Exchange ratesPegs under pressure

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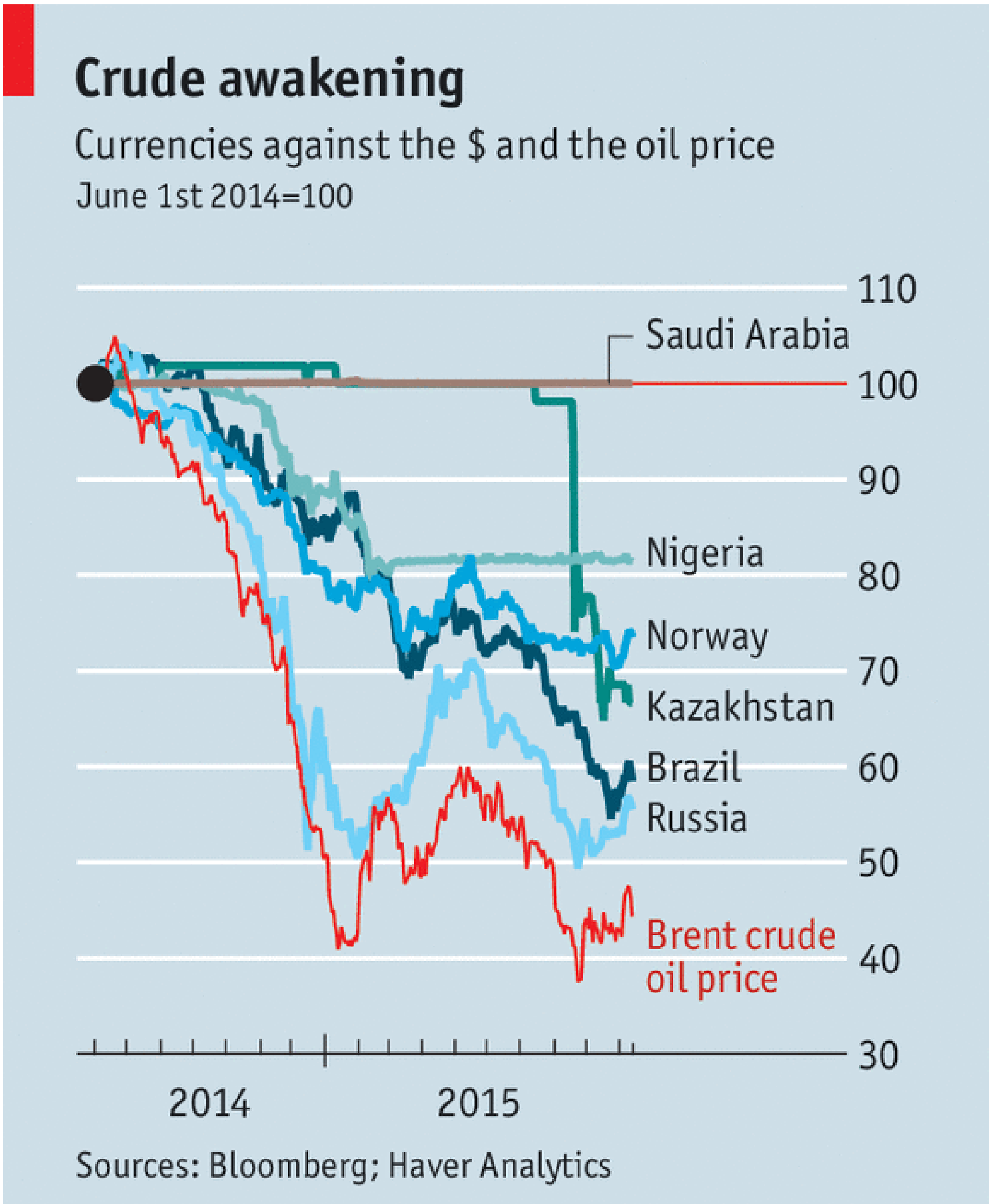

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SINKING might be a better description than floating when it comes to many of the world's currencies. A plunge in commodity prices has hit producers of natural resources hard. The weak oil price, in particular, has undermined the current-account position of oil exporters. The Economist Intelligence Unit (EIU), our sister company, expects the Norwegian current account to have deteriorated by 3.3 percentage points between 2013 and 2015. Many currencies have followed the oil price down. Since June 2014, the Norwegian krone has declined by 26%, the Brazilian real by 40% and the Russian rouble by 45% against the greenback (see chart).

