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Emerging Markets: Taper Tantrum Redux?

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IIF

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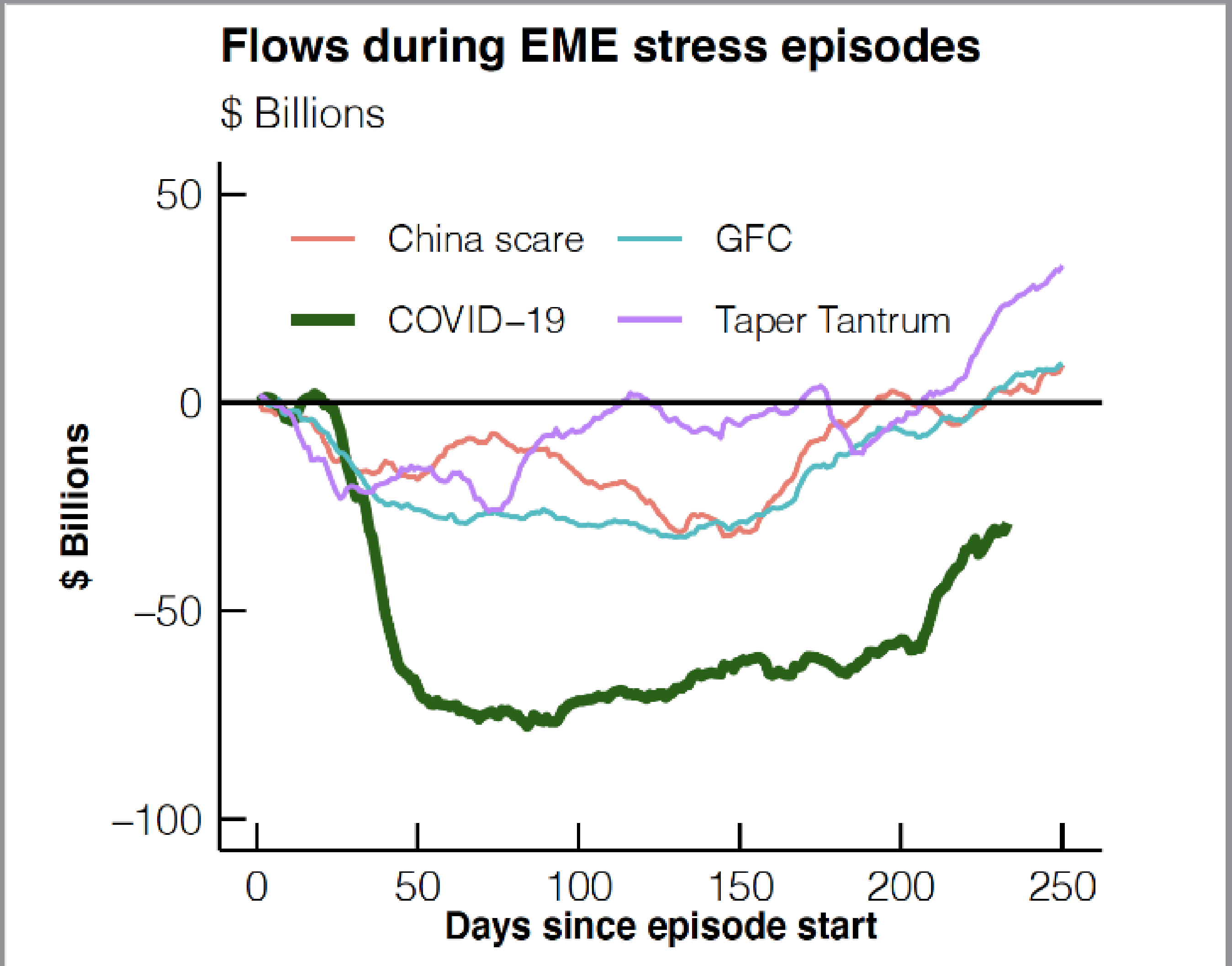
1. April 2021

Sudden "Stop & Go" in international capital flows

- March 2020 outflow, followed by inflow, followed by …



Source: National sources via Bloomberg.
Episode start dates: September 8, 2008 for Global Financial Crisis, May 22, 2013 for Taper Tantrum, July 26, 2015 for China Scare, and January 21, 2020 for COVID−19.
Excludes China. See panel 1 for list of countries included.

- **2 Sudden Stop Theories**
  - Traditional debt focused
  - Safe Asset perspective

Sudden Stop: traditional view

- Multiple equilibrium feature of debt
  (foreign currency denominated)
  - Good equilibrium
    - Low interest rate r low default probability
  - Bad equilibrium
    - High interest rate r high default probability
      (expected restructuring costs)

JUMP

- Jump leads to re-evaluation of foreign denominated debt

Sudden Stop: **Safe Asset** Perspective

- Loss of (domestic) safe asset status
  - Brunnermeier Sannikov (2019) "International monetary theory: Safe Asset Perspective"
  - Brunnermeier Merkel Sannikov (2021) "A Safe Asset Perspective on IPF"

- Asset Price = E[PV(cash flows)] + E[PV(service flows)]

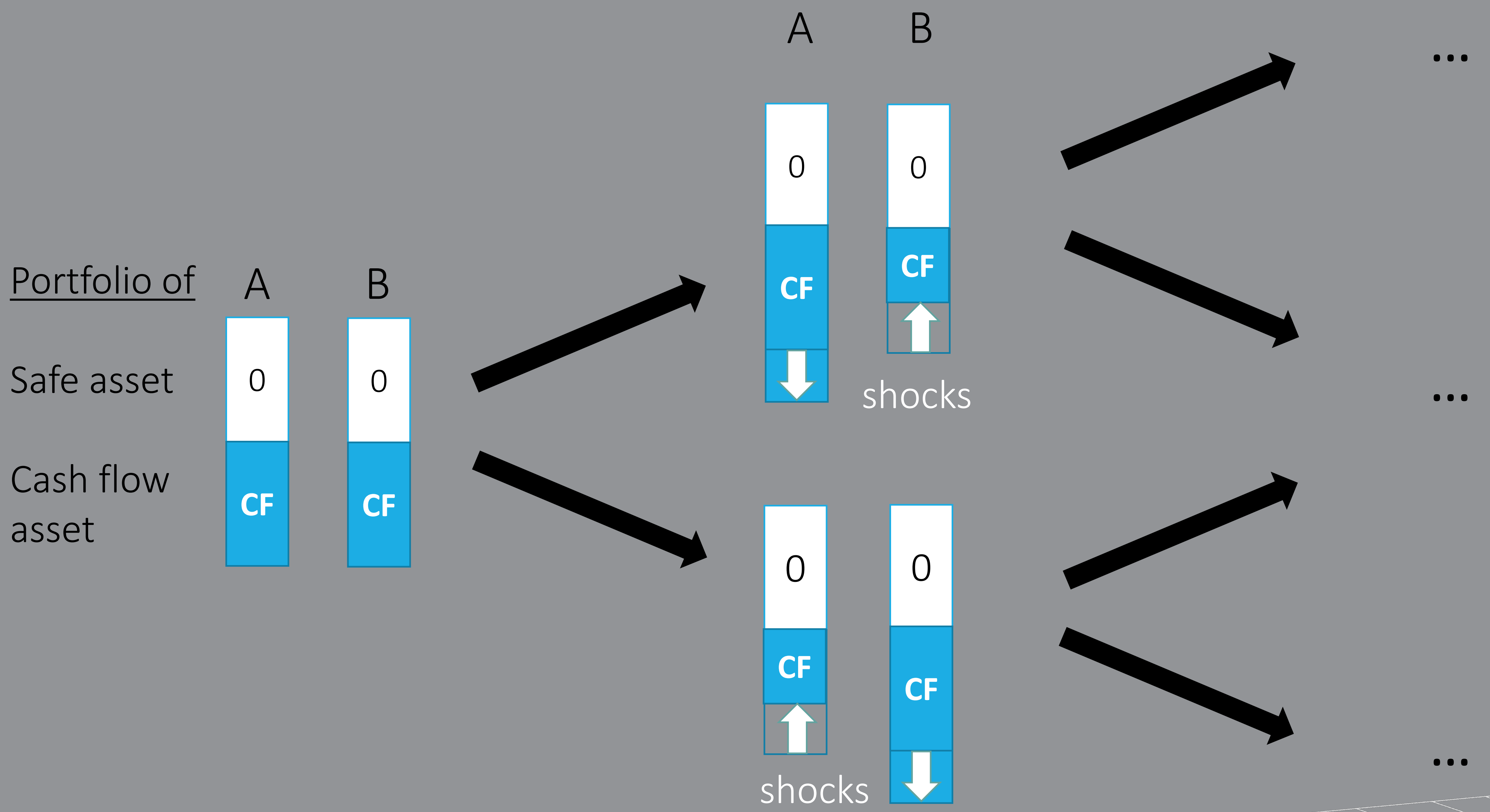
  dividends/interest
  - Service flows/convenience yield
    1. Collateral: relax constraints (Lagrange multiplier)
    2. Safe asset: [good friend analogy]
       - When one needs funds, one can sell at stable price … since others buy
       - Partial insurance through retrading - market liquidity! + Negative β
    3. Money (narrow): relax double-coincidence of wants
  - Higher Asset Price = lower expected return [Exorbitant privilege]

- Problem: safe asset status might burst like a bubble $r < g$
  - Multiple equilibria: [safe asset tautology]

What’s a Safe Asset?

