Mizuho Chart Speak: EM Asia FX

Economics & Strategy | Asia ex-Japan

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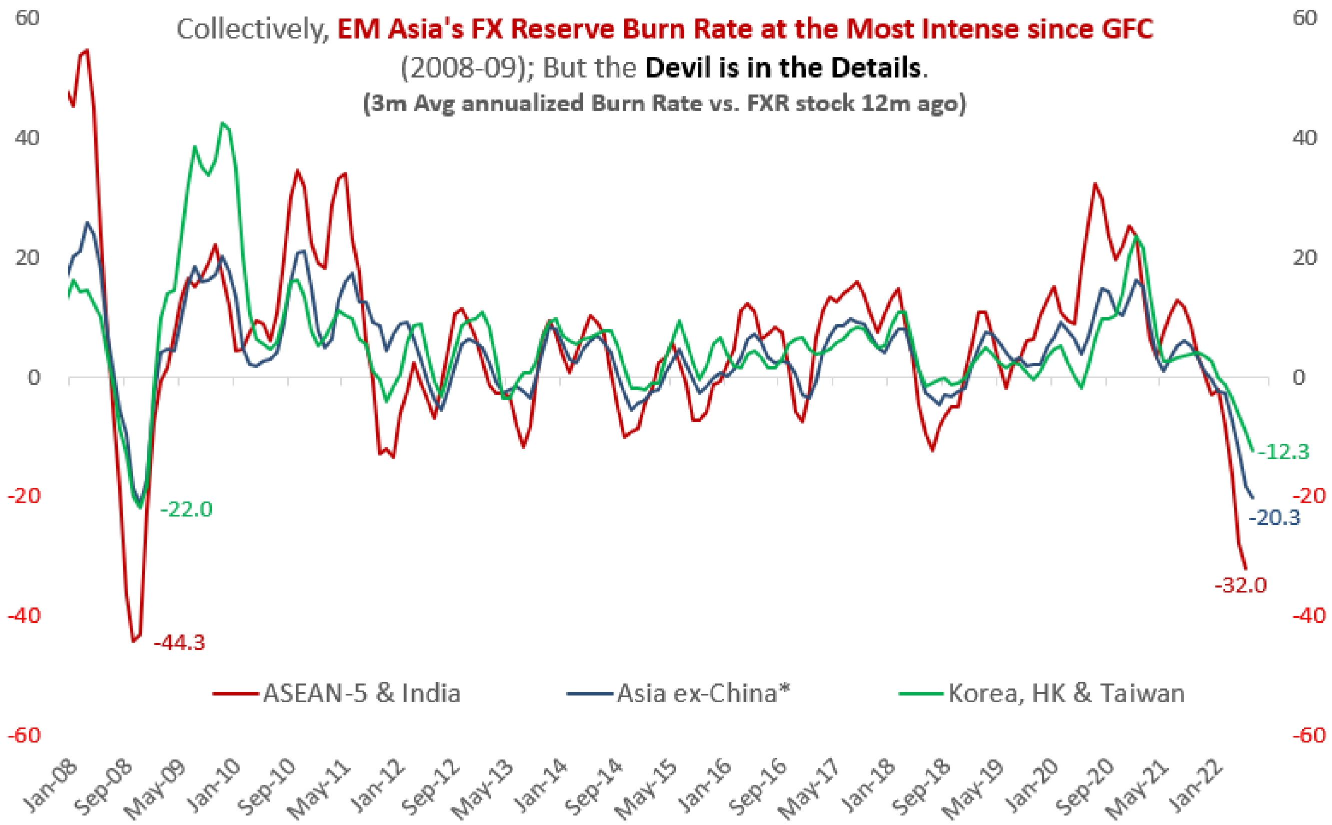
EM Asia FX Risks (Part 2): The "Cash-Burn" Conundrum



"Money is a terrible master, but an excellent servant"**– P. T. Barnum**

In a Nutshell: Despite **EM Asia FX (AXJ) sell-off** this year being **far from AFC-type crisis**, **complacency about AXJ resilience is simply not an option**. In fact, it is **reckless**, **given elevated "cash burn"** (at the *most intense since the GFC in 2008;* Chart above). Especially in the context of **persistent and possibly more profound pipeline AXJ pressures**; as **rising inflation in EM Asia** conspires with **aggressive Fed tightening** to **set the stage for adverse reflexivity** (which entails *a vicious spiral of sharp currency depreciation and capital outflows aggravating one another*)
. *To paraphrase P. T. Barnum, cash is great when it serves to back up currency value, but dangerous when its depletion rules over the risks.*

Specifically, **intensifying "cash burn" may perversely amplify, not ameliorate, sharp currency depreciation**; as **USD drawdown** ("cash burn") from reserves **to defend the currency ironically triggers fresh currency sell-off** on **panic about inadequate FX reserves**. Arguably, *more than a cash buffer conveying confidence, the conspicuous lack thereof threatens* to consign currencies to *collapse.* However, this **tipping point for excessive "cash burn"** is **hard to determine**. Accordingly, the **sharp end of further currency sell-off will be hard to predict and/or time**.

