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Turbulent times ahead for foreign currency debtors in emerging markets

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Since the start of the financial crisis, emerging markets (EMs) have benefited from cheap finance and large capital inflows resulting from the accommodative monetary policy of advanced economies. Due to an imminent tightening of monetary policy in the USA – the first rise in interest rates for nearly a decade – the financing environment is likely to deteriorate. Exchange rates have already shifted in many EMs, significantly increasing their foreign currency debt expressed in local currency.

A systemic crisis is not expected

In previous cycles, normalisation of US monetary policy was often accompanied by critical events in emerging markets, such as the Asian financial crisis of the late 1990s. Compared with then, EMs are now better equipped to deal with crises: their foreign currency reserves have increased more than tenfold in the last 15 years (Figure 1). As a result, the forthcoming hike in US interest rates is unlikely to trigger a systemic crisis. Nevertheless, some countries may suffer more than others, as happened two years ago when hints from the Fed about a possible reduction of bond purchases caused turbulence in securities and foreign exchange markets. At the time, attention focused particularly on Turkey, Brazil, India, Indonesia and South Africa (dubbed the "fragile five"), in view of their heavy dependence on foreign sources of financing.

Little has changed since then in terms of countries' external vulnerabilities. Only India has significantly reduced its current account deficit. Comparing present levels of foreign currency reserves with external financing requirements, it would appear that Turkey, South Africa and Indonesia are still extremely vulnerable: in the case of persistent capital outflows these countries' reserves will be too small to cover their current account deficits over a long period. Turkey's reserves are only sufficient to cover 60 % of its short-term foreign debt plus current account deficit; the ratios for South Africa and Indonesia are 90 % and 120 % respectively. Brazil's and India's reserves are twice their funding requirements.

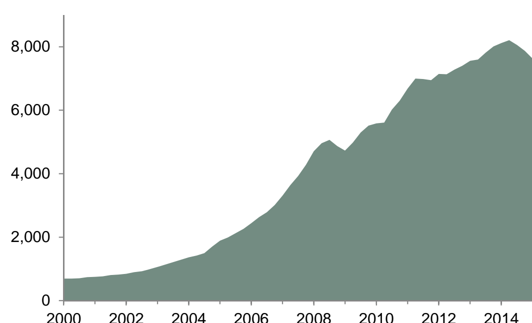
The burden of a strong US dollar

Since the beginning of the year, the Brazilian and Turkish currencies have fallen the furthest – by 30 and 20 % respectively – followed by South Africa and Indonesia with around 10 %. The Indian rupee on the other hand has remained relatively stable (all data as at 14.08.2015). This trend places heavy pressure on the private sector in emerging markets, where foreign currency debt has been growing strongly since 2007. Turkey has seen the biggest increase in foreign currency denominated liabilities of non-financial companies and households. Brazil and Indonesia have also recorded substantial rises (Figure 2).

Companies increasingly look to the bond markets for funding: the outstanding volume of EM bonds has almost trebled since 2007; around one fifth is denominated in hard currency, mainly US dollars. A reversal of capital flows is especially likely to affect companies that rely on international capital markets to refinance maturing debt. As far as changes in exchange rates are concerned, the risks for many issuers and borrowers – particularly companies from the commodity sector – are limited, since revenues in US dollars largely provide a natural hedge.

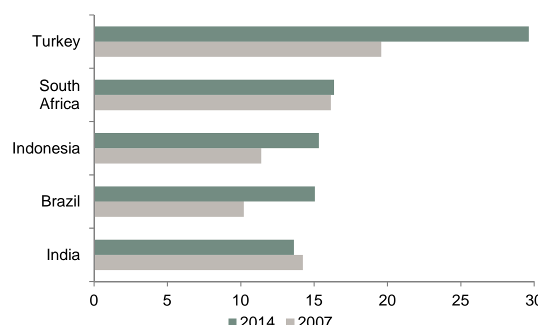
However, in some economies, such as Turkey, having a large number of companies whose foreign currency debt is not hedged via corresponding revenues or derivatives may represent a threat to financial stability. ■

Figure 1: Foreign currency reserves of developing and emerging countries (in billions of US dollars)



Source: Datastream

Figure 2: Foreign currency debt – loans and bonds – of the private sector (in percent of GDP)



Source: IMF

Note: This paper contains the opinion of the authors and does not necessarily represent the position of KfW.