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Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

China: inclined toward putting off hard structural policies?, etc.

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 # Thoughts on the spread of depreciation among emerging currencies (Toshikazu Kumagai, Manager, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

Against the backdrop of rising long-term US interest rates many currencies in emerging countries have taken a tumble. While the possibility of a US rate rise kicking off drops in emerging currencies like the 2013 taper tantrum was always present, until the end of last year emerging currencies held relatively strong. This is no longer the case. For example the Argentinian peso has dropped precipitously and the country's consultation for aide from the IMF has drawn intense scrutiny. Reports alluding to the possibility of other currencies depreciating have also increased. Looking at changes in currencies from the beginning of the year, the Turkish lira, the Russian ruble, as well as the Brazilian real have fallen sharply, though most other currencies have fallen as well (Figure 1). In order to consider the spread of currency weakness in emerging countries I was to take a closer look at the current state of the fundamentals in each country.

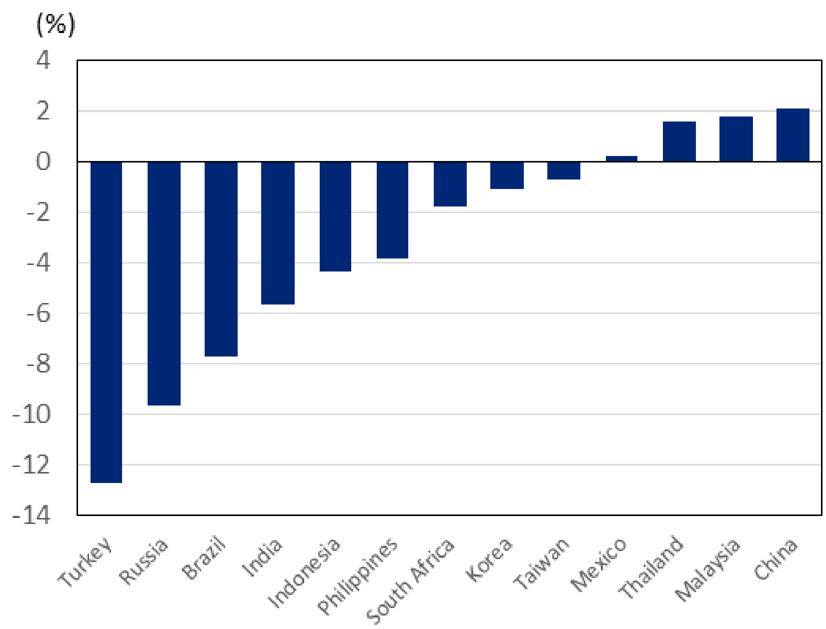
Normally, when a country has both a current accounts and budget deficit, their currency is easily depressed. For example, in order for a country with a current accounts deficit to pay another country what it owes, it must first exchange its own currency for another – in this way it is easy to depress one's own currency. It is also though that as a country carries and expands a budget deficit, when it becomes difficult for a country to service said debt this naturally invites capital outflows. In addition, a current accounts deficit shows that the situation is more than the country can handle internally. This deficit is then added to the budget deficit. From a currency perspective, debt in a foreign currency then grows, which makes it easy for concerns about a country's ability to pay to spread. When we look (Figure 2) at the condition of both the current account balance and the fiscal balance in 2017 (estimated), on the whole countries that saw a drop in their currencies were ones that also had negative current and fiscal account balances (bottom-left quadrant).

Next, foreign capital reserves are also important when a currency drops – it is this money that forms the capital of a currency intervention. Here we have calculated and published countries' actual foreign reserve amount vs. the necessary amount as defined by the IMF*(ARA: Assessing Reserve Adequacy). Comparing the difference over ten years (2007 – 2017), we can perhaps see growing resistance to fixing this imbalance in many countries. While some countries are below 100% (Figure 3), we can also see that still other countries' situations have worsened. The amount of freedom a country has regarding currency interventions will depend on their foreign currency reserves. While it cannot be unconditionally stated that the higher the foreign reserve ratio the more secure a country is, but one should also keep in mind that a low foreign reserve ratio limits the power of a government to intervene in its own currency.