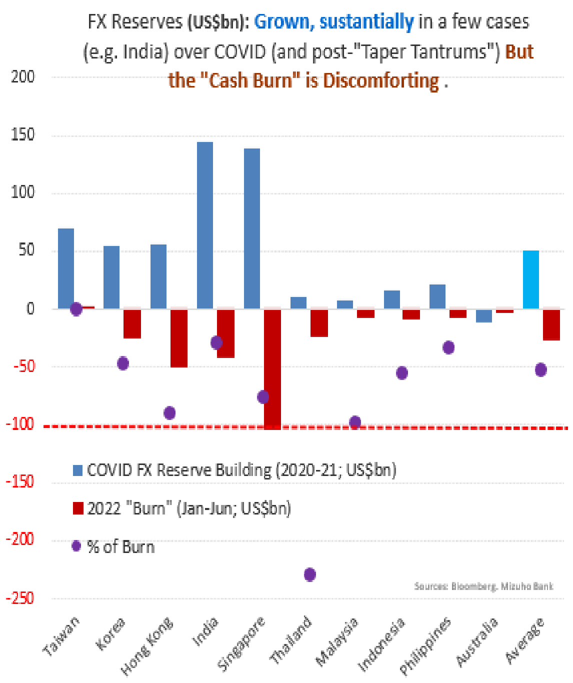
Nevertheless, with aggregate **EM Asia, ex-China (cash) "burn rate" at the worst since the 2008 GFC** (Global Financial crisis), and more dire than "taper" and/or "Fed/China" turbulence, the **current sell-off**

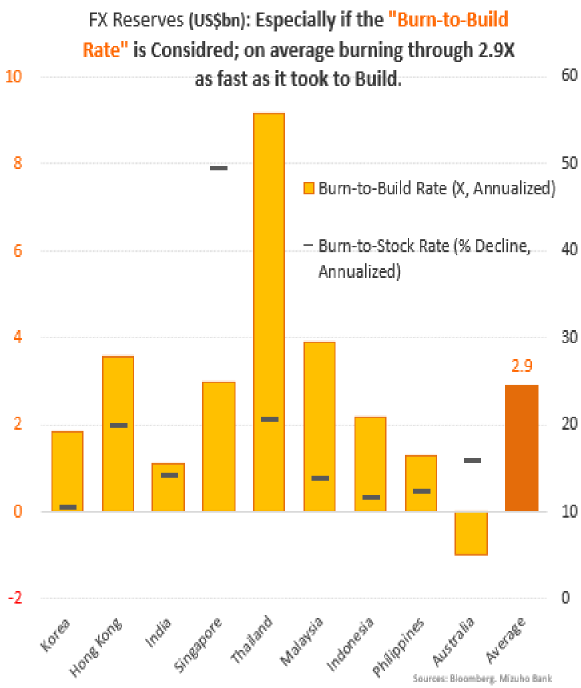
may actually be under-stating potential AXJ risks. *THB and PHP in particular appear vulnerable to "cash burn" risks perpetrating as further FX pressures and turbulence;* although *relative IDR and INR resilience may quickly prove tenuous and tentative.*

Persistent, Possibly More Profound, Pressures: As established in Part 1*, **despite relief** that the EM Asia FX (**AXJ**) **sell-off is not in the league of AFC-type crisis**, it is **not free from further turbulence** either. Fact is, **echoes of 2013 "taper" and 2014-15 "Fed-China sell-off"** are **consistent with persistent pressures** potentially entrenching and extending current downside risks to AXJ. Crucially, *higher inflation in EM Asia* alongside unremitting and *aggressive tightening by the Fed* set the stage for **potentially more profound pressures on AXJ ahead**.

Simply put, **overconfidence about AXJ resilience are cavalier given lingering risks and worrying "cash burn"**. In particular as "cash burn" is *the* ***most intense since the 2008 Global Financial Crisis*** (GFC; Chart above). This highlights that **inherent latent risks are more elevated** than simplistic comparisons of FX sell-off to 2013-14 "Taper Tantrums" and 2014-15 "Fed-China" crisis would suggest (Part 1)

Some Comfort from Build-Up in FX Reserves: To be fair, **comfort that worse-case outcomes may be averted** is **not completely groundless**. After all, many EM Asia countries have not only built-up sizable FX reserves since the 2013 "taper tantrums" but also over COVID (2020-21; Charts below). And that has supported narratives **that the build-up in FX reserves** has **buttressed EM Asia FX**. There is some truth to this. **But** many caveats as well.





