Chapter 9
Financial Market

Financial market is a market for the exchange of financial assets as well as a market for the pricing of financial assets. Typical financial market includes the monetary market, the securities market, the derivative market, the foreign exchange market and the gold market. This chapter will mainly discuss the performance of the E11 in the foreign exchange, bond and stock markets. In 2015, the E11's financial markets became more fragile, and investors became more anxious. In the foreign exchange markets, the exchange rate of the E11's currencies against the US dollar has moved to depreciate more or less in 2015. The price of treasure bonds issued by some E11 economies fell, reflected as the yields of these countries' 10-Year treasury bonds climbed up significantly. The E11's stock markets fluctuated vehemently in 2015 and saw wild swings in the third quarter in sync with developed economies' stock markets. The sovereign rating of a few E11 economies had been downgraded, causing furious fluctuations in the foreign exchange, bond and stock markets.

9.1 The Devaluation Trend in the Foreign Exchange Market

This section will analyze the change of the nominal exchange rates of the E11 currencies against the US dollar and review major factors behind the E11's foreign exchange market performance, such as the change of US dollar index, the change of economic fundamentals and the change of foreign exchange reserves.

9.1.1 The Widespread Devaluation of the E11 Currencies

The E11 economies had generally seen devaluation of their currencies against the US dollar in 2015 except Saudi Arabia which continued to peg its currency to the US dollar. Among them, South Africa, Brazil and Argentina had registered double-digit devaluation for four consecutive years. After slight appreciation in 2013 and 2014, the currencies of China and Korea joined with other currencies to depreciate against the US dollar in 2015. The Chinese yuan and the Korean won on average depreciated against the US dollar by 1.4% and 7.4% year on year in 2015.

Generally speaking, the devaluation of the E11 currencies against the US dollar became more drastic in 2015 than previous years and some countries even saw the omen of currency crisis. Sharp devaluation of foreign exchange rate is often deemed as a sign of currency crisis. Among the E11, the Russian ruble, the Brazilian real, the Turkish lira, the Mexican peso, the South African rand, the Indonesian rupiah and the Argentinean peso had all fallen by more than 10% against the US dollar over the previous year. Russia was the country that saw the sharpest devaluation in 2015 as its ruble fell by 58.8% against the US dollar over the previous year. The Brazilian real and the Turkish lira also fell sharply against the US dollar in 2015, down by 34.3% and 21.4% respectively over the previous year (See Figure 9.1). Since the end of the WWII, devaluation deeper than the threshold of 25% should have meant more or less a currency crisis.[1] According to this criteria, Russia and Brazil had entered into currency crisis in 2015.

Developed economies' currencies also devaluated considerably against the US dollar in 2015. The devaluation of the E11 currencies was in line with that of developed economies in 2015. The euro, the Japanese yen, the Canadian dollar and the British pound on average fell by 19.1%, 14.1%, 14% and 7.3% respectively against the US dollar in 2015 over the previous year (See Figure 9.1). For other developed economies with homogenized exports as the US, such devaluation of their currencies against the US dollar will help enhance their price competitiveness in international trade and boost economic growth in the future.