- Asset Price = E[PV(cash flows)] + E[PV(service flows)]

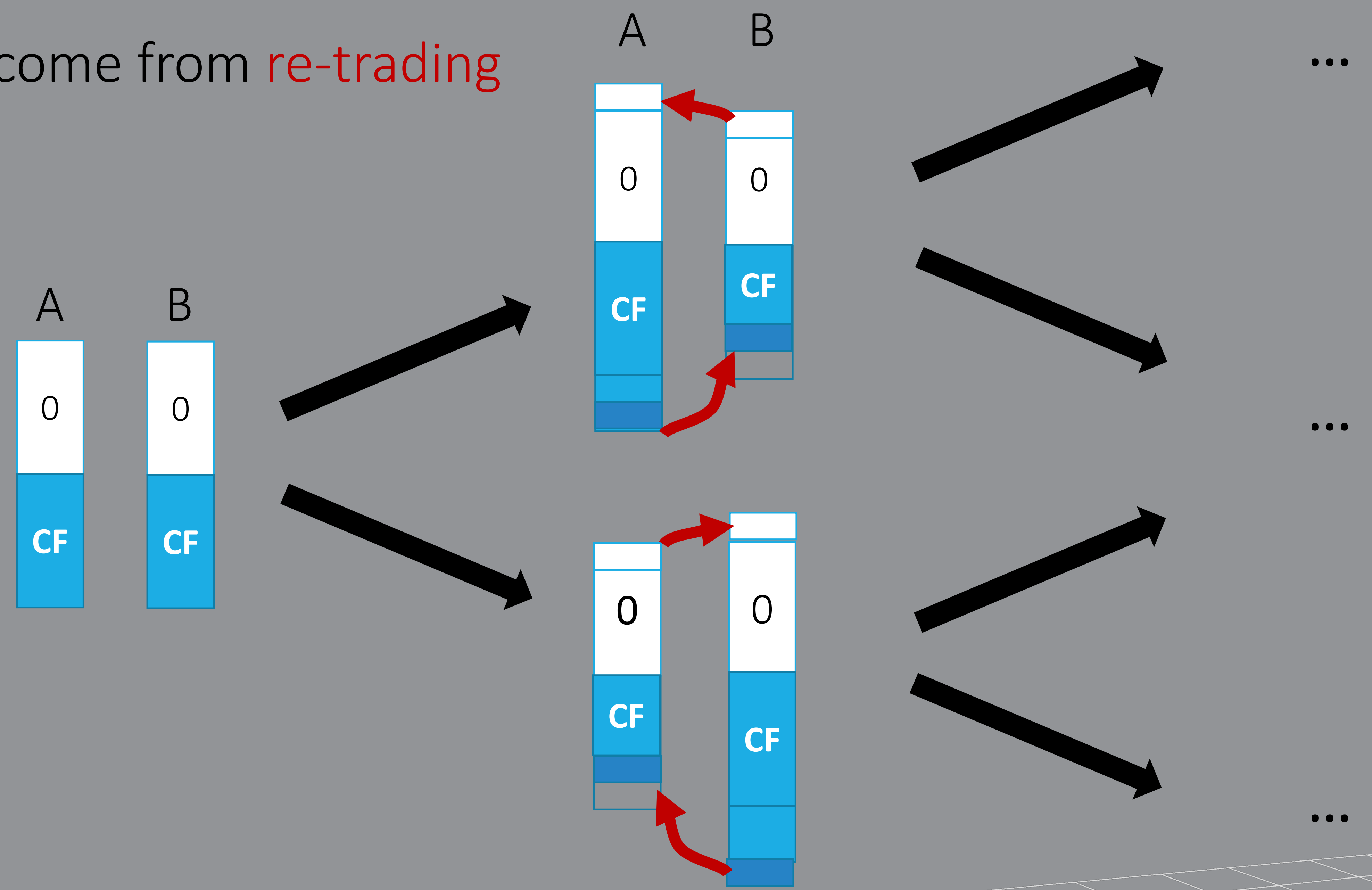
dividends/interest convenience yield



What’s a Safe Asset?

- Asset Price = E[PV(cash flows)] + E[PV(service flows)]
  dividends/interest convenience yield

- Value come from re-trading



Loss of Safe Asset Status: From **Risk-on** to **Risk-off**

- Bubble condition: $r = r^f + \text{risk premium} < g$
- AE: safe asset has negative $\beta \Rightarrow \text{risk premium} < 0$
  - see "Debt as Safe Asset" paper
- EM: loss of safe asset status risk $\Rightarrow \text{risk premium} > 0$

- Risk-on vs. risk-off
  - Price of risk rises
  - Risk of EM rises to lose local safe asset status

$\Rightarrow$ Risk premium rises

Loss of Safe Asset Status: **US Monetary Policy Spillovers**

- Bubble condition: $r = r^f + \text{risk premium} < g$
- No flight to safety condition: $r \geq r^\$$

Sandwhiched!

- Problem: Raise r in response to higher $r^\$$
  - Exceeds growth rate g
  - Lowers growth rate g

  $\Rightarrow$ "safe asset bubble bursts"

  - Citizens save in international safe asset instead of local safe asset

- Ideal arrangement:
  - Use local safe asset for idiosyncratic risk (within EM)
  - Use international safe asset for country-wide shocks

Poll Questions

1. How high will the 10-year Treasury yield go by the end of the year?
   a. 1.7% (i.e. current levels)
   b. 2.0% (i.e. a bit higher)
   c. 2.5% (or higher)
2. Will rising US interest rates cause a repeat of the 2013 taper tantrum for EM?
   a. Yes
   b. No
3. What should EMs do if their currencies get hit like in 2013?
   a. Let them fall
   b. Intervene or hike interest rates
   c. Capital controls

Taper Tantrum Redux
EM in 2021 versus 2013

April 2021

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INSTITUTE OF INTERNATIONAL FINANCE

Outline

Rising US long-term yields

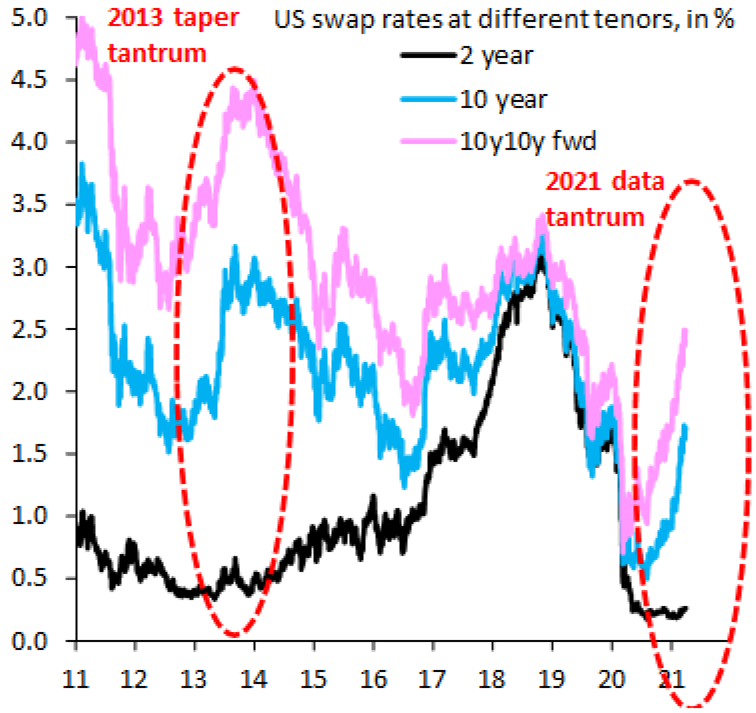
- There are many parallels with 2013 taper tantrum.
- Back then, the Fed initially welcomed rising yields.
- But yields overshot and the Fed had to react.
- Risk of a similar overshoot in 2021 is high.

