A Adj. (% GDP)	(9) IMF (% GDP)	(10) IIF (% GDP)	(11) Misal. ^ (%)
G10											
AUD	0.7	-2.5	-3.1	-18.9	-0.8	1.0	2.4	3.3	-0.4	1.5	14.2
CAD	-1.7	-2.5	-3.3	-6.6	-1.2	1.6	1.2	-0.2	2.0	-1.0	4.5
EUR	4.0	-5.0	-2.8	-3.9	-3.1	1.9	1.7	4.4	1.1	3.0	5.2
JPY	3.7	-3.0	-3.4	1.3	-0.8	0.9	-0.2	3.5	3.1	3.0	5.1
NZD	-2.8	-1.0	-3.5	-13.5	-0.4	1.5	2.1	0.3	...	-0.5	5.0
NOK	3.8	-1.0	-3.5	-15.7	-0.5	2.0	4.1	9.4	...	7.0	9.9
SEK	3.3	-2.0	-3.6	-12.8	-1.2	2.4	2.9	7.4	1.0	4.0	12.6
CHF	13.3	0.5	-4.0	0.2	0.4	4.0	-0.8	16.8	5.9	10.0	16.8
GBP	-2.3	-1.5	-4.2	0.3	-0.7	1.9	0.1	-1.0	0.5	-2.0	5.9
USD	-2.2	-3.0	-5.1	6.1	-0.7	1.0	-0.5	-2.5	-0.9	-2.0	-6.2
CEEMEA											
CZK	-0.6	-1.0	-3.7	-0.3	-1.1	4.3	1.4	4.1	...	2.0	4.4
HUF	-1.4	0.5	-3.8	-11.0	0.6	5.0	5.9	10.1	...	7.0	6.0
PLN	-1.6	-0.5	-3.9	-3.9	-0.4	2.9	1.5	2.4	-2.3	1.0	4.6
TRY	0.6	-2.0	-3.7	-21.9	-0.8	1.3	2.3	3.4	-1.6	2.5	6.4
RUB	1.1	-3.0	-3.7	-15.0	-0.9	1.5	1.9	3.6	3.1	3.0	3.4
ZAR	-0.9	-4.5	-3.6	-19.4	-2.1	1.7	4.1	2.8	0.5	4.0	-6.5
SAR	-3.1	-3.0	-3.7	-1.1	-1.4	2.4	0.1	-1.9	...	-1.0	-3.4
LatAm											
ARS	1.7	-9.0	-5.9	-21.8	-2.0	1.2	1.1	2.0	-2.5	3.0	-12.9
BRL	-1.9	-8.0	-5.3	-30.6	-1.6	1.0	2.2	-0.2	-2.9	-1.0	10.1
MXN	1.2	-5.0	-3.8	-13.4	-2.7	2.0	2.9	3.4	-2.6	2.0	6.6
CLP	0.9	-4.0	-5.1	-17.6	-1.8	2.4	4.0	5.5	...	3.0	13.2
PEN	-0.8	-2.0	-5.6	-2.0	-0.7	2.1	0.1	0.6	...	0.5	0.8
COP	-3.2	-0.5	-11.1	-18.6	-0.2	2.7	2.2	1.5	...	1.0	5.7
EM Asia											
CNY	1.4	-6.0	-2.8	3.3	-1.8	0.9	-0.3	0.2	-0.4	-0.5	5.0
INR	0.2	0.0	-3.6	-5.9	0.0	1.1	0.4	1.7	-3.4	2.5	-6.5
KRW	2.3	-1.0	-3.7	-8.6	-0.6	2.6	2.7	6.9	2.7	4.0	10.4
MYR	2.2	-2.0	-3.0	-1.1	-1.9	3.3	1.6	5.2	-0.2	4.0	2.6
THB	2.0	-0.5	-3.1	2.8	-0.5	3.2	-0.3	4.4	0.1	3.0	3.4
IDR	-2.0	-0.5	-3.5	-12.1	-0.2	1.2	1.2	0.2	-0.9	1.5	-10.0
PHP	0.4	0.5	-3.3	5.5	0.3	1.5	-1.4	0.7	...	1.0	-1.5
TWD	9.6	-1.5	-3.5	-1.5	-1.3	3.6	0.3	12.2	...	10.0	5.2

^ Estimated FEER misalignment, where -ve signals overvaluation (needs to fall) and +ve signals undervaluation (needs to rise).

Source: Haver, IIF