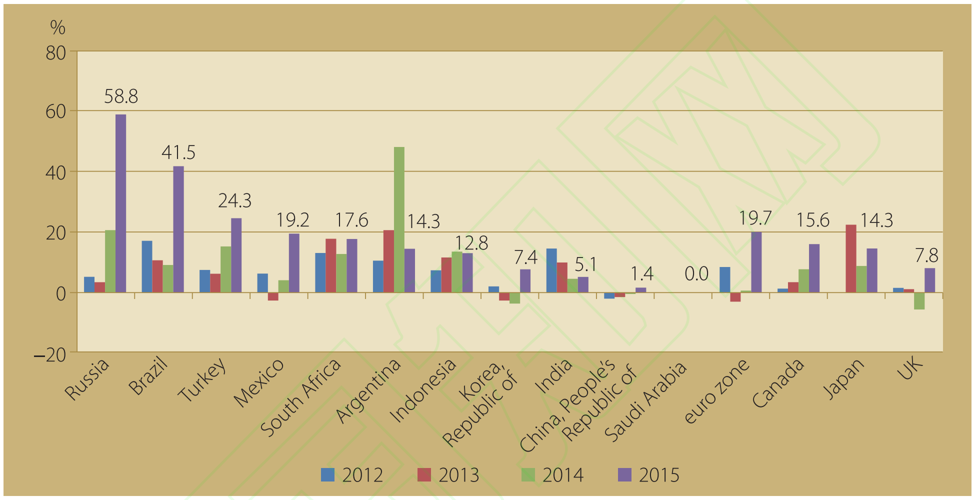

Figure 9.1 The change of annual nominal exchange rates of the E11 and the G7 between 2012 and 2015

Note: Direct foreign exchange quotation against the US dollar, >0 means devaluation, <0 means appreciation; the marked data in the figure is for 2015.

Source: IMF-IFS, Feb. 2016.

The exchange rates against the US dollar of most E11 currencies had been falling in 2015, except a few temporary appreciations of that of some countries in some quarters. Russia saw the widest fluctuation of nominal exchange rate among the E11. The quarterly average exchange rate of the Russia ruble against the US dollar had rose from 47.35:1 to 62.19:1 in the first quarter of 2015, down 31.3% over the previous quarter. Thanks to a rebound of the foreign exchange market and the intervention by the Russia monetary authorities, the Russia ruble climbed up by 15.3% against the US dollar in the second quarter. But then the Russia ruble returned to the track of devaluation, falling by 19.6% and 4.6% respectively against the US dollar in the third and fourth quarters. In the fourth quarter of 2015, the Argentinean peso had fluctuated most among the E11 currencies. The exchange rate of the Argentinean peso against the US dollar rose from 9.2:1 to 10.16:1 in the third quarter, down 10.4% over the previous quarter (See Figure 9.2). The day after the US Federal Reserve announced to raise federal funds rate by 25 basis points on December 16, 2015, the daily average exchange rate of the Argentinean peso against the US dollar plunged by nearly 40% over the previous day. The quarterly average exchange rate of the Chinese yuan against the US dollar depreciated from 6.12:1 in the second quarter to 6.26:1 in the third quarter, down by 2.4%. It continued to depreciate to 6.39:1 in the fourth quarter, down by 2% over the previous quarter. Because of the impact of factors such as the interest rate hiked by the US Fed, the Chinese yuan gradually fell to 6.49:1 against the US dollar in December 2015.

1 Carmen M. Reinhart, Kenneth S. Rogoff. This Time is Different: Eight Centuries of Financial Folly. Beijing: China Machine Press, 2010, pp5.