Emerging market flows

- Emerging markets saw large outflows in 2020.
- But foreign holdings have also grown over time.
- Scaling for this, 2020 was ¼ as bad as 2008.

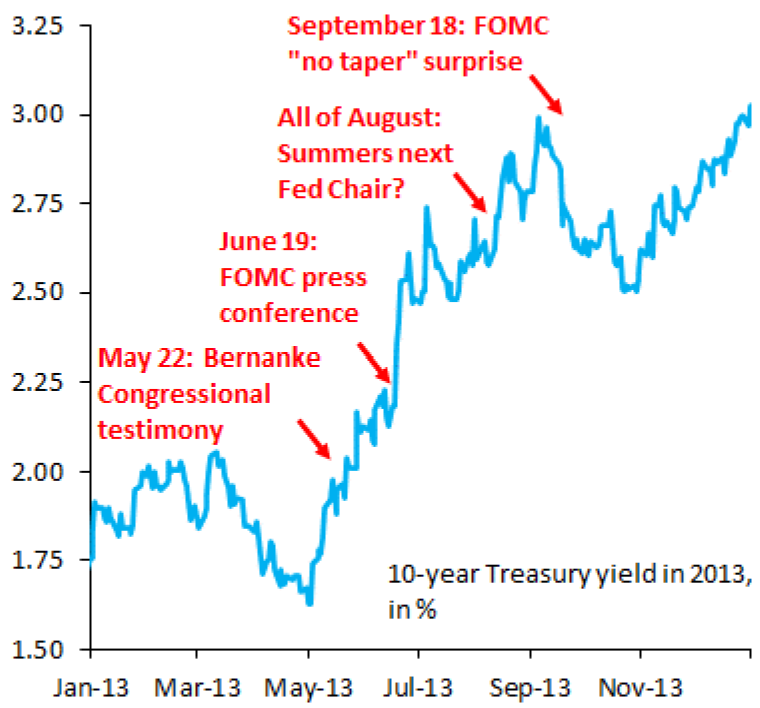
EM in 2021 versus 2013

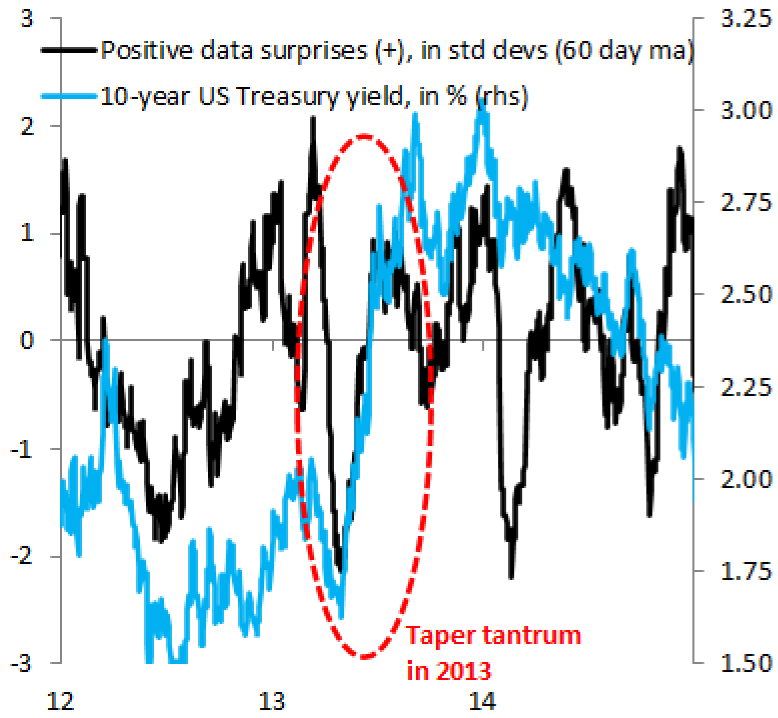
- On the surface, initial conditions are better now.
- But the underlying challenge is a lack of growth.



Rising US Long-Term Yields

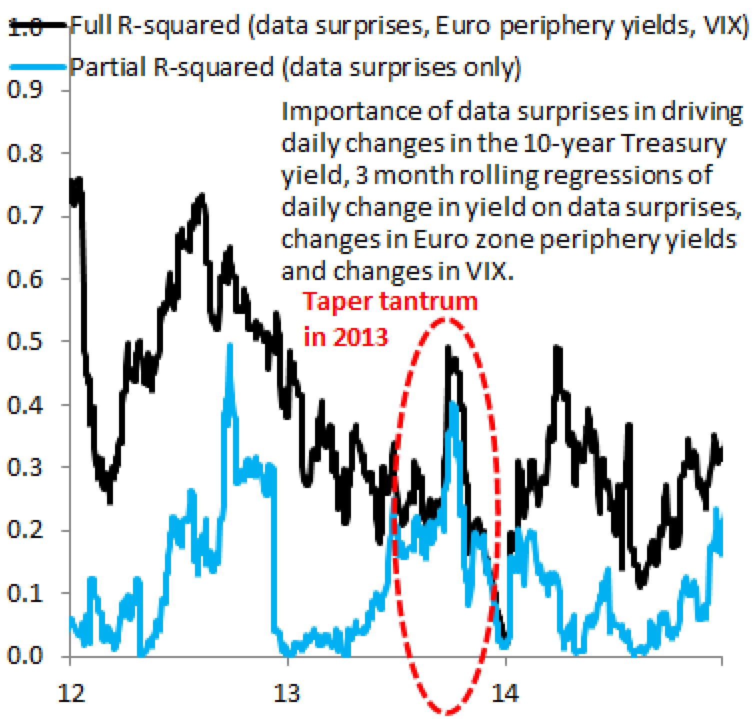
- The Fed initially welcomed rising long-term yields in 2013.
- But yields overshot, leading to the Sep 2013 *“no taper”* surprise.

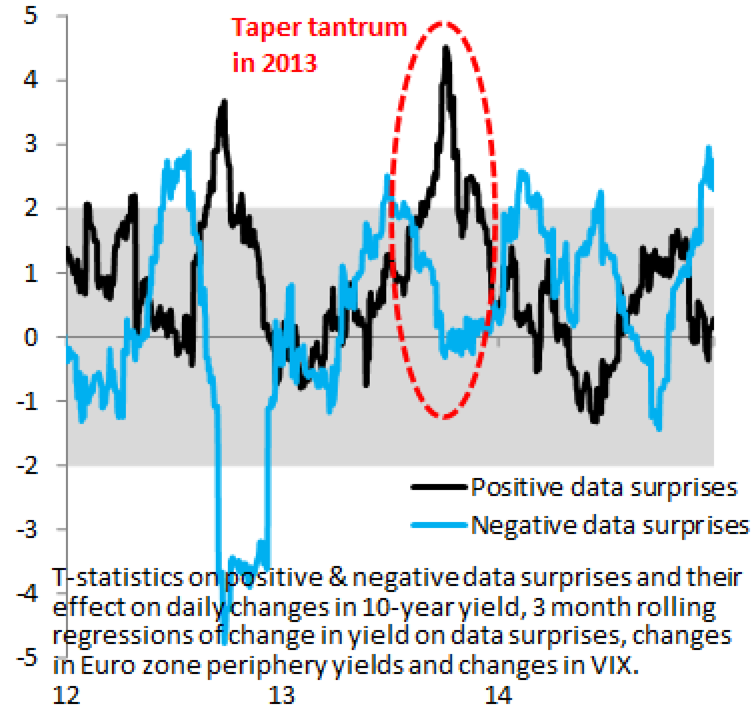




Rising US Long-Term Yields

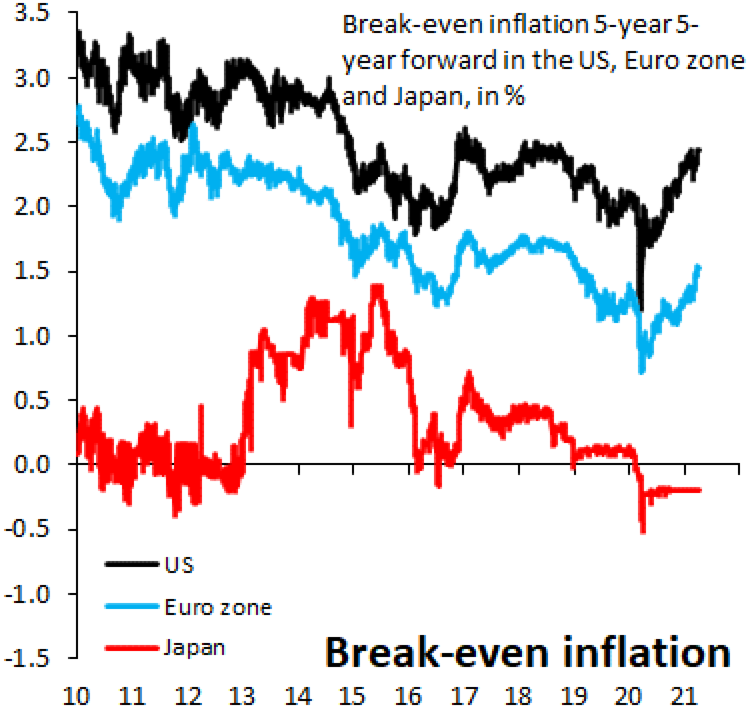
- Markets became very sensitive to data surprises in 2013.
- Positive data surprises became important for 10-year yield.