But No Blanket Immunity: The bottom-line being, **despite relief from bumped up FX reserves, AXJ resilience is not unconditional**. Fact is, **FX reserves at best provide limited buffer** to defend and slow currency sell-off on the way down. **But** by **no** measure does it bestow **blanket immunity** from currency stress from overarching macro headwinds. Mainly because ***FX reserves*** **are visibly and painfully finite**. And crucially, ***take much longer to build than to burn*** through (Charts above).

A lesson that China learnt painfully in the China/CNY crisis that depleted $1trln (2014-16) from what, at that time, appeared to be an impenetrable $4trln FX reserve war chest. And so, the pertinent take-away is not EM Asia FX resilience; but that **resilience is contingent on how quickly FX reserves are "burnt"**.

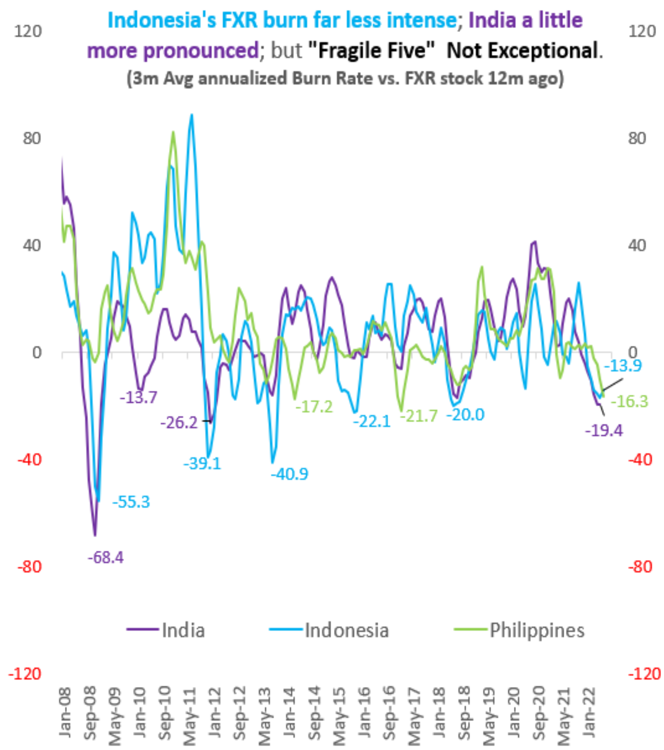
Perverse "Tipping Point" Risks: In fact, the risk is that **excessive "cash burn" beyond a certain "tipping point" may perversely amplify, rather than ameliorate, FX sell-off**. It is but a **short, slippery descend from confidence about currency resilience to terror about the rapid depletion of FX reserves hollowing out the currency**.

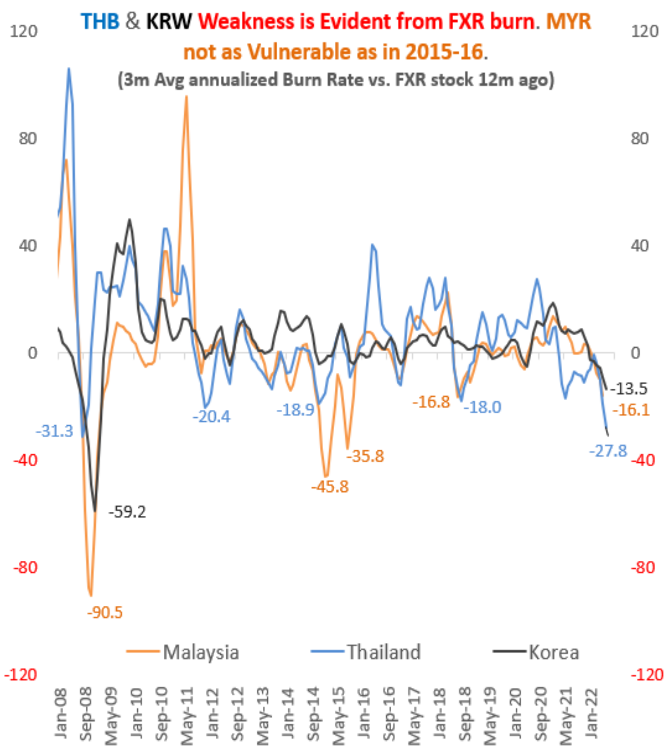
Point being, the *faster the "burn", the more likely that FX reserves are perceived, if not proven, to be lamentably inadequate* to bolster the currency (AXJ) amid outflows. With the ever-present perils of *vicious spiral of sharp currency depreciation and capital outflows aggravating one another,* **rapid FX reserve depletion beyond the "tipping point" will eventually accelerate currency's plunge**; validating wisdom that **like most anti-speculation deterrents, FX reserves are most effective when unutilized**.

