News from the financial markets

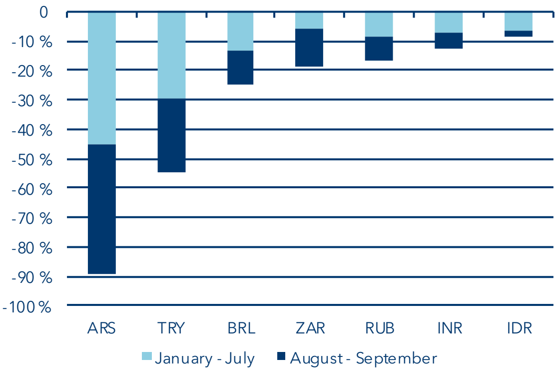
Emerging markets under pressure – A general conflagration is not to be anticipated

The emerging markets are currently in the spotlight. Due to the massive currency price losses in places, the question arises as to whether there is now the threat of payment defaults. However, the situation between the different countries is significantly more heterogeneous than was the case, for example, in the 1980s and 1990s. Some countries are coping better than others with the currency price losses. Therefore, a general conflagration accompanied by an extensive payment default in the emerging markets is not to be anticipated.

Fed balance sheet total reduction becomes burden

Emerging market currencies have been grappling with depreciations since the start of the year; however, price losses have accelerated again in the last two months. While in the first few months of the year the fear of more significant interest rate increases by the US central bank (the Fed) and the trade conflicts had a negative impact, fears of a Turkish payment default ultimately led to a new escalation level.

Losses of emerging market currencies against the USD

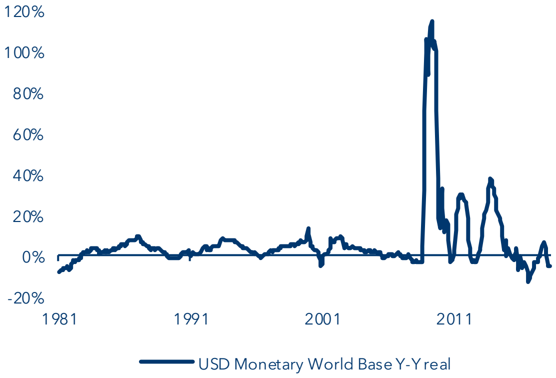


ARS: Argentinian peso, TRY: Turkish lira; BRL: Brazilian real; ZAR: South African rand; RUB: Russian rouble; INR: Indian rupee; IDR: Indonesian rupiah

Source: VP Bank, Thomson Reuter's Datastream

In a broader consideration, initial indications of a certain scarcity of US dollars are likely to manifest themselves herein. This is not necessarily deducible at first glance. Why should the US dollar be scarce if the currency can be bought anywhere at the valid exchange rate in each case? The Fed is in the middle of a balance sheet total reduction. In other words, the previous quantitative easing has now become the exact opposite, a so-called quantitative tightening. Thus, the 'printed money' from the crisis years is being recollected again. The balance sheet total is set to being reduced monthly by USD 50 bn in the peak. In a simple construct, we have calculated a real aggregated money supply for this and given it the name 'USD global money supply'. This monetary aggregate includes the central bank money directly controllable by the US central bank and the USD reserves of foreign central banks at the Fed. Finally, we have converted this aggregated money supply into a real size using the US inflation rate. Admittedly, this may sound slightly technical, but the result is simple: the real USD money supply decreases considerably year on year. The reversing of the expansive US monetary policy is thus in full flow.

