Falling FX Reserves Herald Asia Financial Crisis 2.0

Region's central banks fast depleting foreign currency stockpiles to defend their flagging currencies against US rate hikes

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Few narratives spook Asia more than word of trouble in Thailand – even more so when foreign-exchange reserves are involved.

It was Bangkok's devaluation in July 1997 that set in motion the Asian financial crisis. As foreign-exchange reserves ran out, the government and Bank of Thailand had no choice but to scrap the US dollar peg and drive the baht sharply lower.

Twenty-five years later, Southeast Asia's second-biggest economy isn't quite cascading toward a repeat of that meltdown. Yet Bangkok is again ground zero of something getting increasing attention in world markets: the speed with which developing Asia's central banks are depleting their currency reserves.

Thailand now displays the region's biggest drop in reserves as a ratio to gross domestic product (GDP). Malaysia is next, followed by India.

Generally speaking, says economist Divya Devesh at Standard Chartered in Singapore, emerging Asian nations, excluding China, are sitting on their smallest piles of reserves since the 2008 Lehman Brothers crisis.

The bank's focus is on how many months' worth of imports each economy can finance with today's foreign-exchange holdings.

In August 2020, the region averaged about 16 months. At the start of 2022, it was down to 10 months. Today, it's in the neighborhood of seven months – not where most investors or government officials thought Asia might be.

Raising the stakes, the dollar is rising at the fastest pace versus the Japanese yen in 24 years, up nearly 26% this year. It's up nearly 9.6% versus the Chinese yuan.

As the dollar surges, thanks largely to Federal Reserve rate hikes in Washington, Asian currencies are coming under heavy downward pressure. Fewer reserves mean less firepower to defend exchange rates.

That's not to say China isn't part of this conversation.

As the yuan gets near the psychologically important 7 to the dollar level, the People's Bank of China "will be more concerned with slowing the pace of depreciation and keeping expectations stable than defending a specific level for the exchange rate," says economist Lauren Gloudeman at Eurasia Group. "But if depreciation expectations coincide with robust capital outflows or depletion of reserves, its defense may strengthen."

Gloudeman points to data out last week showing that "China's FX reserves continued to slide to their lowest level in almost four years." And, according to the Institute of International Finance, portfolio outflows persisted for a seventh straight month in August.

Economist Carlos Casanova at Union Bancaire Privée observes that the PBOC recently unveiled a cut in reserve requirement ratios for foreign exchange to 6%, down from 8%. It was the second RRR cut on foreign exchange in 2022, following a 100 basis-point reduction in April. During that period, the yuan depreciated to 6.5 to the dollar from 6.3.

The idea is to boost dollar liquidity and prod banks to convert a proportion of foreign-exchange reserves into yuan, boosting the Chinese currency.

But, Casanova concludes, that "move alone won't entirely offset depreciatory pressures. This is a signal that the PBOC is not comfortable with one-way depreciatory expectations, even if they are comfortable with some yuan weakness."

The yen's drop, though, is shaking up Asia in unpredictable ways. The worry is that China, South Korea or other major economies might feel the need to weaken exchange rates, too, in race-to-the-bottom competitive devaluations to salvage exports.

At the same time, says economist Brad Setser at the Council on Foreign Relations, indications that either China or Japan are selling large blocks of currency "could be additional pressure on other Asian currencies."

Yet now's not the time to panic, says economist Louis Kuijs at S&P Global Ratings. "Levels of foreign reserves remain generally adequate. But global uncertainty and prospects for still higher global interest rates call for scrutiny of the underlying dynamics."

Even so, the politics of the moment are raising the temperature in Tokyo, Beijing and elsewhere. In China, says economist Ting Lu at Nomura Holdings, the yuan's weakness is hovering over the Communist Party's once-in-a-decade leadership reshuffling process – and at a moment of elevated US-China tensions.

"Chinese leaders," Lu says, "especially care about RMB's bilateral exchange rate with the dollar because they believe RMB/USD somehow reflects relative economic and political strength. Second, a big depreciation of RMB/USD could dent domestic sentiment and speed up capital flight."