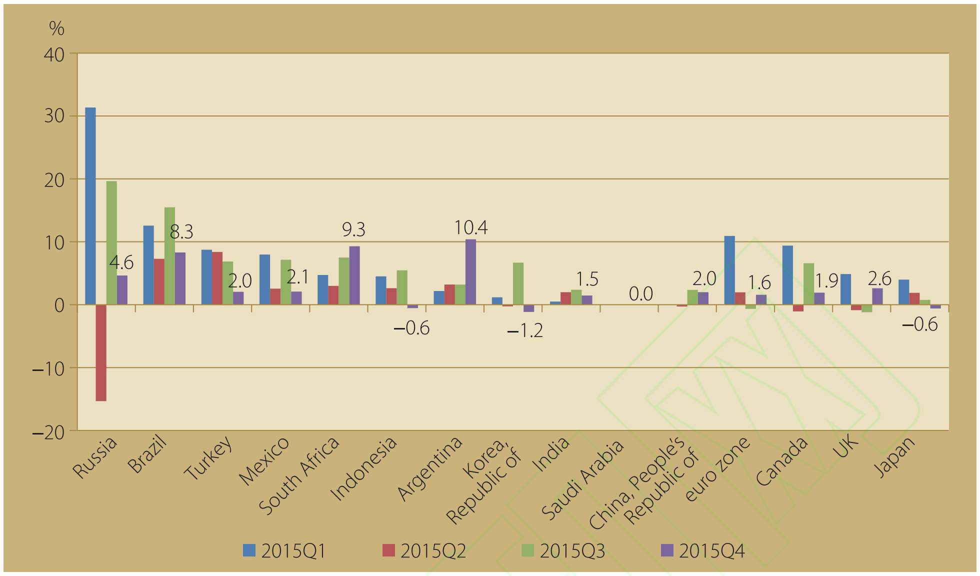

Figure 9.2 The change of quarterly nominal exchange rates of the E11 and the G7 in four quarters of 2015

Note: Direction foreign exchange quotation against the US dollar, >0 means devaluation, <0 means appreciation; the marked data in the figure is for the fourth quarter of 2015.

Source: IMF-IFS, Jan. 2016

9.1.2 Analysis of Reasons behind the Devaluation of the E11 Currencies

The performance of the E11 currencies in 2015 can be attributed to both common factor like the appreciation of the US dollar and individual factor resulted from the specific conditions of each country.

1) A strengthening US dollar

The US dollar index had maintained about 80 since the 2008 global financial crisis. Then upward pressure on the US dollar grew gradually and a breakout took form in the mid of 2014. The fastest three rising months of the US dollar index among 2015 were 4.2% in January, 3.7% in March and 3.5% in November (See Figure 9.3). Though there were slightly downward adjustments in some months, the strengthening trend of the US dollar largely remained unchanged. Since the US dollar index enters the track to rise at the second half of 2014, it rose from 79.9 in May 2014 to 98 in December 2015, up about 23%.

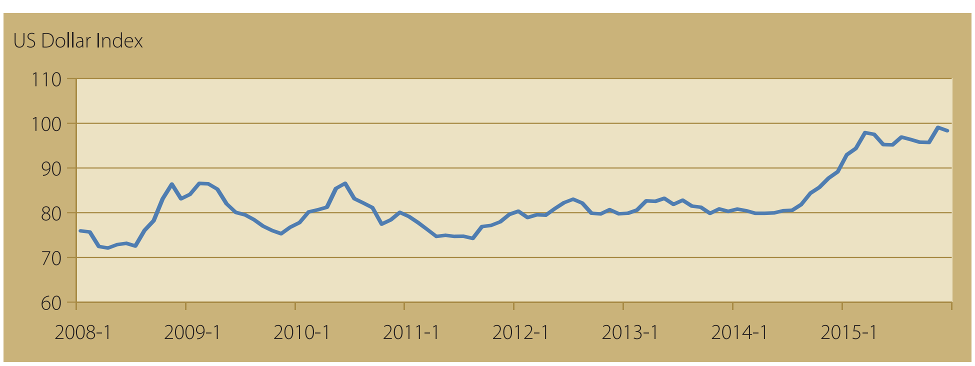

Figure 9.3 The US Dollar Index (Spot) between 2008 and 2015

Source: Commodity Research Bureau, CRB, Jan. 2016.

There are three main factors behind a strengthening US dollar. First, the US economy performed relatively better than other developed economies. According to the estimate by IMF in January 2016, the US saw a 2.5% GDP growth in 2015, 1 percentage point higher than 2014. And the US economy is predicted to grow by 2.6% in 2016. Second, the interest rate spread between the US and other major economies. Since the US Federal Reserve started to raise interest rates in December 2015, the interest rate spread between the US and other countries has been enlarged to increase the demand for the US dollar. Third, risk aversion rose in the financial market, as the flight to safe assets denominated in US dollar. It is predicted that the US economy will maintain stable growth in 2016 and the US Federal Reserve may raise interest rates twice. If risk aversion remains high in the market, the US dollar index may continue to move upward.

