Economic Update
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Emerging-Market Currencies Suffer as Advanced Economies Tighten Policy

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The global economy is faced with heightened economic uncertainty due to trade-related concerns and tightening monetary policy in advanced countries adversely affecting emerging economies. Despite these trepidations, the forecast for gross domestic product (GDP) growth in advanced economies remains unchanged. However, emerging economies experienced a 0.1 percentage-point reduction in the GDP growth forecast for both 2018 and 2019, largely due to currency devaluations for a handful of emerging economies in response to the tightening in advanced economies.

Stability Overcomes Uncertainty in Advanced Economies

Despite ambiguity over the future impact of recently settled trade policy, growth in the United States and the euro area remains stable. Year-over-year GDP growth in both economies in the second quarter has been revised up slightly since early August, and inflation has remained largely unchanged.

The U.S., Mexico and Canada have negotiated a revised version of the North American Free Trade Agreement (NAFTA), to be called the U.S–Mexico–Canada Agreement (USMCA). The U.S. and Mexico reached an agreement weeks ago but recently added Canada to preserve the trilateral free-trade relationship. USMCA differs from NAFTA, and it is yet to be seen how these changes will affect business once the agreement is in place. Both the Mexican and Canadian central banks stated that the trade renegotiation is the primary risk to their economic outlooks.

Concurrently, on Sept. 17, the U.S. imposed tariffs on $200 billion worth of Chinese goods, resulting in retaliatory tariffs on $60 billion of U.S. imports from China (*Chart 1*). U.S. trade policy is evolving rapidly but has not yet affected the International Monetary Fund's World Economic Outlook forecast for 2.7 percent U.S. GDP growth in 2019.

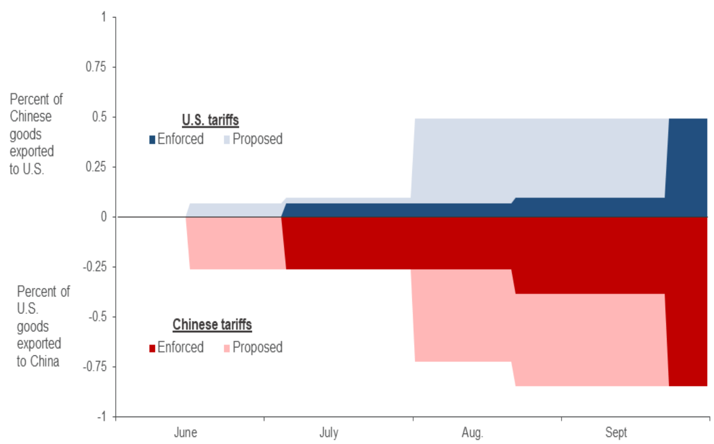
The United Kingdom and European Union have yet to agree on a plan to facilitate Brexit (the U.K.'s exit from the EU) after the EU's chief negotiator rejected the Chequer's plan put forth by the U.K. If a deal is not reached by the EU summit on Oct. 18, there is an increased likelihood of a "hard Brexit," in which the U.K. and EU would not have any special trading relationship and default to the trade rules of the World Trade Organization that governs 164 member countries. Despite the uncertain trade future, forecast GDP growth in both the U.K. and EU increased between July and August.

Monetary policy tightened in the U.K., with the Bank of England raising rates from 0.5 to 0.75 percent. The European Central Bank did not raise rates, remaining at zero, but took policy action by announcing that it would wind down its asset-purchase program, reducing the future monetary supply.