Goldman Sachs analyst Maggie Wei says "we think the PBOC might have tolerance for further yuan depreciation against the dollar, especially as the broad dollar continues to strengthen, though they might want to avoid continued and too fast one-way depreciation if possible."

Likewise, economist Julian Evans-Pritchard at Capital Economics thinks Beijing will be very careful not to let the yuan weaken past the 7.2 level that "we saw during the trade war."

Yet, the dollar's gains and the likelihood the US Fed will continue tightening are presenting Chinese officials with a big balancing challenge as economic growth slows. Last week, PBOC deputy governor Liu Guoqiang said that, in the short term, yuan exchange rates should fluctuate in two directions and people "should not bet on a specific point."

Liu, however, is clearly focused on the bigger picture in stressing that "in the future, the world's recognition of the yuan will continue to increase."

Diana Choyleva at Enodo Economics says this tension between the next 20 weeks and the next 20 years is becoming increasingly difficult to pull off. "China," she says, "has largely benefited from the dollar-led global financial] system. But Beijing now perceives its dependence on the dollar as a strategic vulnerability."

On the one hand, Choyleva says, Xi's team "wants to guard against the US deploying the dollar as a weapon against it."

On the other, she adds, China "wants to use the yuan as a tool for consolidating an economic sphere of influence, thereby bolstering China's economic security. And it wants the yuan to be a symbol of its great power status, to help bolster its claim to represent a viable alternative to the US-led international order."

For now, though, the dollar's zigs and zags are dominating Asia's 2022 and odds are it will in the year ahead, too. Hence the focus on Asian foreign-exchange reserve levels as Fed Chairman Jerome Powell's team in Washington steps up the pace of tightening.

Hopes US inflation had peaked in July were dashed by news of a 0.1% increase in consumer prices in August. It means that, from a year earlier, prices are up 8.3%.

Last week, Powell said the Fed will act "forthrightly" to curb overheating risks. Some top Fed officials are hinting at another 75 basis-point rate hike next week.

The latest data mean "they're definitely going 75" again, says economist Jay Bryson at Wells Fargo & Co. Tiffany Wilding, an economist at Pacific Investment Management Co, says the "scorching" nature of recent price data suggest the problem is "stickier and broader-based" than the conventional wisdom and means "the Fed has more work to do."

So do Asian central banks as local currencies come under increased downward pressure. With average reserves falling "steeply," says analyst Thomas Rookmaaker at Fitch Ratings, many economies "still have substantial reserve buffers, but for a small number, the fall is an indication of mounting external financing stress."

Fitch calculates that Asia-Pacific region reserves declined by roughly $590 billion between the end of 2021 and July 31, 2022. "For many APAC sovereigns," Rookmaaker says, "reserve buffers have fallen to pre-pandemic levels, after a significant rise over the past two years, partly driven by pandemic-related factors, including demand compression."

The largest declines in value terms were seen in China, Singapore and Japan. But the depletion dynamic among developing nations is the real worry as the dollar rally accelerates.

"Should the regional decline in reserves be sustained, this would eventually put downward pressure on ratings for some APAC sovereigns," Rookmaaker says.

This risk, he adds, "could be significant where reserves have been a rating strength that offsets other credit weaknesses, such as in the [Philippines](#) or where external finances have traditionally been weaker than peers, such as in Indonesia."

In his own research, Devesh at Standard Chartered notes that when using reductions in reserves as proxies for currency intervention, New Delhi and Bangkok have been among the most assertive. Reserves declined by $81 billion and $32 billion, respectively, so far in 2022.

Meanwhile, stockpiles fell by about $27 billion in Seoul, $13 billion in Jakarta and $9 billion in Kuala Lumpur. By these metrics, Thailand, the Philippines, India, Indonesia and Malaysia warrant the greatest concern from a stability standpoint should the dollar continue surging.

In the case of Thailand, economist Chartchai Parasuk writes in the Bangkok Post, "the quickly depleting reserves raise concerns about the country's economic stability." The trend, he warns, "is unnatural and against economic theory."

And for investors worried about an Asian Financial Crisis 2.0 trajectory for the region, it's a sign of potential trouble to come.

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Featured image: Thailand's central bank is spending big again to prop the baht. Image: Twitter

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