2) Differentiated country factors

The change of exchange rate of one country's currency against the US dollar hinges on both the trend of the US dollar and the fundamental situations of this country. Economic growth and the health of current account, investor confidence and sentiment, monetary policy and interest rate policy as well as geopolitics could all have an impact on the change of supply and demand of one country's currency in the foreign exchange markets. Take Russia as an example. It is the country that saw the largest volatility in the exchange rate of its currency in 2015. The performance of its currency in the foreign exchange markets was affected by not only the factors such as plummeting energy prices, disappointing economic growth and soaring inflation, but also the fact, unlike other countries, that it was under economic sanctions imposed by the US and European countries. After the Ukraine crisis, economic sanctions had become the keyword when the US and Europe discuss relations with Russia. Implementation of economic sanctions had caused the relation between Russia and the US and Europe to deteriorate rapidly. Russia's financial institutions have been blocked from the US and European financial markets on financing for investment, directly leading to rapid devaluation of the Russian ruble.

That crude oil prices had wandered on a quite low level for so long, which has not only resulted in poor economic growth and reduced government revenues for Russia but also imposed negative impact on its foreign exchange reserves. Before Russia announced a free floating foreign exchange regime in November 2014, its central bank had made use of its foreign exchange reserves to intervene in the market. Lasting low oil prices had not only made a dent on Russia's fiscal revenues but also deprived its central bank of tools to stabilize the foreign exchange market. On January 26, 2015, Standard & Poor's downgraded Russia's sovereign rating from BBB to BBB-, triggering a new round of devaluation of the Russian ruble. As a result of its central bank's intervention in May 2015, the Russia ruble stopped falling and began to climb. However, the further fall of crude oil prices and Russia's tough stance after its bomber was shot down by Turkey had caused panic among investors in the foreign exchange markets and the Russian ruble returned to the track of devaluation after October 13, 2015 (see Figure 9.4).

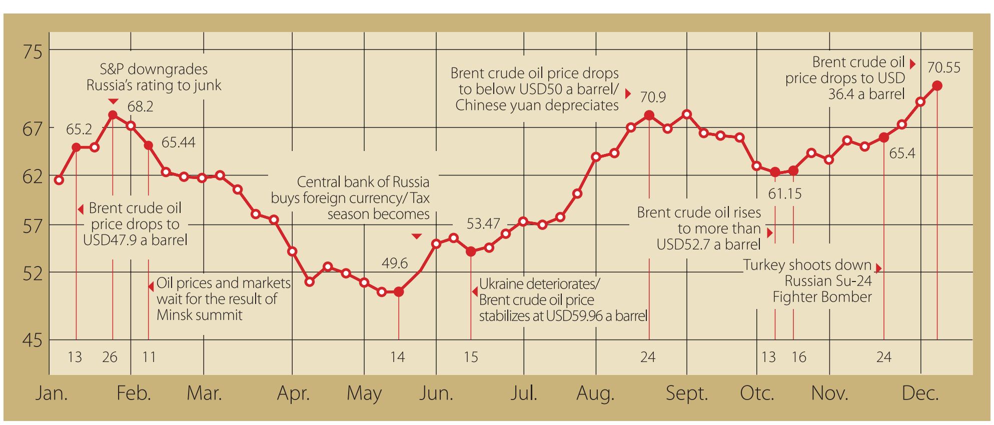

Figure 9.4 The daily exchange rate of the Russian ruble against the US dollar in 2015

Source: Anna Kuchma. What happened to Ruble in 2015? Russia in perspective. 2015. http://tsrus.cn/jingji/caijing/2015/12/25/554397.

