

BANK FOR INTERNATIONAL SETTLEMENTS

# Enhancing EME resilience \*

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\* The views expressed in this presentation are my own and not necessarily those of the  
Bank for International Settlements.



# Outline

1. A changed environment: old and new risks facing EMEs
2. How can EMEs become more resilient?



# A changed environment: old and new risks facing EMEs

## Selected old risks

- Faster than expected normalization of US monetary policy, snap-back in yields and spreads
- Hard landing in China
- Growth models run out of steam
- Domestic banking distress
- Exogenous risk-off episode
- Geopolitical risks, especially in Middle East and Asia



# A changed environment: old and new risks facing EMEs

Under discussion : major policy shifts in advanced economies

- More restrictive trade policies in advanced economies
  - Direct effects
  - Indirect effects through
    - global value chains
    - Trade diversion



## A changed environment: old and new risks facing EMEs

Under discussion: major policy shifts in advanced economies

- More restrictive trade policies in advanced economies
- Changes to US corporate tax system
  - Incentives to repatriate overseas profits
  - Lower tax rates affect investment location
  - Trade and exchange rate effects of Border Tax Adjustment
- Centrifugal forces in EU/euro area



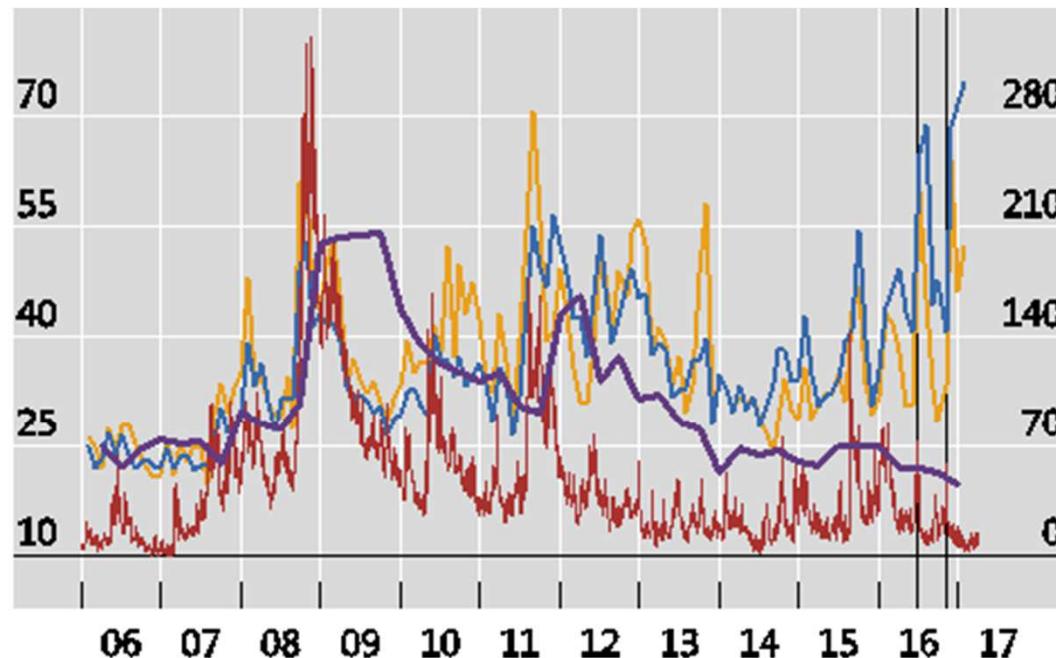
## A changed environment: old and new risks facing EMEs

These new policies may take a long time to be implemented, and some may never come into force

→ Expect long period of uncertainty



## A changed environment: old and new risks facing EMEs



Lhs:

— VIX

— G-7 economic uncertainty<sup>3</sup>

Rhs:

— Global policy uncertainty<sup>4</sup>

— US policy uncertainty<sup>5</sup>

- but markets don't seem to care



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## A changed environment: old and new risks facing EMEs

Uncertainty makes live difficult but also provides an opportunity to build resilience



