Turkey, Doves, Hawks and Owls

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It's tough to keep your head at times when the financial markets are behaving like they are. It may be especially tough when you are the governor of the central bank of a country with a 4% current account deficit and 6% inflation. In emerging markets especially, this is exactly the kind of mix that speculators are targeting right now. And yet, amidst all the swings in sentiment and the "risk-on, risk-off" trading, Reserve Bank of India Governor Raghuram Rajan expressed concern over following "the flock," saying: "We are neither hawks nor doves. We are actually owls."

The most recent events to roil markets have been those in Turkey. With pressure on countries that rely on external funding, it was surely not going to be too long before Turkey attracted the attention of traders. After all, it runs a current account deficit of over 7% of GDP and its inflation rate is also above 7%. Its policymakers decided to try to head off currency speculation by dramatically hiking interest rates from 5% to 10% in an effort to make shorting the lira uncomfortably expensive. But such high interest rates do put a strain on the domestic economy. How long can they conceivably keep rates so high before they sacrifice domestic growth for the sake of protecting the currency?

Feathers have been flying in Latin America, too, where most major nations are in external deficit. Argentina—whose international credibility has never really recovered from the debt default at the end of 2001—is being treated as the canary in the coal mine for the whole of the emerging market universe, including Asia. One need not be a scavenger these days to find opportunities to short emerging markets. Traders have been casting around for other targets like Turkey and Argentina. However, emerging markets are not a homogenous block, either culturally or economically, as many countries in Asia have proven by their ability to close the gap in living standards with the West over the past 30 years. Asian economies continue to enjoy high savings rates and robust productivity growth. Most of Asia remains unruffled as the region runs healthy current account surpluses. Only Australia, Thailand, Indonesia and the Indian subcontinent run external deficits and perhaps only the latter two are really prey to currency speculators. And even here, India has already been restraining credit growth for some time in an attempt to squeeze any short-term excesses out of the economy. In Indonesia, despite short-term migration of capital, the government has been taking steps to remove supply-side obstacles to more efficient growth; China too remains an interesting potential source of long-term foreign direct investment to keep the economy investing in new capacity.

Not that currency speculators are going to pay much attention to Governor Rajan—they love to "take on" central banks. However, whilst their options in other parts of the emerging market universe may keep the speculators circling, opportunities in Asia are less widespread. After all, in Asia, current account surpluses abound: Japan (1.0% of GDP), China/Hong Kong (2.0%), Philippines (4.2%), Malaysia (4.5%), Vietnam (5.5%), South Korea (6%), Taiwan (11.5%) and Singapore (17.5%). Private U.S. dollar debt is manageable as a percentage of GDP and, unlike Latin America, bond issuers have increasingly relied on domestic lenders rather than the international markets. Outside of the Indian subcontinent, inflation rates remain manageable too—averaging about 2% in North Asia and a little above 3% in Southeast Asia, excluding Indonesia. In addition, Asia's largest economy, China, is also in a relatively strong position. Its nearly US$4 trillion foreign exchange reserves and closed capital account make an externally forced currency crisis extremely unlikely.

So, the current market sentiment is something of an albatross around Asian economic and market performance. Whilst it is never safe to assume the currency speculators have "gone away," the region's economies have put in enough hard work over the previous decades, it seems, to earn some goodwill. Not all emerging markets are created equal. We don't want to count any chickens, but the fact that Indonesia (+4.6%) has outperformed the U.S. (-1.6%) thus far this year* does suggest that a bit of owlishness is creeping back into the markets.

*Year-to-date performance in local currency terms, as of February 11, 2014.