Boxes

1 EME financial market developments after the 2016 US presidential election compared with developments after the 2013 tapering talk episode

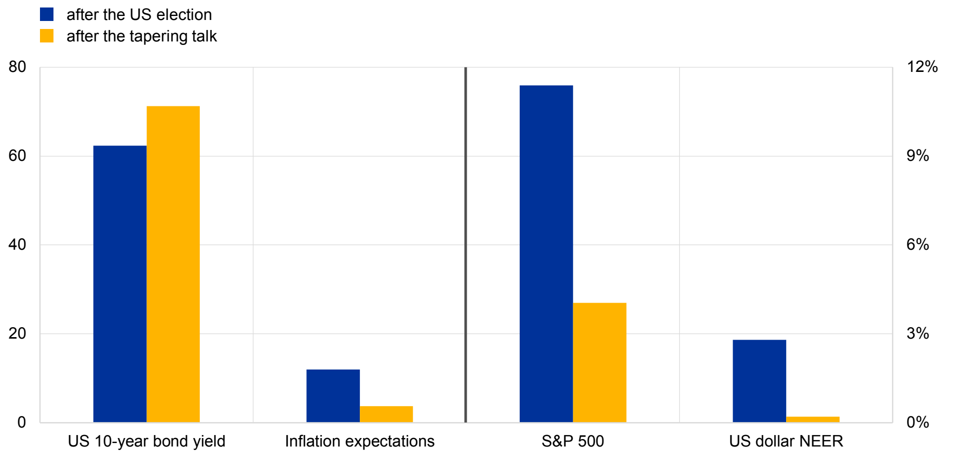
This box compares financial market responses in the United States and emerging market economies (EMEs) since the 2016 US presidential election with developments during the 2013 "tapering talk" episode and emphasises the risks to the outlook for EMEs stemming from US policies.

In both episodes, expectations of a faster pace of US monetary policy normalisation were associated with significant movements in US financial markets (see Chart A). In May 2013 remarks by the Chairman of the Federal Reserve System, Mr Bernanke, announcing that the Federal Reserve System would begin to taper asset purchases under its QE3 programme, caused a marked increase in US bond yields. Since the US presidential election in 2016 US bond yields have increased by a similar amount. In contrast to the 2013 episode, however, stock markets in the United States have rallied, market-based measures of US inflation expectations have increased and the US dollar has strengthened. In both episodes, the yield curve shifted upwards across the maturity spectrum.

Chart A

Changes in US equities, bond yields, inflation expectations and the US dollar exchange rate after the 2016 US election compared with changes after the tapering talk

(percentages (right-hand side); basis points (left-hand side))



Sources: Bloomberg, Federal Reserve Board and ECB calculations.
Note: "Inflation expectations" refers to the "US Inflation Compensation: Coupon Equivalent Forward Rate: 5-10 years" series and the "US dollar NEER" is the nominal effective exchange rate of the US dollar; "after the US election" refers to changes between 8 November 2016 (the date of the Federal Open Market Committee (FOMC) meeting) and 3 March 2017 and "after the tapering talk" refers to changes between 22 May and 19 September 2013.

