Deutsche Bank
Markets Research

Global

Foreign Exchange
FX Spot

Date
3 June 2013

# FX Daily

## The fundamental case for further EMFX depreciation

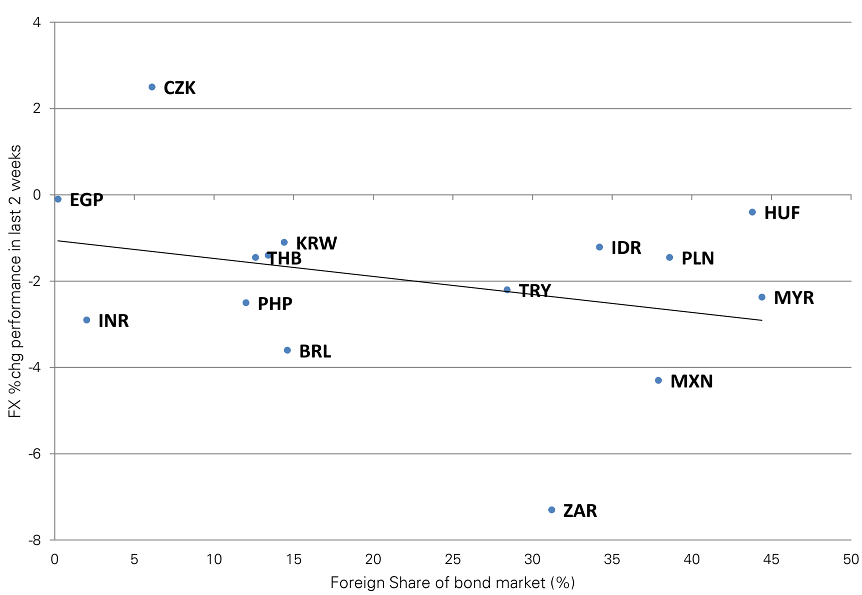
- *Limited inflation pressures; relatively soft EM/BRIC growth; and strong real TWI starting points suggest broader EMG currency depreciation fits relatively easily with the global fundamental backdrop.*

There has been plenty of chatter about the lack of liquidity on some of the most liquid EM currencies like ZAR and MXN, which is truly ironic, since one of the reason these currencies have been hit so hard is precisely because they are seen as relatively liquid vehicles, either to hedge their own less liquid asset markets, or, other currencies/assets.

Obviously the MXN and ZAR also fit the bill of currencies where foreigners hold a large slice of the domestic bond market. The market fears high foreign ownership in times of stress, given obvious concerns about fleet of foot portfolio outflows, and, because the currency might be used as a hedge for large illiquid local market holdings.

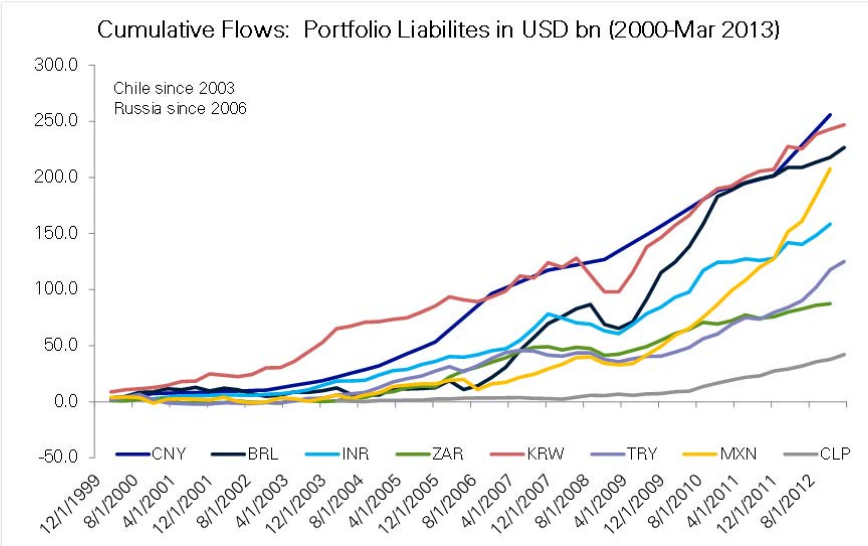
The chart below, of the recent currency performance (last 2 weeks) relative to foreign ownership of local bond markets, shows just how imperfect that link has been so far.

Figure 1: Currency performance (last 2 weeks) vs. foreign ownership of bond market




Source: Deutsche Bank

Figure 2: Cumulative flows: portfolio liabilities since 2000




Source: Deutsche Bank

This is no surprise since countries with high bond ownership and limited FX response are typically those where central banks are particularly active in limiting currency fall-out, and MXN and ZAR are being hit not least because they are relatively free floating exchange rates.

Going forward, central banks have extensive reserve firepower so their willingness to stand in the face of currency weakness will be a key factor in determining which currencies are least/most vulnerable.

There are at least 5 important reasons why the majority of EM central banks should be relatively tolerant of currency weakness, including:

1) With few exceptions (Brazil, Russia, South Africa) inflation is not a major issue;

2) Growth across the BRICs and most EM is well below recent trends. A country like Brazil has recently made the most overt step, raising rates more than expected but tolerating greater FX weakness to reorient growth away from domestic toward external demand. Few countries will not wish to boost external demand, if the inflation cost is seen as limited.