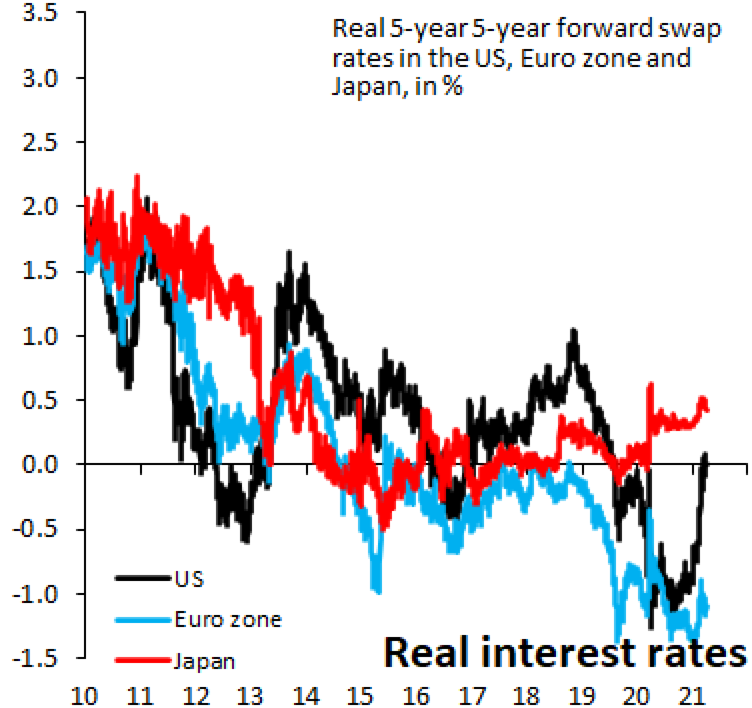




Rising US Long-Term Yields

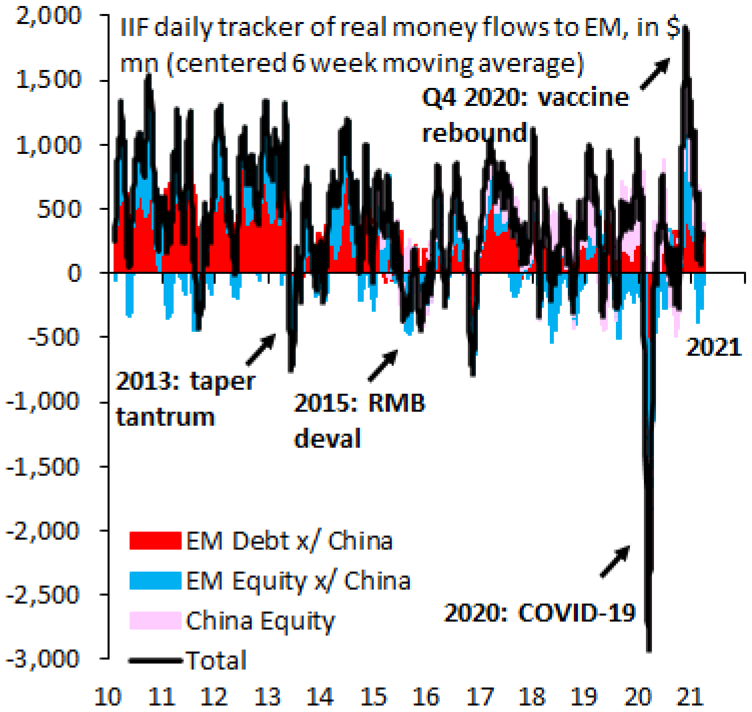
- Risk of an overshoot in real interest rates is building.
- This is foremost a communication challenge for the Fed.

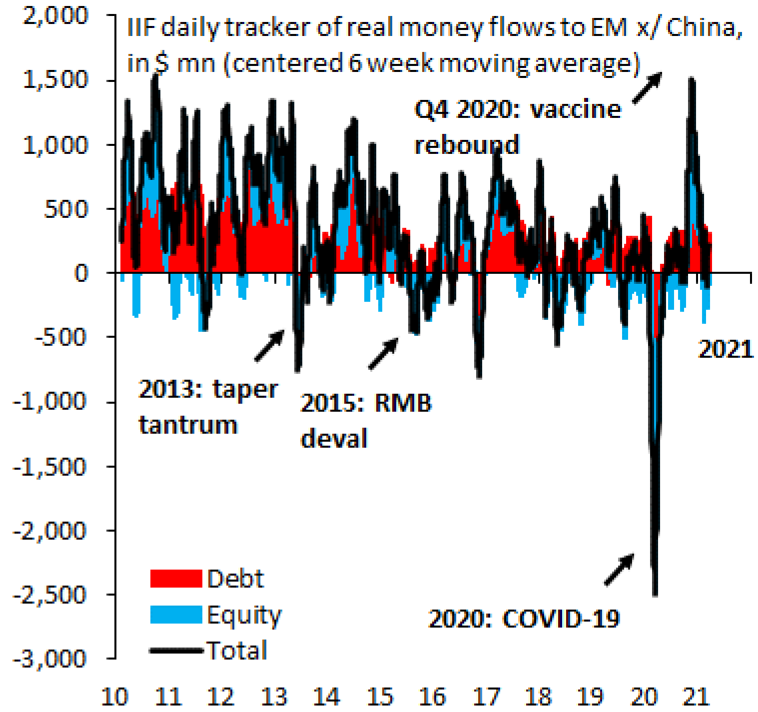




Emerging Market Flows

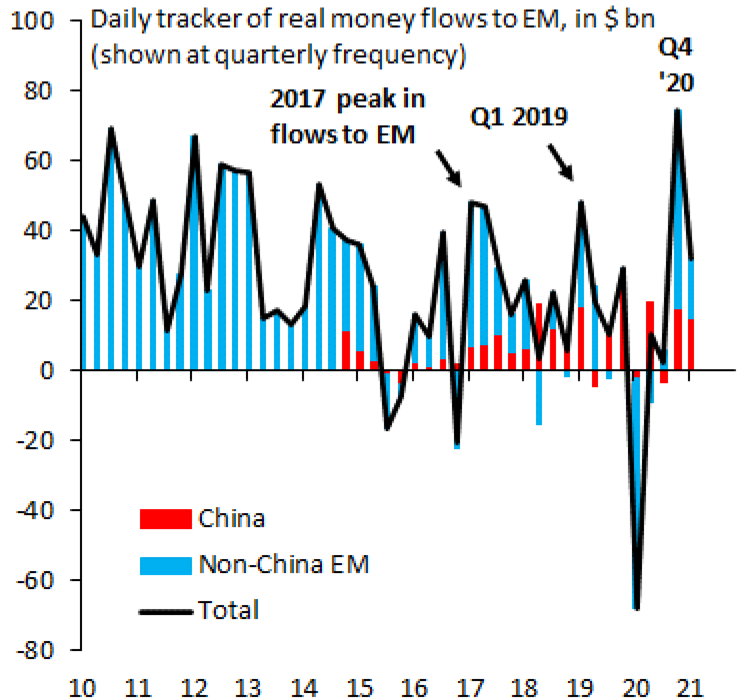
- We track daily foreign investors flows to 14 EMs.
- Rising US yields have weighed on flows to non-China EM.