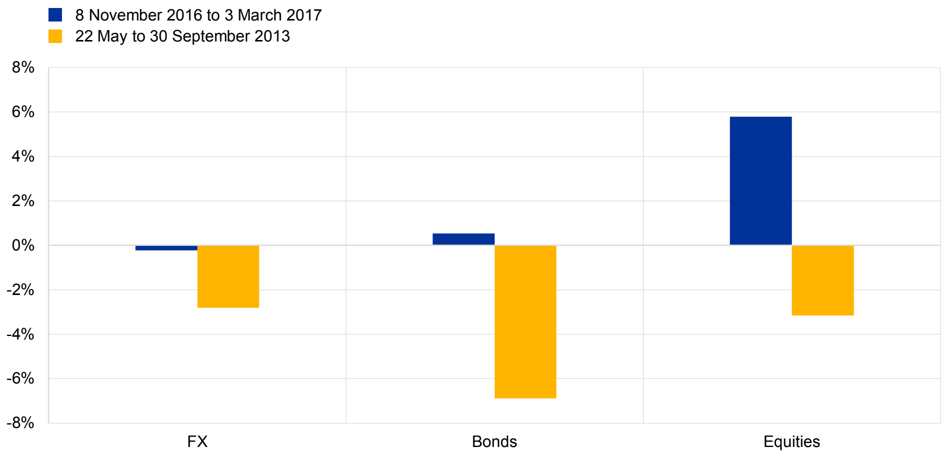
However, the reasons for the rise in US bond yields in each case seem to have been different. In the present episode, the interaction of US equity prices, bond yields and the US dollar exchange rate suggests that a positive demand shock is driving US asset market developments. Rising equity prices and falling bond prices, in particular, seem to have reflected market expectations of fiscal stimulus measures. Following the tapering talk in 2013, by contrast, it seems that a monetary policy shock – a shift in market expectations regarding the future path of monetary policy – led to the rise in US bond yields.

As a result, the reaction of EME financial markets in recent months has been milder overall than during the tapering talk episode. In the weeks after the US presidential election, EME currencies depreciated, bond prices declined (i.e. yields rose) and equity prices fell markedly. The initial decline in EME bond and equity prices has since reversed, with EME equity prices even rising to levels above those prevailing before the election, and EME currencies have bounced back. Conversely, during the tapering talk episode the decline in EME exchange rates and in bond and equity prices was significantly more persistent (see Chart B). Indeed, the sell-off in May 2013 marked the beginning of a long-term downward trend in EME asset prices that persisted until early 2016.

Chart B

Changes in EME financial asset prices following the 2016 US election and after the tapering talk

(percentage changes)



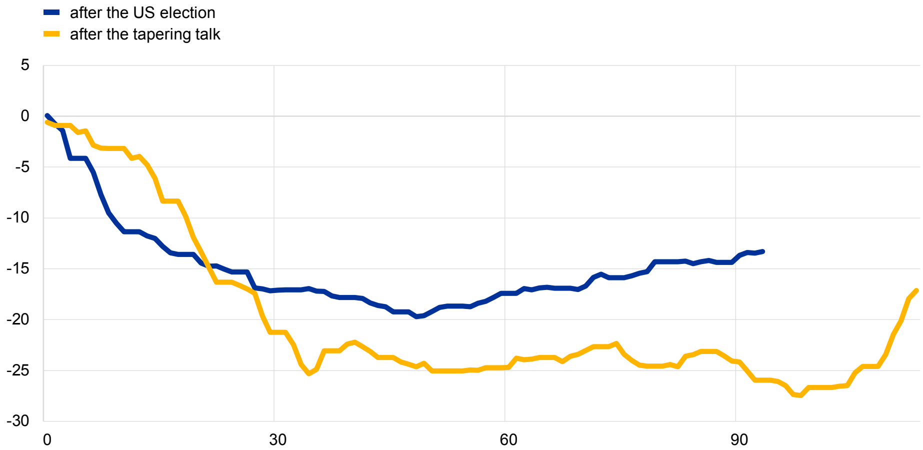
Sources: Bloomberg and ECB calculations.
Notes: “FX” is the trade-weighted JP Morgan EM currency index (EMCI). “Bonds” is the JP Morgan bond price index for US dollar-denominated sovereign debt (EMBI). “Equities” is the MSCI global EM index.

Recent EME equity and bond market outflows have been smaller than the levels seen during the tapering talk episode. Cumulative EME portfolio outflows in the month after the US election reached USD 17 billion (according to data from the Institute of International Finance), only slightly less than the outflows over the same period after the tapering talk which amounted to USD 21 billion (see Chart C). Recent developments have largely been driven by foreign disinvestment from EME bond markets, reflecting the pronounced rise in US yields. At the beginning of this year, however, these capital outflows reversed, which helped to stabilise EME asset markets. In both episodes, non-resident portfolio outflows were quick to rebound and no sudden stop occurred.