## Building resilience

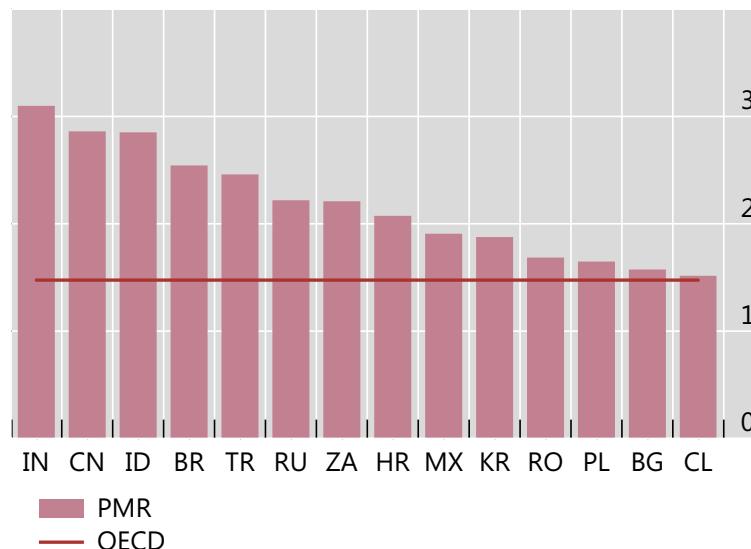
- Address vulnerabilities and increase flexibility
  - Reduce debt and modify its structure
  - Diversify international trade
  - Improve investment conditions
  - Reduce frictions that hinder adjustment



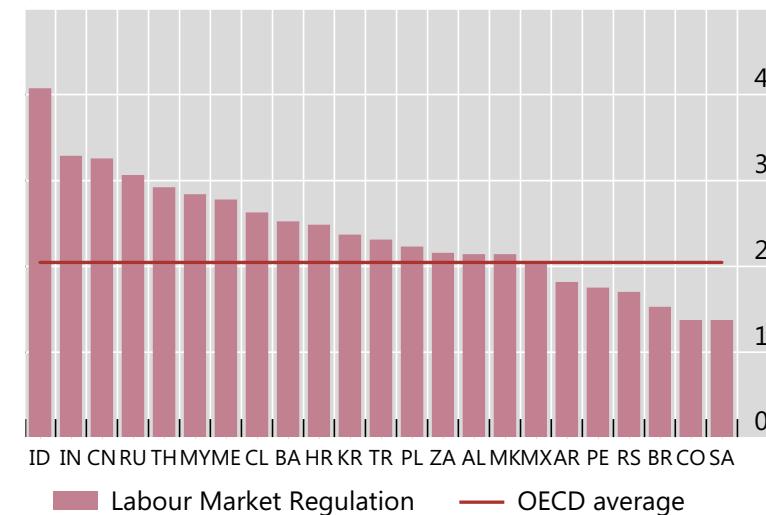
# Building resilience

Strict product and labour market regulation hinder adjustment

Product market regulation



Labour market regulation



GraphFootnote

Source: OECD.



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## Building resilience

- Address vulnerabilities and increase flexibility
  - Reduce debt and modify its structure
  - Diversify international trade
  - Improve investment conditions
  - Reduce frictions that hinder adjustment
- ... all this can be done but takes time
- Flexible exchange rate can help