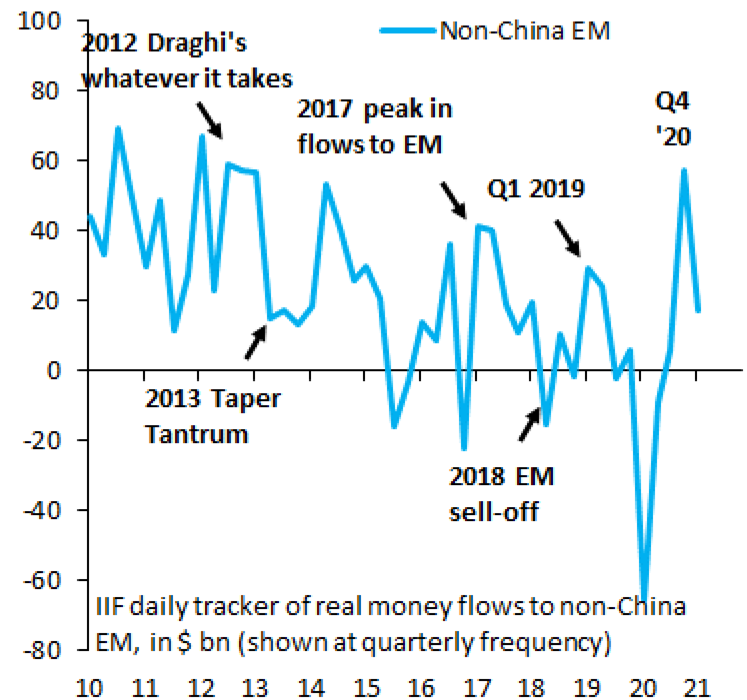




Emerging Market Flows

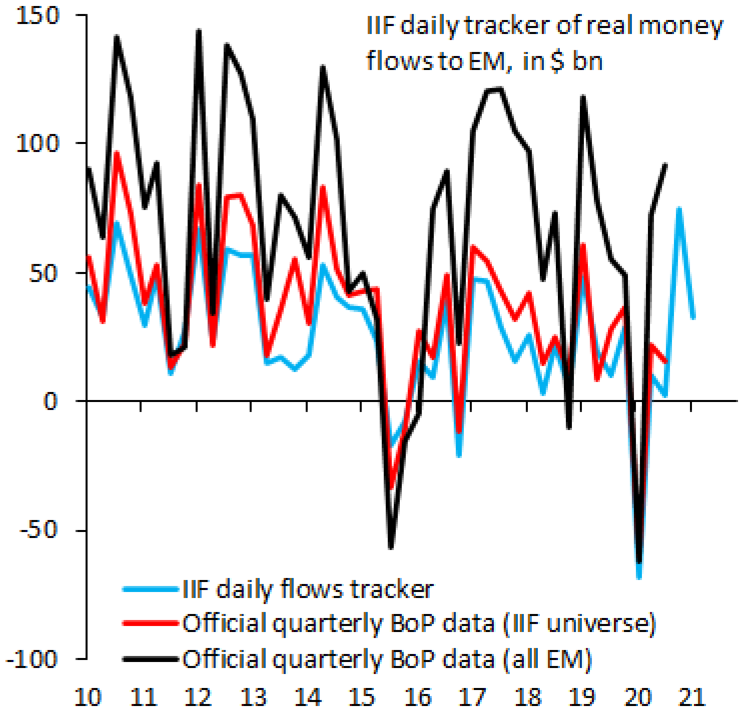
- We aggregate these daily flows to a quarterly frequency.
- China flows are completely distinct from non-China EM.

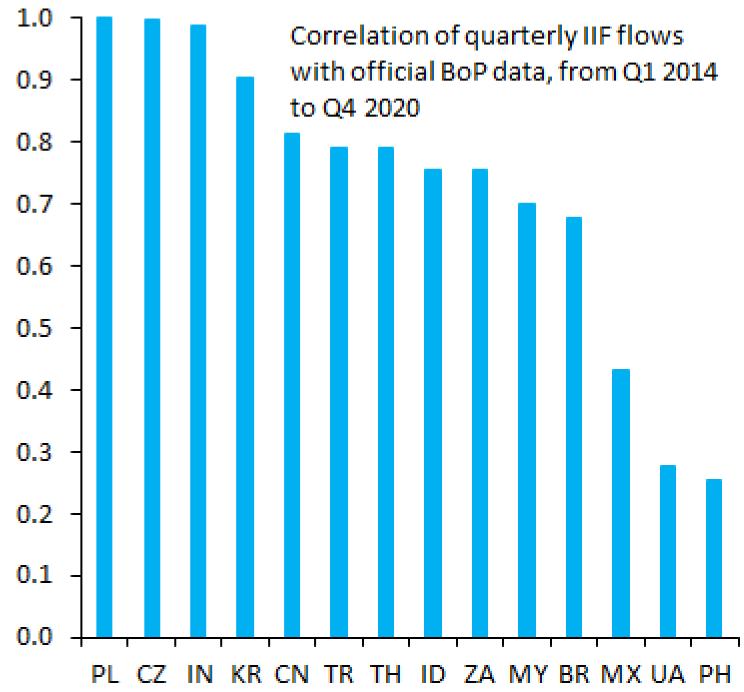




Emerging Market Flows

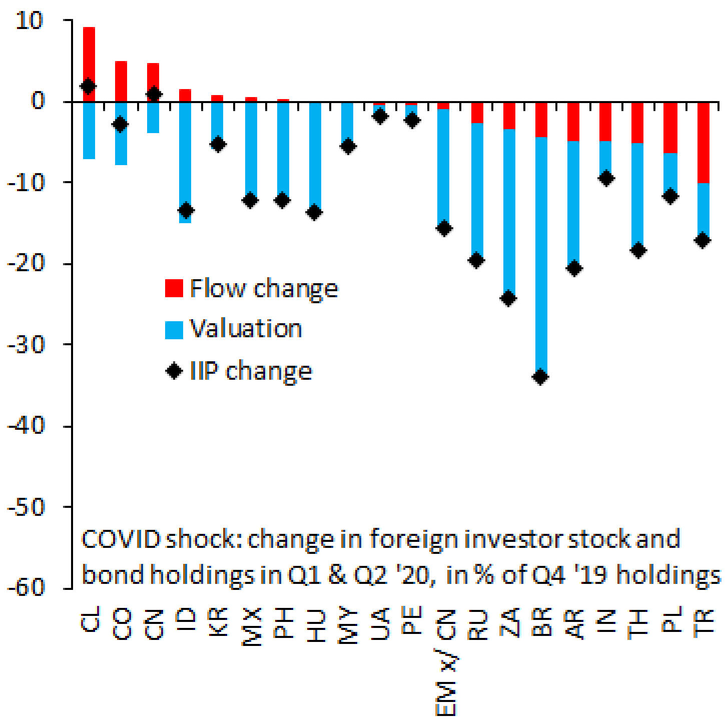
- Our daily flows have a high correlation with official BoP data.
- We're constantly adding new countries to our daily series.