Major Asian Central Banks Resort to Alternative Policy Action

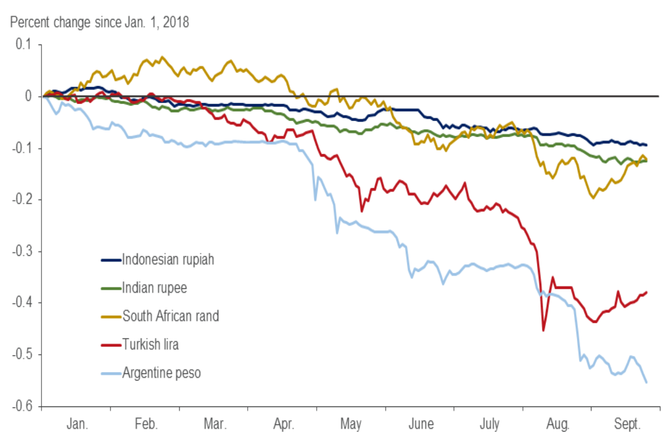
China and Japan have not raised rates since the Federal Reserve's September 2018 meeting but have remained active nonetheless (*Table 1*). In China, alternative measures of credit tightening fell. These measures included the three-month government debt yield and the Shanghai Interbank Offered Rate. In Japan, policymakers introduced formal forward guidance for the first time as the central bank announced a commitment to continue expanding the monetary base until the year-over-year inflation rate exceeds 2 percent.

Chart 1
Tariffs Levied on Bilateral Exports Between U.S. and China



NOTE: Data are tariffs levied on the percent of goods since June 2018.
SOURCES: China-Briefing.com; author's compilation.

Chart 2
Argentina and Turkey Face Rapid Devaluation of Their Currencies



SOURCES: National sources; Haver Analytics.

Capricious Currencies Cause Commotion in Emerging Economies

Emerging economies have suffered a general decline in forecast GDP growth, and inflation rose in a handful of countries. The tightening of monetary policy in advanced economies, both through rate hikes and other policy actions such as forward guidance, results in capital outflows from emerging economies with low reserves relative to their foreign debt.

The Argentine peso has depreciated 30 percent, and the Turkish lira has lost 26 percent of its value against the U.S. dollar since the Federal Reserve's August 2018 meeting (*Chart 2*). This rapid currency devaluation is the result high levels of foreign debt and low levels of reserves or savings in both countries. Other emerging economies with similarly elevated debt-to-reserve ratios, such as South Africa, Indonesia and India, have also experienced currency depreciations the past few months, as shown in Chart 2.

Argentina and Turkey have responded to their respective currency crises with rate hikes; Argentina's central bank raised its policy rate 15 percentage points, and Turkey increased its rate 6.25 percentage points. Both the Indian and Indonesian central banks have raised their rates since early August, while South Africa has held its rate constant, as shown in Table 1.

Brazil has seen the value of its currency erode as well, falling 7.8 percent compared with the U.S. dollar since the Federal Reserve's meeting in August 2018, but has held its rate constant. Significantly, Brazilian inflation estimates for 2018 have risen 0.1 percent over this period, pushing up import prices.

As advanced economies tighten their monetary policy, emerging economies considered to be less-safe investments will continue to suffer, widening the gap between the two.

—Michael Morris

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About the Author

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Table 1: Policy Rates

Country	Latest Rate	Percentage-point change since August FOMC meeting (Aug. 1, 2018)	Percentage-point change since last year (Sept. 20, 2017)
U.S.	2.125	0.25	1.00
Advanced (ex. U.S.)			
Canada	1.50	0.00	0.50
Euro area	0.00	0.00	0.00
Japan	-0.10	0.00	0.00
United Kingdom	0.75	0.25	0.50
Emerging			
China	4.35	0.00	0.00
Mexico	7.75	0.00	0.75
India	6.50	0.25	0.50
Brazil	6.50	0.00	-1.75
Russia	7.50	0.25	-1.50
South Africa	6.50	0.00	-0.25

NOTES: The advanced-economy policy rates are: U.S. fed funds rate, Canada target rate, European Central Bank main refinancing operation rate, Japan complementary deposit facility rate and U.K. official bank rate. The emerging-economy policy rates are: China one-year lending rate, Mexico target rate, India repo rate, Brazil overnight SELIC target rate, Russia one-week repo auctions loan rate and South Africa average repo rate. Daily data were updated on Oct. 1, 2018. FOMC refers to the U.S. Federal Open Market Committee.
SOURCES: Bloomberg; Haver Analytics; national sources.