

Emerging Markets

Impacts of the Fed's taper on vulnerable emerging markets

- Fed taper puts pressure on emerging markets
- Inflationary pressures pronounced in Turkey and South Africa

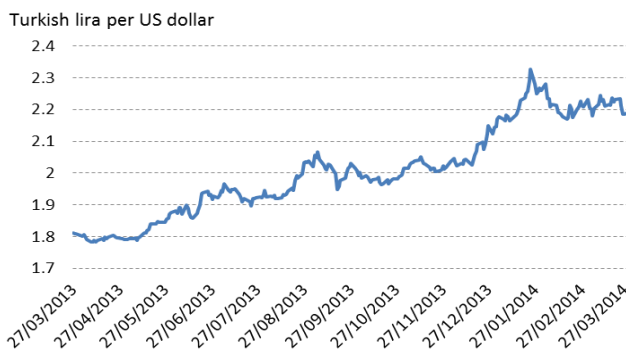
As the US Federal Reserve continues to cut back its asset purchases, in a process often referred to as the 'taper', much has been made of the effect this has had, and may have in future, on emerging markets. Brazil, India, South Africa, Turkey and Indonesia (dubbed the 'fragile five' by Morgan Stanley) are reckoned to be most at risk. This mostly reflects large current account deficits, reliance on overseas investment and elements of political instability linked to elections. This note uses PMI data to look at how these economies have fared since the taper began.

The signs are that Turkey and South Africa have been the most impacted, with inflationary pressures accelerating sharply at the start of the year amid currency depreciation.

Pressure on emerging market currencies

The US Federal Reserve announced its intention to scale back its asset purchases in May of last year, leading to pressure on the currencies of those emerging markets seen to be at risk of capital flight. Over the past year, all of the fragile five have seen the value of their currencies depreciate against the US dollar by more than ten per cent, with the Turkish lira seeing a 20.9% depreciation (see charts for remaining countries in appendix).

Turkish lira per US dollar



Source: Ecwin

There was an intensification of the pressure on these currencies in January as the Fed's taper began. The Turkish and South African currencies both fell sharply during January, suggesting that among the fragile five they are seen as being the most at risk.

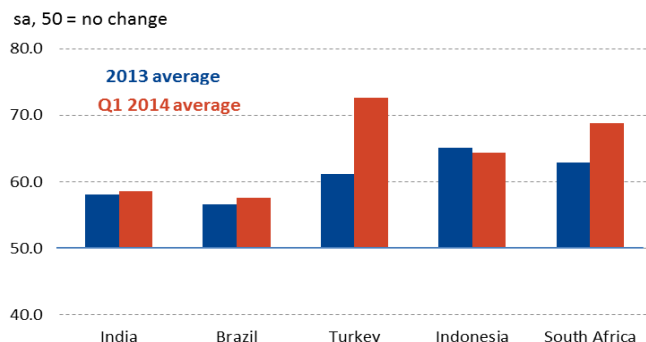
Depreciation of currency vs US dollar in Jan 2014	
South Africa	6.3%
Turkey	5.3%
Brazil	2.1%
India	1.3%
Indonesia	0.4%

The sharp depreciations led central banks in South Africa and Turkey to take action to offer some support to their currencies. The Turkish central bank raised its marginal funding rate from 7.75% to 12% at the end of January, while in South Africa the repurchase rate was upped from 5.0% to 5.5%. The remaining fragile five countries also saw action from their central banks in order to support their currencies. These measures did have an effect, with each having seen currency appreciation since the end of January.

Strong cost inflation in manufacturing sectors

Weaker currencies have the effect of raising the cost of imported goods, and PMI data suggest that, in line with the trends seen in currency markets, firms in South Africa and Turkey have seen the greatest impacts on input prices of the Fed's taper so far in 2014. In the year to date, both have seen rates of purchase price inflation well above 2013 averages, contrasting with generally weakening inflation at the global level.

PMI Input Costs Indices¹



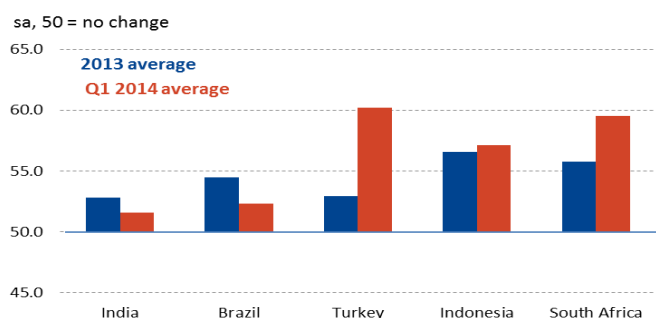
Sources: HSBC, Markit

Turkey saw manufacturing input costs rise at the fastest pace in almost three years in January, and although slowing, the rate of inflation has remained substantial through to March. Surveyed companies have directly linked higher input prices to the depreciation of the lira. Meanwhile, South Africa registered its highest pace of purchase price inflation since the survey began in July 2011 during February, with companies highlighting the impact of a weaker rand.

The rest of the fragile five have also seen cost pressures rise above their respective survey averages. That said, there are signs that inflationary pressures have peaked for now, with rates of purchase price inflation slowing in four of the fragile five economies in March.

The extent to which firms pass on higher cost burdens to clients can also be seen within the PMI data. Output prices have risen sharply across Turkey, South Africa and Indonesia in recent months, contrasting with a fall in selling prices across the global manufacturing sector as a whole in March. As with input costs, factory gate price inflation has been particularly strong in Turkey and South Africa since the start of the year.

