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Economic Insights:
FX pass-through effects: consumers and insurers beware

Key takeaways

- Changing monetary and financial conditions in 2019 will continue to bring uncertainty to global markets.
- FX weakness could lead to lower output and higher domestic prices in countries that are heavily dependent on imports.
- FX pass-through will also lead to higher costs of servicing some insurance claims and, ultimately, to higher premium rates.
- Insurers should diversify their lines of business, and use currency futures and reinsurance to mitigate their FX pass-through cost exposures.

About Economic Insights
Analysis of key economic developments and their implications for the global re/insurance industry.

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In a nutshell

Global monetary and financial conditions in 2019 are set to bring episodes of foreign exchange (FX) volatility that will impact consumer prices and insurances premium rates. Insurers need to be wary of the FX pass-through effect which can ultimately affect their profitability.

We expect episodes of financial, including foreign exchange (FX), volatility in 2019, with two main catalysts being the continuing transition by leading central banks from monetary easing to tightening policy, and a potential escalation of global trade tensions.[1] A weaker national currency can lead to higher prices for consumer goods in the domestic market, and also increase the cost of servicing insurance claims. Diversification, currency hedging and reinsurance are means for insurers to mitigate their FX exposures.

Episodes of FX volatility and associated pass-through are inevitable. When the basic basket of goods and services has a large import component, domestic purchasing power becomes a function of the strength of the local currency. The weaker (stronger) the currency, the more expensive (less expensive) imports become – a process known as the pass-through effect. Insurance products are subject to the effect because servicing claims in certain lines of business can require paying for imported goods. For example, servicing claims in motor and medical insurance can require spare parts and medical supplies manufactured abroad. Ultimately, the higher cost of claims is passed on to consumers in the form of higher premium rates as insurers try to ensure underwriting profitability at the expense of consumers' affordability.

Changing FX conditions are especially important for countries with low degree of industrialization and diversification, and/or a high reliance on imports as currency movements can weigh heavily on output and prices. The degree of pass-through tends to be more pronounced in emerging markets[2] and is a risk that policy makers and insurers in the emerging world should be wary of. Recent FX developments in Turkey and in Argentina are instructive.

In Turkey, the lira depreciated at a 50% year-on-year pace (yoy) in the second half of 2018. This came as the market reacted to the country's weakening economic fundamentals resulting from deteriorating relations with the US and changes in monetary policy management. Over the same period, inflation spiked, reaching 25% yoy in September and October – well above the 9% average of the previous 10 years.[3] Recent research finds that the extent by which the FX rate passed on to consumer prices was larger and faster than analysis of historical trends could have predicted. It exceeded the ~15% cumulative pass-through generally expected after a one year period,

[1] *sigma* 5/2018: Global economic and insurance outlook 2020, Swiss Re Institute.
[2] *Exchange rate pass-through in emerging markets*, Working paper series No 739, ECB, 2017.
[3] While correlation does not imply causation, a Granger causality test between inflation and depreciation suggests a statistically significant Granger causality from FX to CPI (using 6-12 month lags).

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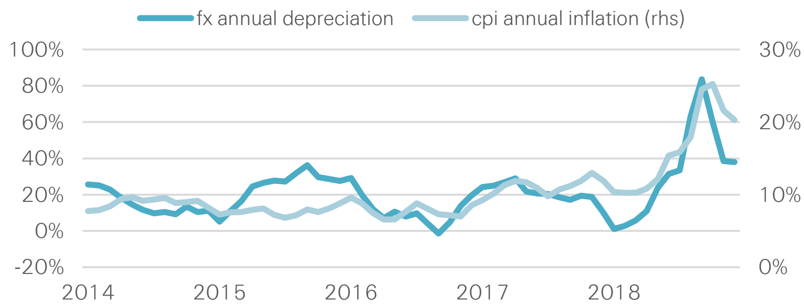
suggesting that price setters hiked prices disproportionally to account for the risk surrounding the FX volatility.[4] With respect to the impact on insurance, in 2017 the authorities imposed a ceiling on motor-third party liability premiums after a surge of popular complaints. The motor loss ratio spiked from 52% to 63%[5]. The ceiling was raised by 5% for 2018 but, after last year's inflation developments, higher losses would ensue if the ceiling is not readjusted.

Figure 1:
FX depreciation and CPI inflation in Turkey



Source: Central bank of the Republic of Turkey, Swiss Re Institute

In Argentina, there were two separate episodes of currency weakness. First, a 35% yoy drop between April and June, and a second of close to 30% in August. Both triggered inflation due to the high pass-through of about 17%.[6] Previous inflationary episodes in Argentina have resulted in a preference for the US dollar over the peso as households and businesses try preserve the value of their assets – making the dollar an anchor for the pricing of goods and services. The distortionary effect of inflation in Argentina is such that the insurance regulator increased minimum capital requirements threefold for insurers and tenfold for reinsurers in 2016 and 2017, respectively, to account for the inflation and nominal growth rates of recent years. FX volatility in Argentina has settled as of late, but the economic outlook remains vulnerable given a key presidential election at the end of 2019.

Economies can insulate themselves by pursuing policies that increase local production, decrease dependency on foreign currencies and foster price stability by solidifying monetary policy frameworks. Insurers can benefit from diversification to not be over-reliant on one particular line of business, by locking in future FX rates with the use of currency hedging products, and/or by increasing their use of reinsurance to transfer their risk exposures.

[4] *Inflation report*, Central Bank of the Republic of Turkey. Fourth quarter 2018.
[5] AXCO Global Statistics.
[6] Castiglione, B. *El traspaso a precios de las depreciaciones cambiarias: una estimación VECM para el caso argentino*, BCRA, 2017.