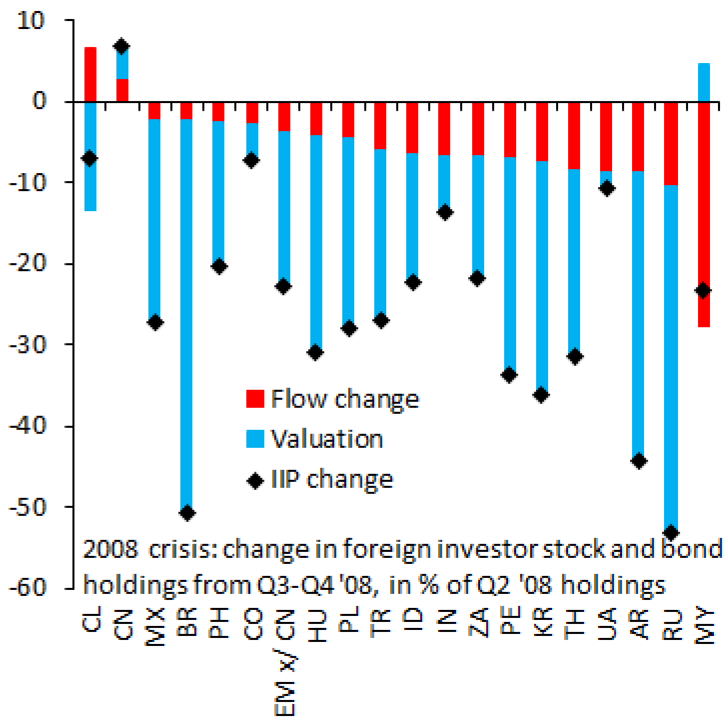




Emerging Market Flows

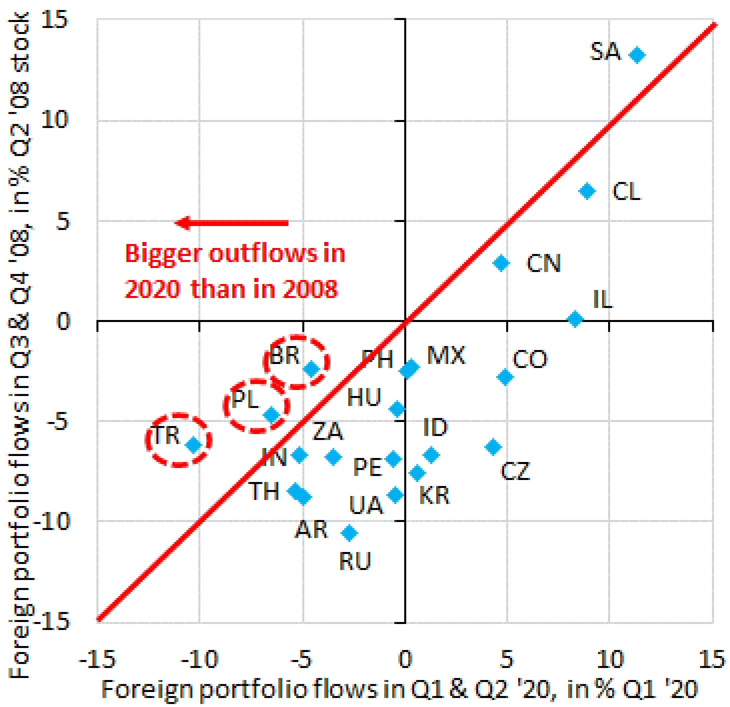
- We scale flows by the stock of foreign holdings from the IIP.
- This allows us to compare Q1 & Q2 2020 to Q3 & Q4 2008.

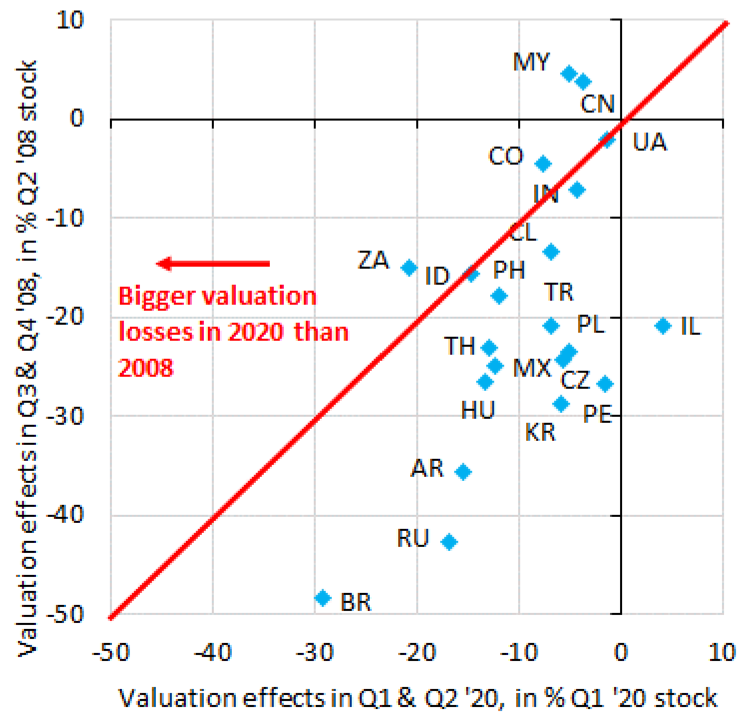




Emerging Market Flows

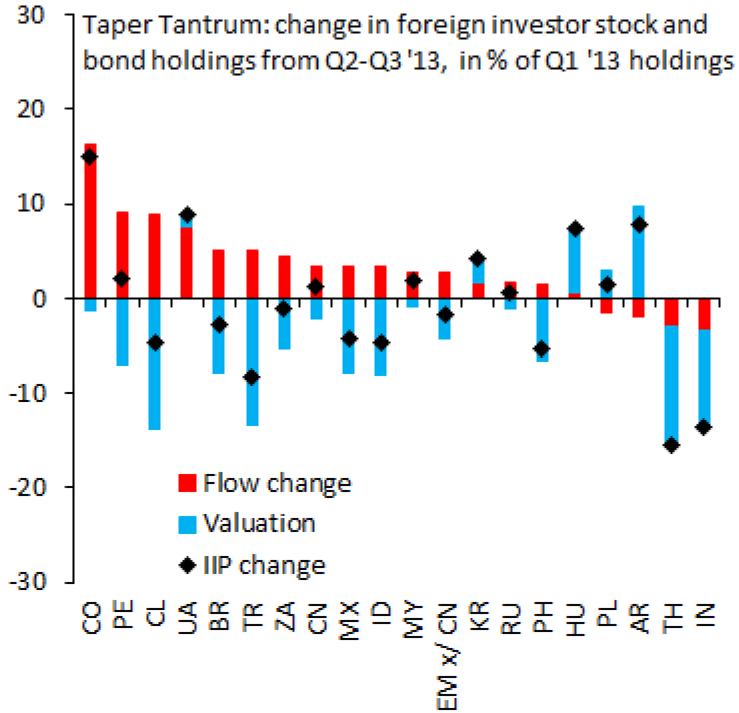
- Outflows were 4% of assets in 2008 versus 1% in 2020.
- Turkey, Poland and Brazil were hit harder than in 2008.

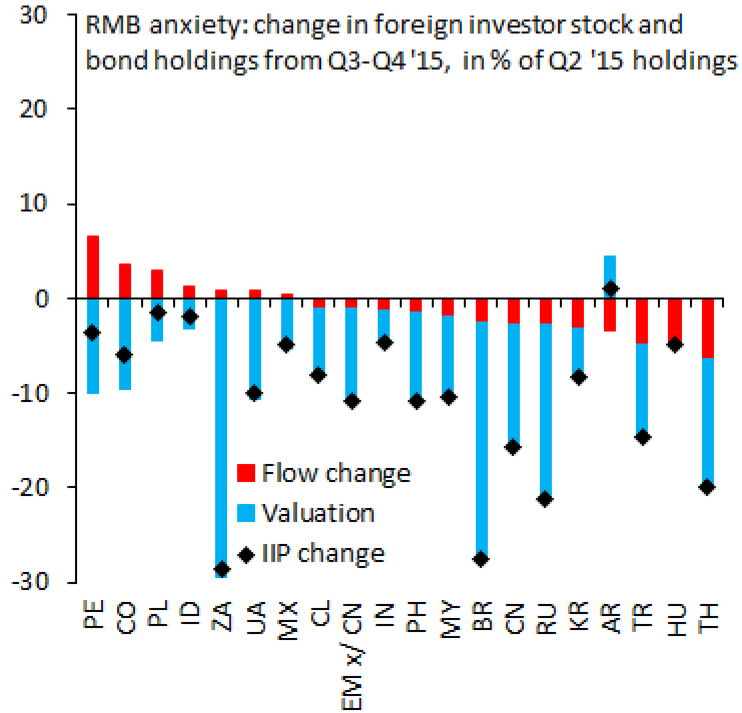




Emerging Market Flows

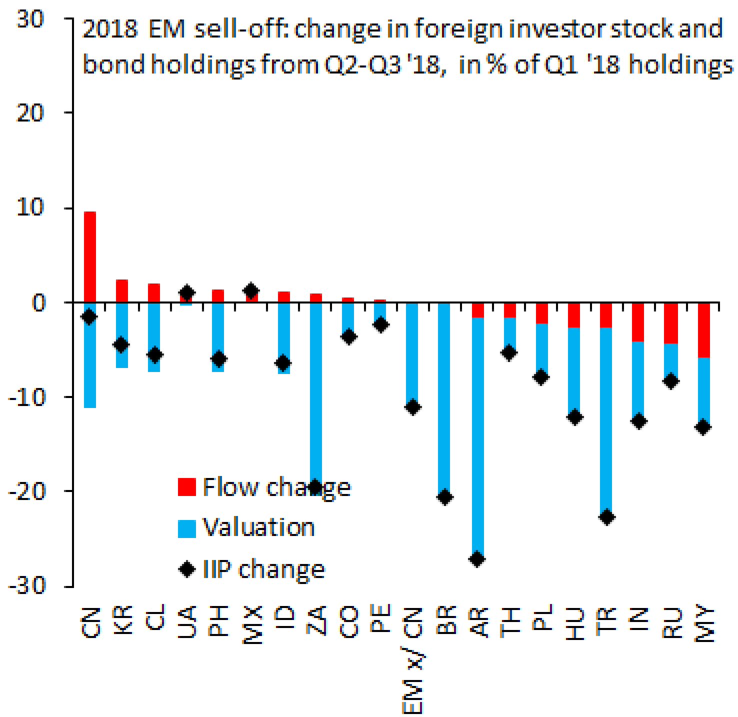
- We look at 2013 tantrum, 2015 RMB deval & 2018 EM sell-off.
- Non-China EM saw inflows in 2013. Not so in 2015 & 2018.