PMI Output Price Indices



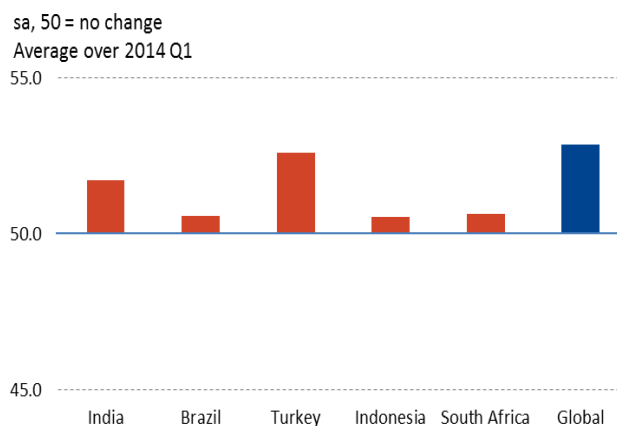
Sources: HSBC, Markit

New export orders increase

A more positive aspect of a weakening currency can be that exporters see an improvement in their competitive position relative to other countries, although rising costs of imported materials can act to cancel this out. Of the fragile five, Turkey and India have seen some improvements with regards to exports, with solid growth recorded in February and March. The remaining fragile five have seen new export orders broadly stagnate during the first quarter of the year.

The overall picture for the manufacturing sectors among the fragile five has nevertheless largely been one of only modest expansion so far this year, with the PMI in each of these countries below the global manufacturing PMI. The negative effects of strengthening cost inflation as a result of currency depreciation appear to be largely outweighing any boost provided to exports.

PMI Indices



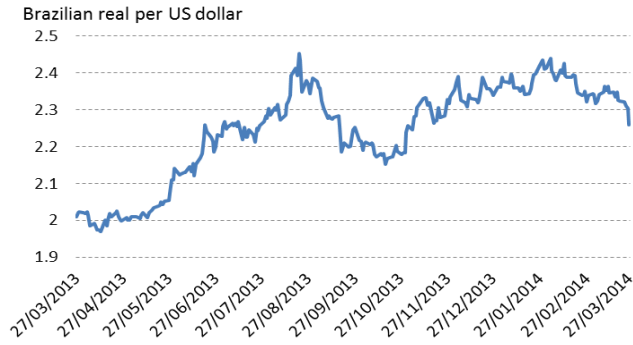
Sources: JPMorgan, HSBC, Markit

So far Turkey and South Africa appear to have been the emerging market economies most affected by the reduction in asset purchases by the Federal Reserve, and so it will be worth watching the PMI data in coming months as the taper continues to see whether this remains the case or whether the action taken by the respective central banks proves to be enough to limit the damage.

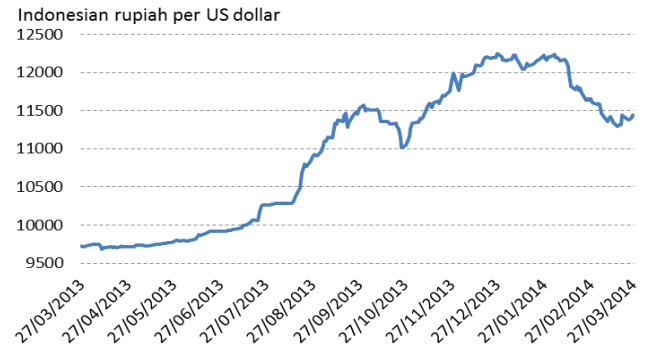
¹ All PMIs are manufacturing apart from South Africa which is a whole economy survey. The Purchase Prices Index is used for South Africa.

Appendix: Exchange Rates

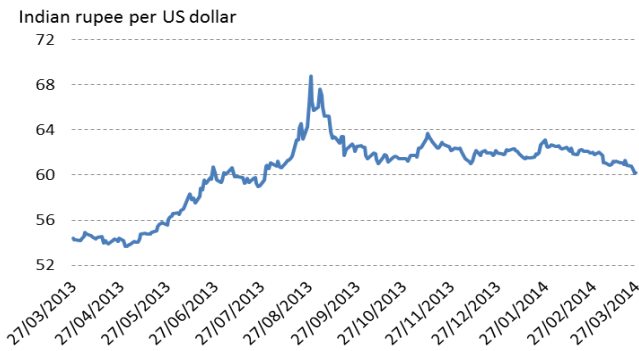
Brazilian real per US dollar



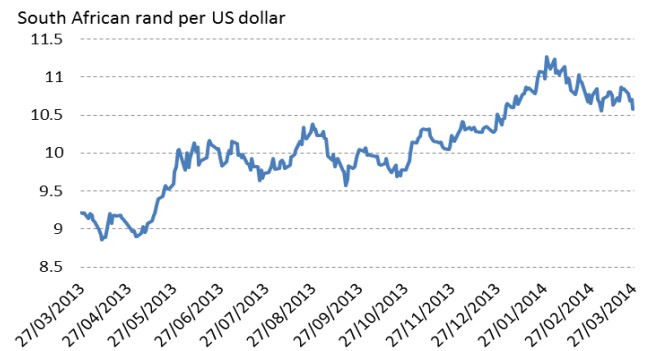
Indonesian rupiah per US dollar



Indian rupee per US dollar



South African rand per US dollar



Source for all: Ecowin

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