EMERGING ECONOMIES ARE NO LONGER AS VULNERABLE TO US MONETARY POLICY AS THEY ONCE WERE

The latest monetary tightening in the United States between March 2022 and July 2023 resulted in much larger outflows of portfolio investments by non-residents than during the previous tightening (2016-2018) and the famous taper tantrum of 2013. However, emerging economies are less vulnerable to monetary tightening across the Atlantic than they were a decade ago. On the one hand, the impact of 'flight to quality' capital movements by non-resident private investors on risk premiums and local currency bond yields is less significant. Secondly, the level and structure of corporate debt have improved.

In August 2021, an economist at the Federal Reserve Bank of Dallas published an article with the eye-catching title 'Don't Look to the 2013 Tantrum for the Effect of Tapering on Emerging Markets'[1]), which he concluded by stating that the announcement of the Fed's reduction in monetary support in May 2013 (known by the highly exaggerated name of "taper tantrum") and the sharp rise in US bond yields that followed could not be taken as a reference to assess the effect of US monetary policy on emerging economies. This argument was based mainly on the observation that between 2013 and 2021, most central banks in the 13 leading emerging economies had rebuilt their foreign exchange reserves. Furthermore, for countries whose reserves exceeded the threshold of 7% of short-term external liabilities, the depreciation of the exchange rate against the US dollar was less pronounced and the rise in risk premiums on corporate external debt was much more limited. The more recent experience of US monetary tightening between March 2022 and July 2023 provides further insight into this analysis[2].

MASSIVE PORTFOLIO INVESTMENT OUTFLOWS IN 2022

In the five months following the Fed's first rate hike on 17 March 2022, there were massive outflows of portfolio investments by non-residents (nearly USD 60 billion in total). By comparison, during the taper tantrum and the subsequent period of monetary tightening (2016-2018), outflows were significantly lower (around 25 billion in both cases). Above all, they were wiped out very quickly (after only four months, compared with 14 months for the 2022-2023 episode).

The size of the outflows during the latest rate hike can be explained by the fact that the Fed raised its key rate more quickly and more sharply than in 2016-20183 . In addition, the resulting rise in US bond yields was more significant (twice as high as in 2016-2018 and three times higher than during the brief period of tension following the tapering announcement). Nevertheless, emerging financial markets remain highly exposed to flight-to-quality capital movements.

EMERGING ECONOMIES ARE LESS VULNERABLE TODAY

However, emerging economies are much less vulnerable than they were a decade ago. On the one hand, the impact of portfolio investment outflows by non-residents is offset by the stability of foreign public investors (central banks, sovereign wealth funds) and the growing importance of local investors. As a result, the share of public debt held by non-residents (private and public combined) is currently at 15%, compared with 25% in 2015. Risk premiums on government external debt (measured by CDS spreads) declined between January 2022 and July 2023 in virtually all countries. Over the same period, local currency government bond yields rose by a median of only 150 basis points (bp), while local monetary policies tightened significantly (by a median of 425 bp as well[4]).

Furthermore, with the exception of Latin American countries, public finances are no longer vulnerable to exchange rate risk, or are only moderately so. In Asia, for half of emerging countries, the share of foreign currency debt does not exceed 5%. For the other half, it varies between 20% and 35%, but with the exception of Indonesia, portfolio investment flows are low, which limits the transmission effects of a flight to quality.

In Europe, EU member countries that are not yet part of the Eurozone have foreign currency debt of 20% or more (43% for Romania), with the exception of the Czech Republic. Stability against the euro, rather than against the dollar, is what matters. In emerging Europe (excluding Russia), only Turkish government debt is highly exposed to currency risk, as 55% of it is denominated in foreign currencies, mainly the US dollar. Within the Africa-Middle East region (excluding Gulf countries, whose public debt is backed by foreign exchange reserves and sovereign wealth funds that are significantly higher), Egypt is also an exception, with one-third of its debt denominated in foreign currencies. Finally, unlike Türkiye, the Egyptian government is heavily indebted and dependent on financial support from the IMF.

1 Don't Look to the 2013 Tantrum for the Effect of Tapering on Emerging Markets - Dallasfed.org
2 Our sample of emerging countries consists of 13 countries (South Africa, Brazil, South Korea, Hungary, India, Indonesia, Malaysia, Mexico, Poland, Thailand, Czech Republic, Thailand and Türkiye). We excluded China and Russia, both because of the lack of data for comparison purposes and the specific characteristics of these two countries (size for China, financial isolation for Russia).
3 The Fed did not mention this during the tantrum.
4 This finding should be interpreted with caution, as local monetary policy can blur the measurement of the causal link between US monetary policy and domestic interest rates via non-resident portfolio investment. Indeed, local monetary policies can alter inflation expectations: a smaller increase in bond yields than in policy rates, which was the case in all countries with a median coefficient of 0.3, can be explained by a decline in expected inflation rather than by the compensatory effect of local investors vis-à-vis foreign investors. However, this low degree of transmission suggests that this compensatory effect was significant.

Regarding LATAM countries, the Brazilian government has only about 5% of its debt in foreign currencies. Mexico has more (17%), and the other economies have even more, ranging from 35% to 50% (Argentina). It has to do with the fact that these countries are exporters of raw materials whose prices are denominated in dollars. However, the negative correlation that existed between the dollar and oil and commodity prices in general has not been observed since 2021. Export revenues therefore offer better natural hedging against currency risk than in the past. These economies are less affected by the "original sin" (external debt denominated in dollars or other major currencies, due to a lack of domestic financing in local currency) which, when fixed exchange rates against the dollar were forced to devalue, triggered the sovereign crises of the 1990s.

MORE MODERATE CREDIT RISK FOR NON-FINANCIAL COMPANIES

On the other hand, the level and/or structure of non-financial corporate debt in emerging economies has improved since 2015, which partly explains why credit risk, as measured by non-performing loan ratios in bank balance sheets, has remained very moderate or continued to decline, despite successive external shocks since 2020 (beyond the moratoriums on non-performing loans decided by governments during the Covid-19 crisis). Unlike governments, whose debt has increased by a median of 12 pp of GDP since 2015, non-financial corporate debt has declined or increased very moderately (by no more than +5 pp of GDP over the period), with the exception of South Korea (+17 pp) and Vietnam (+35 pp). The former is a strong economy, producing and exporting high value-added products, and the latter is a rapidly expanding economy attracting direct investment. Both are likely to benefit from the adjustment of value chains following the trade dispute between China and the United States. Finally, the decline in debt ratios (as a percentage of GDP) has generally been accompanied by a decline in the ratio of foreign currency debt, whether external or granted by local banks.

Ultimately, even if emerging countries are prone to flight to quality, the conclusion of the Dallas Federal Reserve economist is confirmed: emerging economies are much less vulnerable to US monetary tightening than they were a decade ago.

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