Knife's Edge Between Resilience & Reflexivity: But until that "tipping point" is revealed, **"cash burn"** treads a **knife's edge between resilience and adverse reflexivity** (via self-reinforcing loops between a falling currency and more quickly depleted FX reserves from defending the currency drop). Which means, beyond (undefined) **thresholds, defending currencies using FX reserves may be counter-productive**.

Cash is King, But Beware the Emperor's New Clothes: Cash, as assessed by **FX reserves** in the case of sovereigns, is **typically thought to convey resilience**; perhaps most noticeably in a country's currency. And so, cash is in every sense still King. But *arguably,* **of far greater importance is the conspicuous lack of cash that has far greater bearing in consigning currencies to risks of a collapse**. And in that context if **unsustainable pace of "cash burn" can render FX reserves as the "emperor's new clothes" revealing and accentuating weakness rather than providing relief**.

Unusual Suspects, but Usual Warnings: A closer examination of **"cash burn"** across EM Asia ex-China reveals that **THB, PHP and to a lesser extent KRW show worryingly rapid "cash burn"** *vis-à-vis previous crises* (Charts below). This ostensibly **squares with the under-performing currencies identified in Part 1**. The *"unusual" suspects* are perhaps *THB and KRW,* given these currencies are not typically (in recent experience) associated with being the weakest links in EM Asia. But current inflation shocks (KRW, THB and PHP) and tourism shortfall (THB and PHP) explain the current state of play.





Meanwhile, and more importantly, the **apparent resilience in INR and IDR are arguably overstated** given that the **solid build-up in India's FX reserves diminish the "burn rate"** due to higher FX reserves base; therefore, understating absolute cash burn. As for **Indonesia**, **fading commodity buffer means that backward looking "cash burn" resilience exaggerates forward-looking resilience**.

Whereas a hawkish Fed **exacerbating capital outflow risks and pressuring credit metrics** as "twin deficit" risks threaten to re-emerge into prominence **warns of sudden deterioration in "cash burn"**, and attendant amplification of IDR and INR pressures. Point being, *surprising INR buffer and exceptional IDR resilience may prove tenuous and tentative* **if risk sentiments worsen considerably**.

* Mizuho Chart Speak - EM Asia FX Risks (Part 1): Overblown, But Not Obviated, 20 July 2022

FX Forecasts	Sep 22	Dec 22	Mar 23	Jun 23	Sep 23
USD/CNY	6.42 - 6.93 (6.79)	6.38 - 6.86 (6.69)	6.46 - 6.96 (6.62)	6.27 - 6.73 (6.48)	6.18 - 6.64 (6.38)
USD/INR	77.2 - 82.8 (80.5)	76.8 - 81.5 (78.8)	73.4 - 78.5 (76.2)	71.4 - 77.7 (75.3)	70.6 - 76.8 (74.4)
USD/KRW	1230 - 1380 (1310)	1240 - 1380 (1290)	1230 - 1340 (1280)	1220 - 1320 (1270)	1210 - 1330 (1260)
USD/SGD	1.365 - 1.442 (1.412)	1.358 - 1.414 (1.388)	1.340 - 1.421 (1.374)	1.317 - 1.405 (1.354)	1.310 - 1.392 (1.346)
USD/IDR	14400 - 16320 (15200)	14640 - 15570 (15000)	14450 - 15530 (14900)	14180 - 15360 (14650)	13990 - 15200 (14450)
USD/MYR	4.27 - 4.87 (4.55)	4.44 - 4.69 (4.50)	4.18 - 4.60 (4.45)	4.18 - 4.53 (4.38)	4.12 - 4.45 (4.30)
USD/PHP	53.3 - 57.5 (56.2)	54.7 - 57.5 (55.7)	52.7 - 56.6 (55.0)	51.9 - 55.9 (54.3)	51.4 - 55.3 (53.7)
USD/THB	34.0 - 37.7 (36.2)	34.2 - 37.2 (35.2)	32.5 - 36.1 (34.4)	32.3 - 35.4 (34.2)	32.9 - 35.2 (33.8)
USD/VND	23000 - 24300 (23440)	22900 - 23700 (23200)	22900 - 23500 (23100)	22900 - 23500 (23000)	22800 - 23200 (22900)
AUD/USD	0.648 - 0.748 (0.670)	0.665 - 0.755 (0.695)	0.688 - 0.775 (0.742)	0.726 - 0.808 (0.765)	0.737 - 0.811 (0.775)