It is predicted that many emerging nations will increase government spending ahead of elections or increase imports for infrastructure development. Based on this, it is important to keep an eye on the spread of depreciation among emerging currencies.

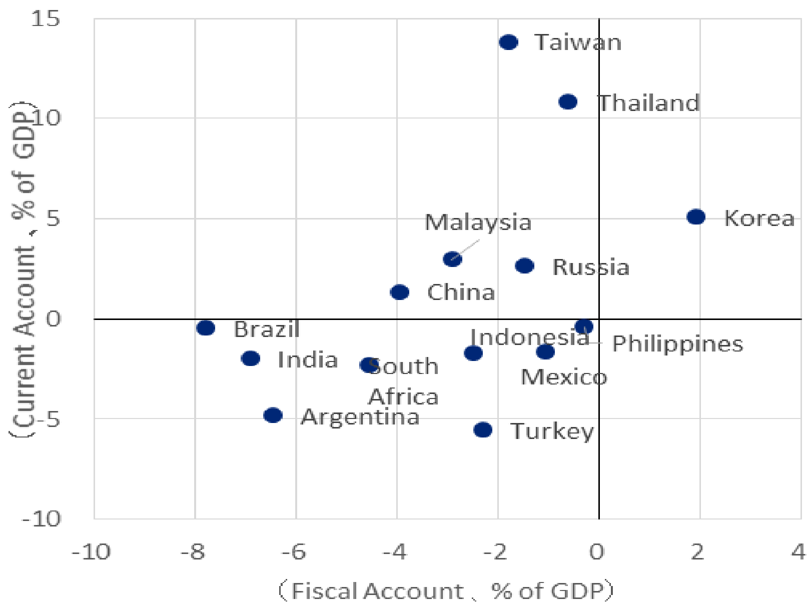
* 5% of exports + 5% of broad money + 30% of short-term foreign debt + 15% of other liabilities

Figure 1: Currency fluctuation rate from the beginning of 2018



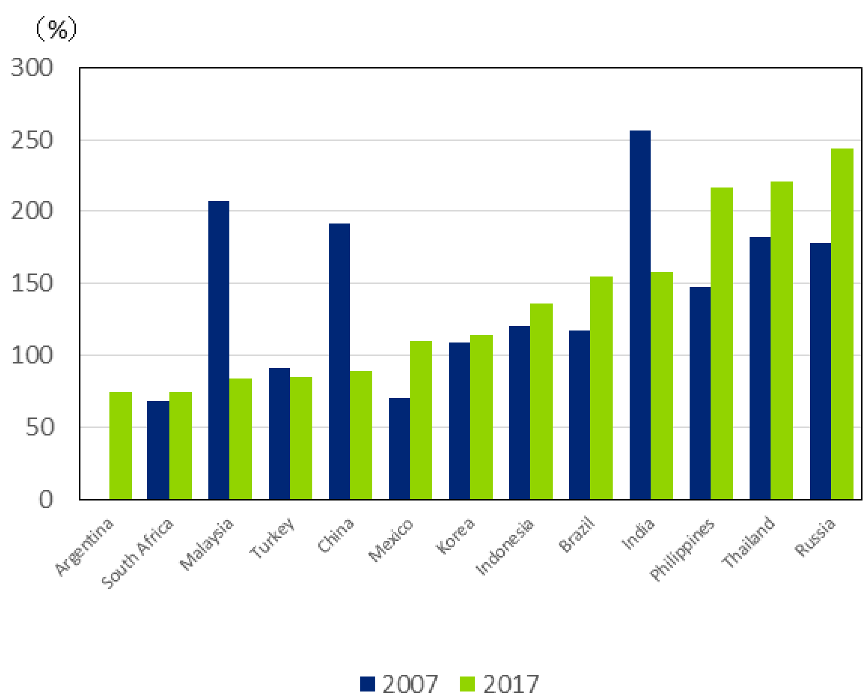
Source: Bloomberg, DTT analysis. January – May 9 2018 rate of change data.

Figure 2: 2017 current account and fiscal balances for selected countries



Source: IMF, DTT analysis.

Figure 3: Ratio of foreign reserve vs the IMF ARA amount



Source: IMF, DTT analysis.

Note: 2007 data from Argentina was not published