3) The intervention capability of the monetary authorities

The change of exchange rates will also be influenced by the monetary authorities' intervention activities in the foreign exchange market. Foreign exchange reserves are the total convertible assets held by a country's government that can be used at any time for the balance of international payments and intervention in the foreign exchange market. Among the E11, though China and Saudi Arabia boast the largest foreign exchange reserves, their official reserves had kept falling in the first three quarters of 2015. The foreign exchange reserves of China and Saudi Arabia had dropped by 5.4% and 7.5% respectively in the third quarter of 2015 compared to the first quarter (see Figure 9.5). On one hand, the reduction of Saudi Arabia's foreign exchange reserve was a result of decreased revenues from exports caused by falling crude oil prices. On the other hand, the country had to intervene in the foreign exchange market to defend its peg to the US dollar. According to a report from China's General Administration of Customs, China's import and export totaled 24.59 trillion Chinese yuan (about USD3.9 trillion, Chinese yuan/dollar=6.3:1) (2)in 2015, down 7% year on year. The country's trade surplus reached 3.69 trillion Chinese yuan (about USD585.7 billion), up 56.7% year on year. In view of the opposite change of the foreign exchange reserves against the current account surplus and increased holding of gold reserves, China's monetary authorities probably had used foreign exchange reserves to stabilize the foreign exchange market.

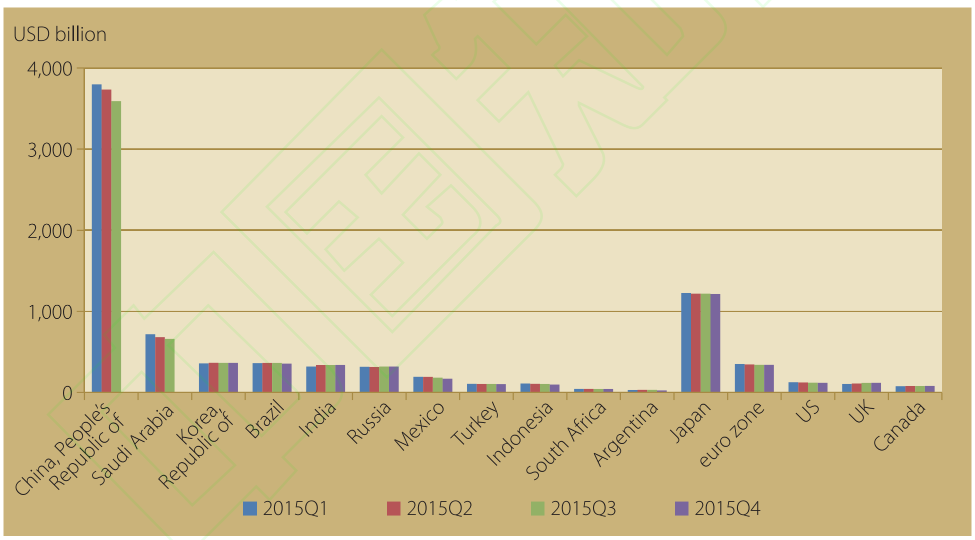

Figure 9.5 The foreign exchange reserves of the E11 and the G7 economies in the four quarters of 2015

Note: The figure has been sequenced according to the data of the third quarter of 2015; China and Saudi Arabia's fourth quarter data are not available.

Source: IMF-IFS, Jan. 2016.

9.1.3 Review and Forecast

The E11 currencies generally depreciated in 2015. Some E11 economies have made efforts to stabilize foreign exchange rates. For instance, China's monetary authorities had used official foreign exchange reserves to keep the exchange rate stable. The vulnerability of financial market, inadequacy of tools like foreign exchange reserves to prevent crisis and monetary authorities' incapability of financial governance, all are the main reasons for a currency crisis. Most E11 economies had experienced financial crisis and fully understood the crisis's destructiveness and lasting impact. They should be more cautious. Because of soaring inflation, sharp currency devaluation and domestic political tension, it is predicted that Brazil can hardly recover in 2016. Argentina's newly-elected president Mauricio Macri had sworn in at the end of 2015. He had put