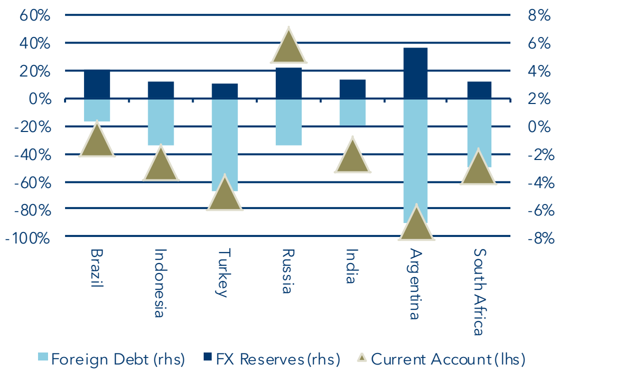
USD: Global money supply in % Y-Y



Source: VP Bank, Thomson Reuter's Datastream

It is noticeable that during many episodes with negative growth of the USD global money supply, the tensioning in the emerging markets tended to increase. All the countries that depend on a steady inflow of US dollars due to a high-deficit current account balance (the latter is reflected mainly in a trade balance deficit) can come into difficulties in such phases. The current situation of Turkey or Argentina matches these criteria. Additionally, foreign debt is very high in these countries. If the foreign currency reserves for this in turn are also relatively low, the situation intensifies further. The following graph illustrates this. The outstanding foreign debts, the foreign currency reserves and the current account balance deficit are shown.

Foreign debt, foreign currency reserves and current account balance in % of GDP



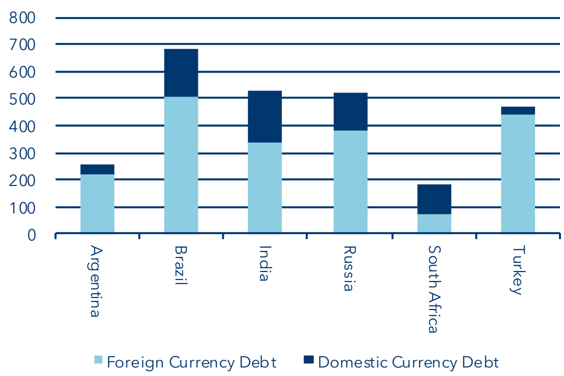
Source: VP Bank, Thomson Reuter's Datastream

Foreign debt under the microscope

The graph shows that the level of foreign debt differs widely. Turkey, Argentina and South Africa stand out negatively. It is in fact the case that Turkey and Argentina are currently spearheading the negative news. However, the situation in South Africa must be put into perspective somewhat at second glance. Why is that? Foreign debt is not to be equated to liabilities in a foreign currency; rather, the definition merely indicates that it is held by foreign creditors. In practice, however, the following applies: foreign investors often shy away from the currency risk of the country in question and instead prefer so-called hard currencies, especially USD or EUR. Therefore, many governments and companies in emerging markets take on debt not only in their national currency, but also, for example, by means of USD – simply in order to increase their investor base. Empirically, therefore, it is mostly seen that foreign debt largely coincides with liabilities in a foreign currency. In the following chart, the currency composition of the foreign debt for a few emerging markets is shown. Here, South Africa stands out positively. Approximately 60% of the foreign debt is denominated in South African rand, for which reason the situation at the Cape of Good Hope turns out to be less precarious at second glance.

If the debt of a state or a company is denominated in its own currency, this is less critical, as the central bank of the country can rush to its aid in an emergency. In general, this would mean that the monetary watchdogs can, in an extreme case, actuate the printing press. It is different with foreign currency liabilities. Debt service requires that the USD, for example, be available in sufficient quantity. If considerable price losses occur in the local currency (as in Turkey, for instance), the outstanding foreign currency liabilities increase on the same scale. On the other hand, if USD is no longer generated in sufficient supply or if, in the worst case scenario, the banking sector even loses access to the foreign currency supply, there is the threat of a payment default.

Foreign debt: Currency in bn USD



Source: VP Bank, World Bank

Heterogeneous countries

The level of foreign debt, the supply of foreign currency reserves and the current account balance situation differ greatly. This alone considerably reduces the risk of a general conflagration. However, further aspects come into play. We want to provide a brief overview of the countries that are currently in the dock.