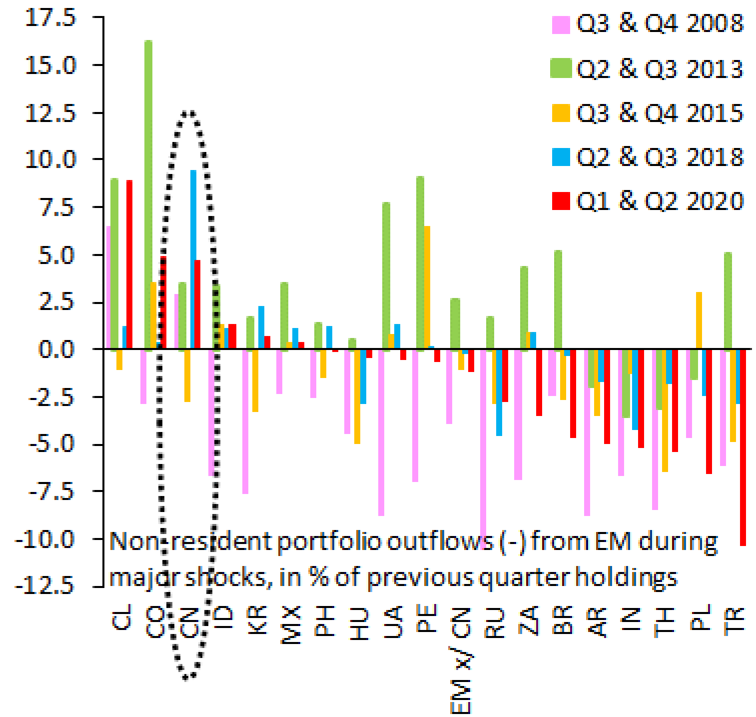




Emerging Market Flows

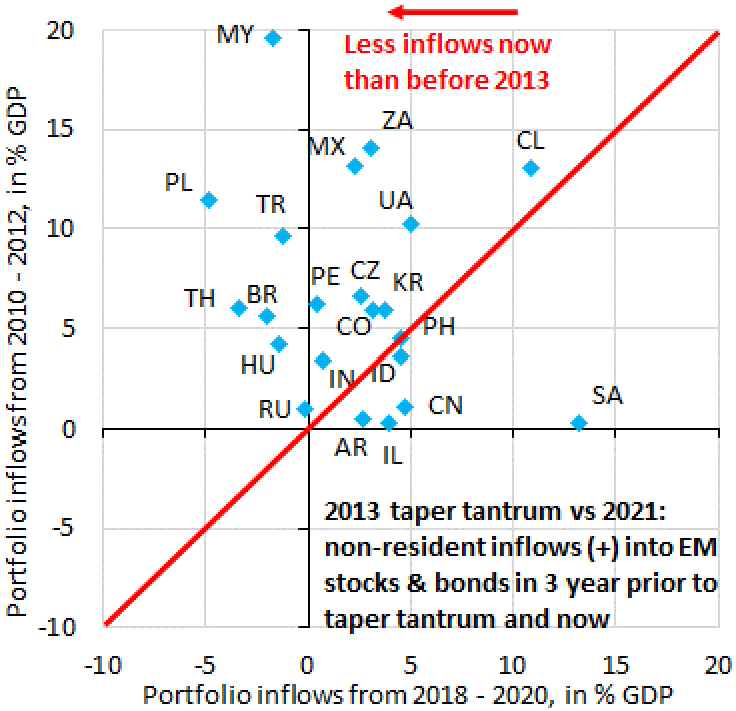
- China is an outlier in EM: consistent inflows except 2015.
- Pre-COVID, Argentina, Russia, India & Thailand are hardest hit.

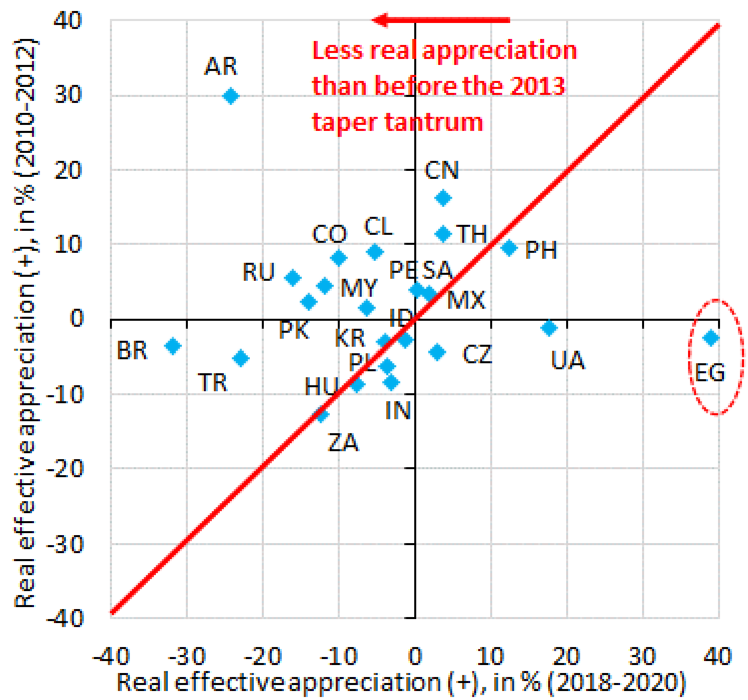




EM in 2021 versus 2013

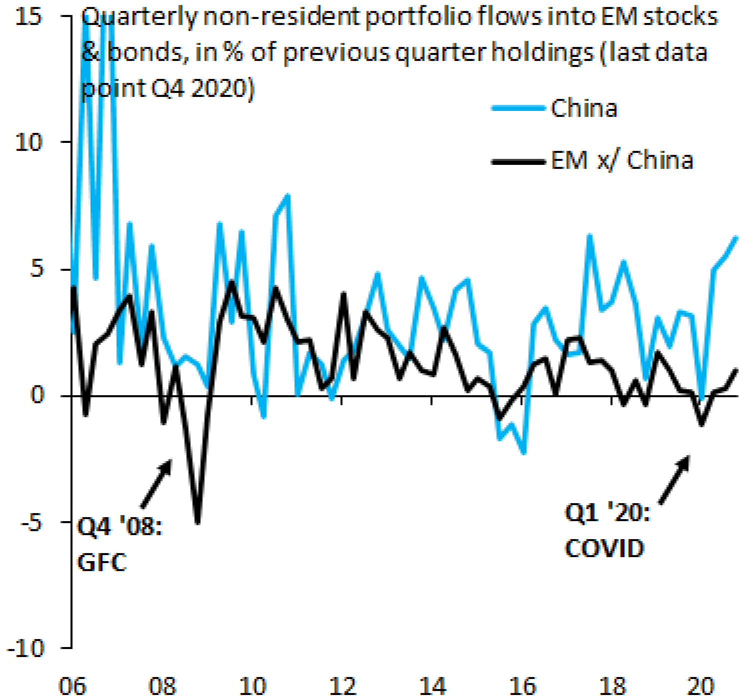
- Some initial conditions coming into 2021 look better.
- Less foreign portfolio inflows, REERs have not risen as much.