3) Commodity producers have suffered from a deterioration in terms of trade;

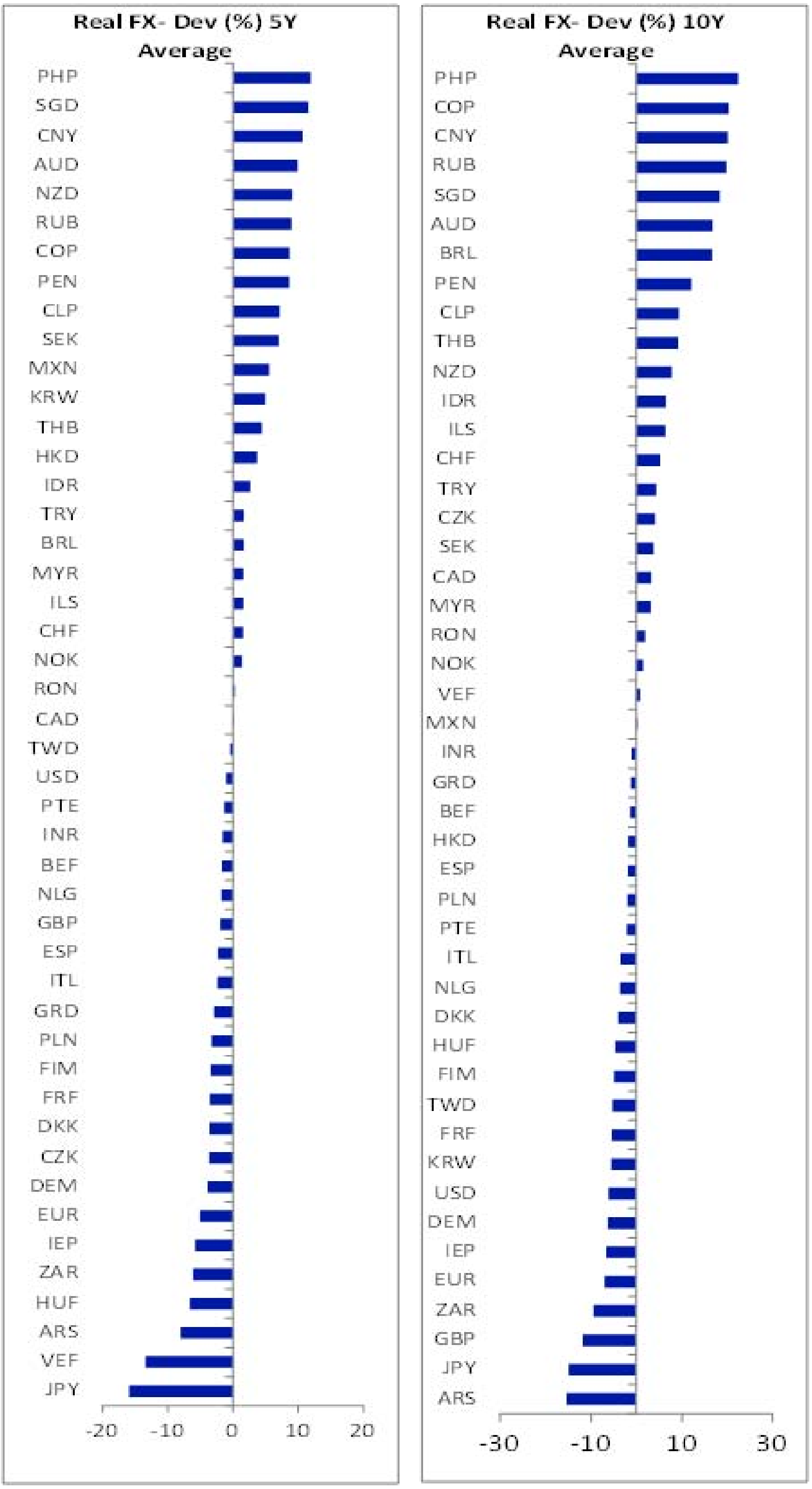
4) Major EM countries like Brazil, India, Indonesia, South Africa, and Turkey have been running sizable external deficits for some time;

5) For many EMG countries, the real exchange rates have been relative strong.

On the latter, it is worth remembering that 'the currency wars' related to excessive USD and JPY weakness and excessive EM FX strength. The current environment is an opportunity to rectify this.

The chart below showing the real TWI deviation from 5yr and 10yr averages (as of the end of April), gives a simple measure of currency strength. EM Asia and commodity currencies are at the top of the list of strong currencies, and most of these countries could view moderate currency slippage as a partial correction from overvaluation.

Figure 2: Real TWI deviation from average




Source: Deutsche Bank

The main argument against FX weakness is the extent to which this creates a fall-out in domestic bond markets. In a country like Indonesia, the high foreign bond ownership is making the authorities particularly wary of tolerating FX weakness, so spot is 'constrained' and the NDF market takes up the strain, for now.

However, for most countries, currency weakness will be more tolerable:

1) The less currency weakness looks to have a domestic source;

2) The more regional competitor currencies are weakening;

3) The more it looks like general USD strength.

This all plays to a view that EM currency depreciation will become more tolerable as other more flexible currencies step in line first, in what may look like a 'domino effect' from the outside, but is to some extent an orderly and rational attempt to avoid a loss of competitiveness. The art for the more cautious central bankers will be less about fighting depreciation and more about not standing out from the crowd, while letting the more flexible FX regimes lead the trend.

In sum, as long as depreciation is orderly, the limited inflation pressures; relatively soft EM/BRIC growth; and, generally strong real TWI starting point, suggests a broader EMG FX currency depreciation fits with the global fundamental backdrop and the stronger USD environment we expect.