Turkey: There is no sugarcoating it; the situation on the Bosphorus is extremely critical. The country's banking sector is carrying along a big mountain of foreign currency debt. At the same time, President Erdogan damaged the confidence of foreign investors when he called into question the independence of the central bank. If foreign banks now reduce or withdraw the supply of USD or EUR to the Turkish financial sector, there is the threat of a financial crisis. Recently, the Turkish central bank raised the key interest rate more than expected by 625 basis points to 24%. This brings back at least some confidence. Investors are still sceptical whether the central bank can escape restraints of the government in the long run.

Argentina: The Argentinian government already recognised in the spring months that there was a storm brewing. At the start of June, the highly indebted country agreed with the IMF on a loan in the amount of USD 50 billion. The agreement provided for an 'immediate payment' in the amount of USD 15 billion, which was already granted in June. In view of the intensifying devaluations of the Argentinian peso, Argentina has now requested an early payment of further instalments of the loan. The Washington-based institution showed itself cooperative, likely also to prevent further contagious effects. A payment default by Argentina thus becomes less likely.

South Africa: The country is already in the middle of a recession. Both in the first and in the second quarter of 2018, the gross domestic product declined. Above all the ongoing drought afflicted the important agricultural sector in the second quarter. However, the second half of the year is likely to produce at least moderately positive growth rates. Then again, the planned expropriation of white farmers still offers considerable political conflict potential. On the plus side, the country can report a relatively small proportion of foreign currency liabilities within the foreign debt. Additionally, the country's raw material income promises a steady inflow of USD. However, to call it as it is: despite certain plus points, the country remains susceptible with its relatively high foreign debt.

Brazil: Foreign debt is comparatively low. Additionally, the foreign currency reserves for this are at a relatively high level. From this perspective, it is hard to target the tropical state. Therefore, the considerable devaluations of the Brazilian real this year compared to the USD are not likely to constitute an existential risk for the country as a whole. The presidential elections in October have risks attached to them for the country and its creditworthiness. According to polls, the right-wing populist Jair Bolsonaro is leading. Riots after the election cannot be ruled out. In short: even though, in view of a relatively low foreign debt, the current creditworthiness risks are low, political uncertainties remain with the upcoming presidential elections.

Indonesia: Measured against its GDP, Indonesia's foreign currency liabilities are rather low compared to countries such as Turkey or Argentina. Even though the Indonesian rupiah compared to the US dollar is at its lowest level since the outbreak of the Asian financial crisis in 1998, the currency's weakness should not lead to a serious crisis. Nevertheless, the increase in debt servicing costs is likely to lead to growth losses. However, a GDP growth of over 4% should be possible in the current year nonetheless.

India: The macroeconomic foreign currency liabilities are at 12% of GDP and are thus manageable. The foreign currency reserves are at 14% of GDP. The Indian central bank (RBI) has already countered the devaluations of the rupee with two interest rate increases. The key short-term interest rate is now 6.50%. However, the currency's recent price fall has so far remained without response from the central bank, which is likely to have led to additional sale pressure. Meanwhile, the Indian economy is one of the fastest-growing in Asia this year. On balance, the devaluations of the rupee will not lead to an Indian financial crisis.

Russia: The Russian rouble also went to the dogs during the recent sale wave of emerging market currencies. Foreign debt is at 34% of GDP. However, the actual liabilities in foreign currencies are at only 23% of GDP, which also corresponds approximately to the country's foreign currency reserves. Thus, the Russian currency's weakness can be stemmed. Paradoxically, the important Russian energy sector can even benefit at present from the currency's weakness, as the oil price is at an all-time high measured in rouble.

Conclusion

Emerging markets cannot be lumped together. Although the respective national currencies are currently under considerable devaluation pressure, the price losses do not have the same negative consequences everywhere. For this very reason, a 'conflagration' accompanied by a series of payment defaults is not to be anticipated. To reassure the market in the short term, clear signals are now required from the central banks of the emerging markets. It must become clear that the currency losses are not being watched inactively – interest rate increases thus have a reassuring effect. In this case, we do not expect further significant currency losses. On the other hand, in the medium term, the Fed's interest rate increase cycle is likely to remain a burden, which, in turn, makes significant upward revaluations of the respective currencies less likely.

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