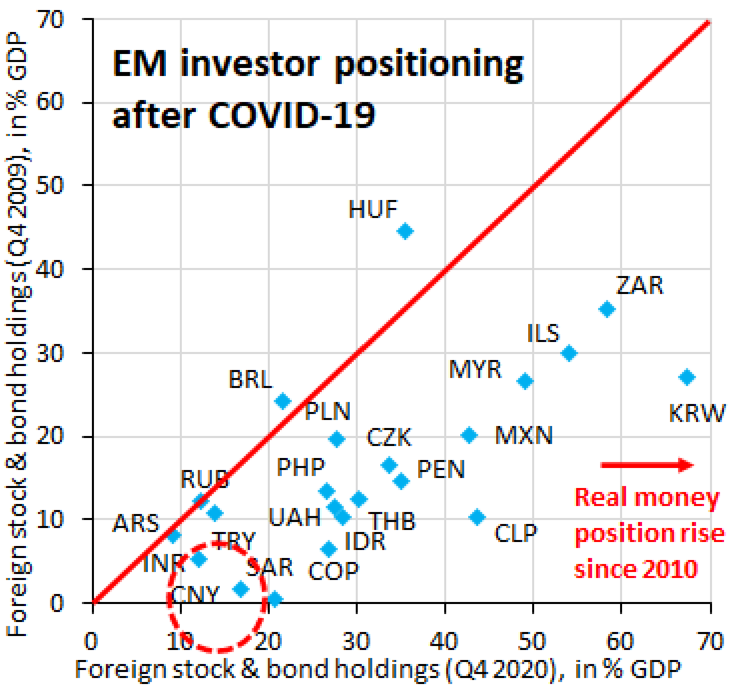




EM in 2021 versus 2013

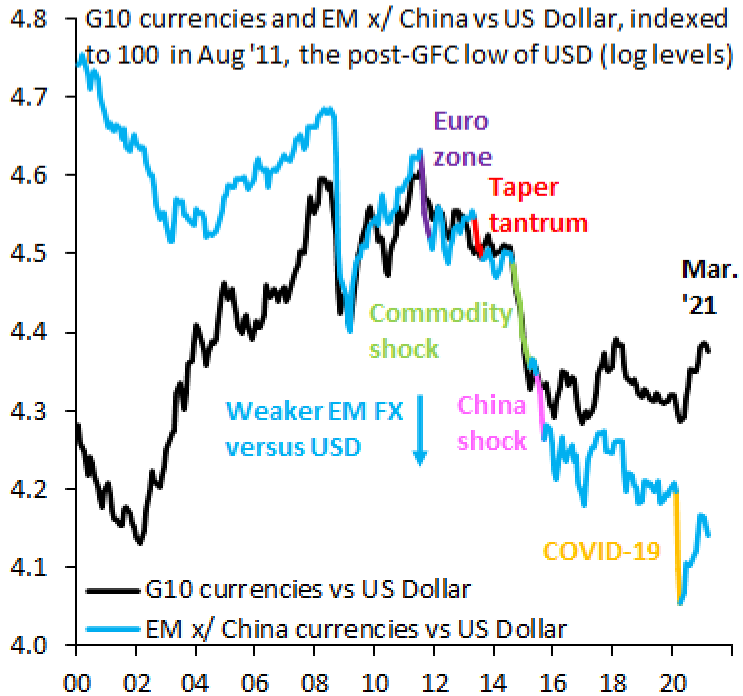
- But that positive picture might be deceptive.
- China may be diverting flows away from non-China EM.

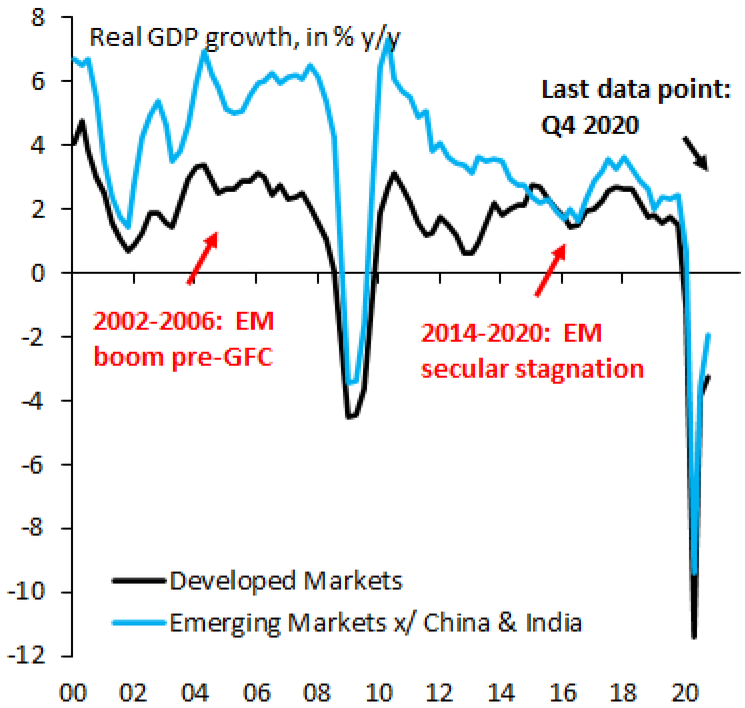




EM in 2021 versus 2013

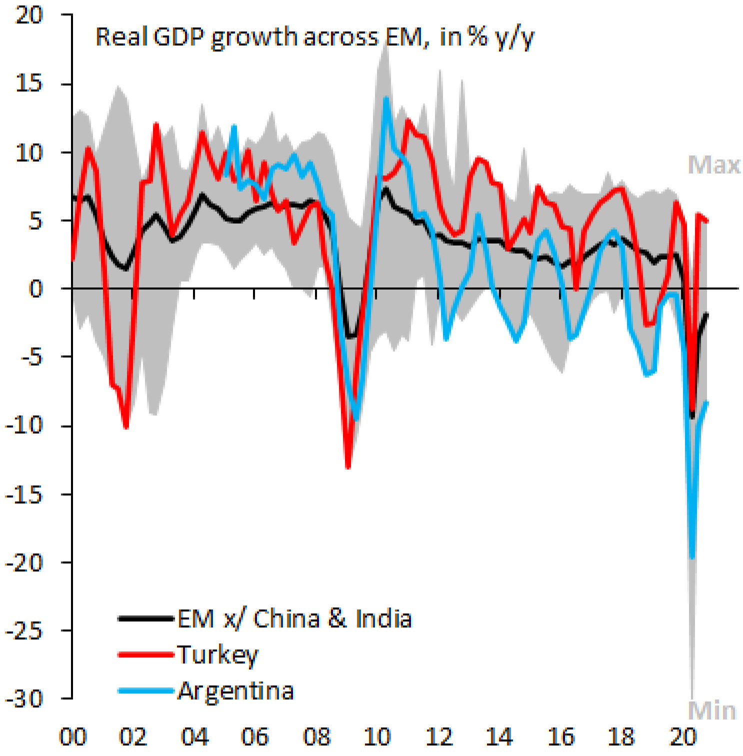
- Emerging markets suffered many adverse shocks since 2013.
- The real crisis in EM has been a lack of growth for many years.

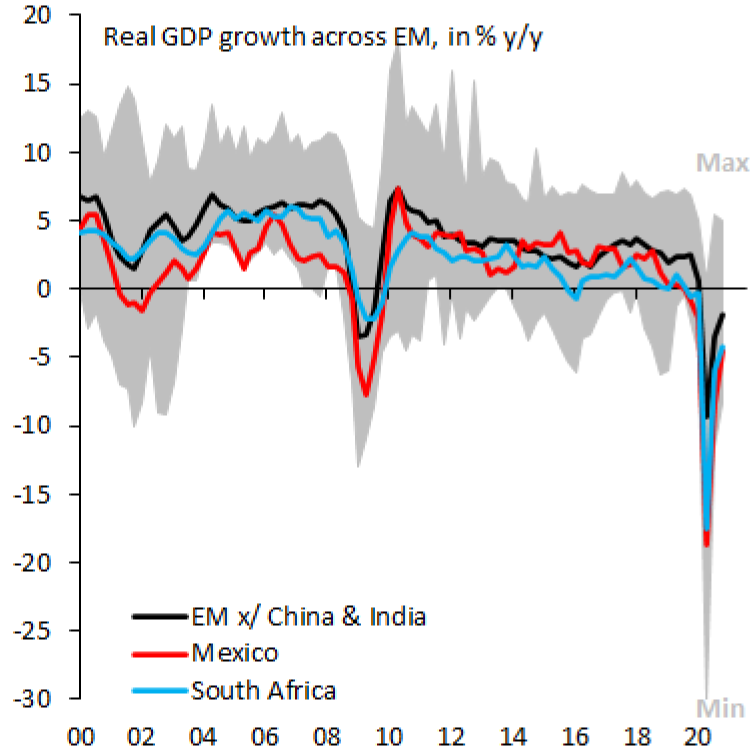




EM in 2021 versus 2013

- Turkey & Argentina are fighting this EM growth slowdown.
- That fight has just produced volatility around a declining trend.





EM in 2021 versus 2013

- Fragile 5 in 2013: Brazil, India, Indonesia, South Africa, Turkey.
- Those countries are still vulnerable, as well as any Dollar pegs.