Those who believe that competitive exchange rates boost economic growth should be pleased. But not every country is willing to let its currency freely adjust. The IMF's annual review of currency regimes, published this month, revealed that at the beginning of 2015 only 35% of member countries let their currencies float, and only 16% intervened rarely enough for the IMF to classify them as "free floating". The rest, from Hong Kong's iron-clad peg to the dollar to the stumbling Nigerian naira, are managed with a tighter grip.

This penchant for pegs can make sense. Many big oil exporters peg their exchange rates to the dollar because oil is priced in that currency. Anchoring a country's exchange rate to another, stable currency allows a weak central bank to latch on to the credibility of a stronger institutions, and so keep inflation expectations steady. Just ask a Zimbabwean whether they prefer the old regime (when 175 quadrillion Zimbabwean dollars exchanged for five American dollars) or the new, hard-currency one.

But pegs come with strings attached. In a free market, a shock such as a collapse in the value of exports would boost relative demand for foreign exchange, which in turn would cause the domestic currency to depreciate. The danger of a peg is that rather than allowing the exchange rate to adjust gradually, imbalances build up. Speculators spot the problem and attack the currency; if the country has to push up interest rates to defend the peg that hurts the underlying economy, but devaluing brings potential ruin to companies that have borrowed in foreign currency.

If the exchange rate does not adjust to a shock, then something else has to shift instead. Some places, like Hong Kong, have enough flexibility to cope; its strong peg to the dollar works because workers' wages can go down as well as up. But not everywhere is so nimble. An alternative approach is to build huge reserves to ward off speculators, as Saudi Arabia has done. According to estimates from Jadwa Investment, a Saudi Arabian fund manager, the government has amassed enough reserves to cover a comforting 48 months of imports. Few seem to think that the Saudi peg will fall soon.

Other pegs have been buckling under global pressures. Both the Kazakh tenge and the Vietnamese dong have seen their pegs break in the wake of the recent Chinese devaluation. The Kazakhs had little choice, even though a similar move in February 2014 led to street protests as imported luxuries were lifted out of the reach of ordinary people. The country has also had to cope with a fall in the Russian rouble, a big trading partner. Maintaining the dollar peg would have left Kazakh exporters painfully uncompetitive.

Naira-do-well

Other oil producers have adopted strategies that risk doing more harm than good. The Nigerian naira and Angolan kwanza have depreciated by 19% and 27% respectively against the dollar since June 2014, as their central banks have allowed them to drop in a series of steps. But according to Yvonne Mhango of Renaissance Capital, an emerging-market investment bank, both still have some way to go.

Rather than getting the pain over with, the Nigerian government is trying to shock the economy into plugging the gap between import and export revenues. In June the Central Bank of Nigeria produced a list of 41 items that cannot be bought using foreign exchange, including rice, rubber, toothpicks and private jets. According to Ms Mhango, these import restrictions are causing a recession in its manufacturing sector, which cannot get access to the raw materials it needs. "There is nothing to suggest that the gap in supply that has been created by the import ban can be filled. In the short term, the prices of those goods are just increasing," she says. The government is creating the very problem it is trying to prevent.

Venezuela is also in a fix. The falling oil price is expected to turn its current account from a surplus to a deficit. With enough reserves for only three months of imports, it has clamped down on access to foreign exchange. The IMF expects it to be one of this year's worst economic performers. The inflation rate is widely estimated to be in triple digits.

For countries such as these, burning through central-bank reserves is a short-term solution to defending a currency; and restricting trade is self-defeating. Nigeria and Angola have already devalued more than once, and investors sense that there is further to go. The only question is what will force the move; outside speculators, or economic pressure from within.