Chart C

Non-resident portfolio outflows from EMEs following the 2016 US election and after the tapering talk

(x-axis: days since start of episode; daily cumulative flows in USD billions)



Sources: Institute of International Finance and ECB calculations.
Notes: "after the US election" refers to cumulative changes from 8 November 2016 to 9 February 2017, while "after the tapering talk" refers to cumulative changes from 23 May to 13 September 2013. Aggregate flows are based on eight EMEs that publish daily information on portfolio liabilities: Indonesia, India, Korea, Thailand, South Africa, Brazil, the Philippines and Turkey.

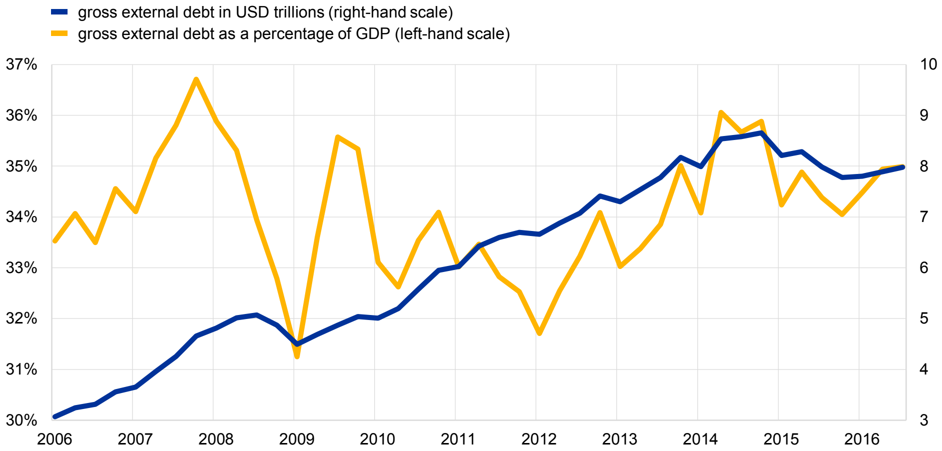
Despite the overall benign financial market developments, downside risks to EME activity prevail, related in particular to a potential increase in protectionist sentiment targeted at key EMEs, which would harm global trade. If implemented, protectionist measures could more than offset the potential gains from stronger US activity and would overall weigh on EMEs' economic growth. For instance, the possibility of rising protectionism has already contributed to a higher degree of uncertainty about Mexico's future trade prospects with the United States, which is weighing on the country's growth prospects. Moreover, exports of many EMEs typically have a high import content. These closely interlinked supply chains imply that any rise in trade barriers would have major repercussions and would lead to global feedback loops.

Moreover, the build-up of EMEs' foreign debt, coupled with the preference of EME firms and banks for US dollar funding, may leave some EMEs in a vulnerable position. The external debt of many EMEs expanded after the global financial crisis and has continued to expand since the taper tantrum episode, owing mainly to very loose global financial conditions (see Chart D). As the US dollar strengthens and interest rates rise globally, debt service payments become increasingly onerous. In addition, in countries confronted with intensified inflationary pressures stemming from the sharp depreciation of their currencies, central banks may need to tighten further their monetary policy stance, further increasing the debt service burden stemming from domestic currency-denominated credit. Overall, the higher debt service ratio could weigh on economic activity, causing negative consequences for consumption and investment in the EMEs concerned.

Chart D

EME gross external debt

(percentages of GDP, USD trillions)



Sources: World Bank and national sources for GDP.
Note: This series is an aggregate of 14 countries (Argentina, Brazil, China, India, Indonesia, Mexico, Russia, South Africa, Korea, Turkey, Hong Kong, Malaysia, Singapore and Thailand).