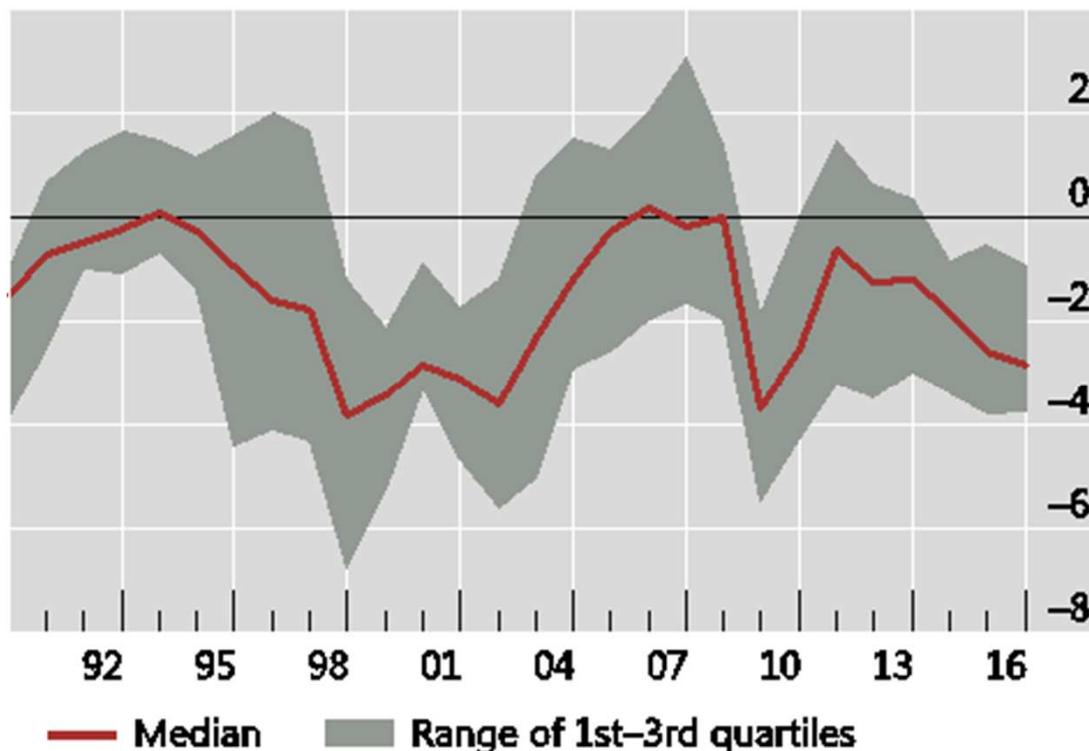


## Building resilience

- Address vulnerabilities and increase flexibility
- Macroeconomic policies to smooth adjustment
  - Rising deficits and high debt may limit fiscal space



## Building resilience



- Marked deterioration in fiscal balances suggest limited fiscal space



## Building resilience

- Address vulnerabilities and increase flexibility
- Macroeconomic policies to smooth adjustment
  - Rising deficits and high debt may limit fiscal space
  - Market response may limit monetary accommodation
    - Risk-taking channel of currency appreciation goes into reverse: currency depreciation may drive up risk premia

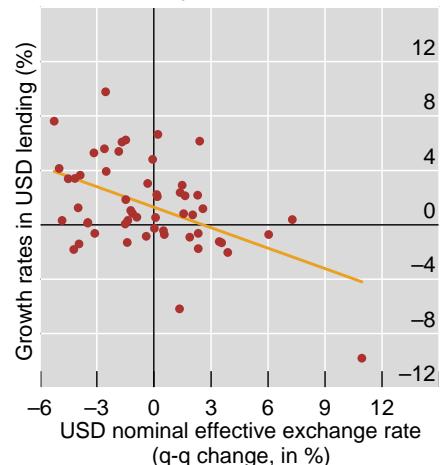


# Building resilience

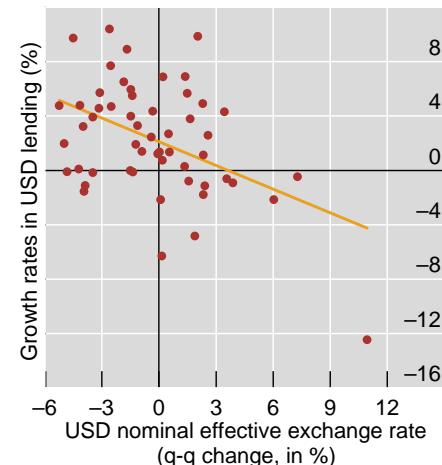
Risk taking channel of the exchange rate

Graph 10

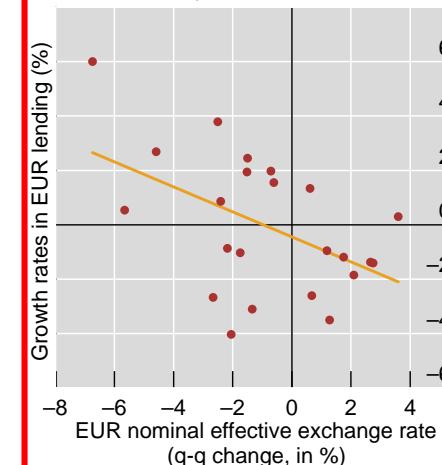
USD-denominated bank credit to borrowers outside the US  
(coef= -0.503; p-val= 0.000)<sup>1</sup>



USD-denominated bank credit to EMEs (coef= -0.581; p-val= 0.001)<sup>1</sup>



EUR-denominated bank credit to borrowers outside euro area  
(coef= -0.459; p-val= 0.018)<sup>2</sup>



Note: Positive changes in FX rate mean that the US dollar or the euro has appreciated.

<sup>1</sup> The observations cover the period from Q2 2002 to Q3 2015. <sup>2</sup> The observations cover the period from Q1 2010 to Q3 2015.

Sources: National data; BIS Locational Banking Statistics; BIS calculations.

- Dollar appreciation associated with lower capital flows (Bruno and Shin (2015))



## Determinants of sovereign risk premia in EMEs

D.V.: 5 yr sovereign CDS spread

Table A1

Coefficients at	10th percentile (low CDS spread)	30th percentile	Median CDS	70th percentile	90th percentile (high CDS spread)
CPI inflation	0.036*** 0.009	0.066*** 0.010	0.084*** 0.017	0.114*** 0.019	0.096*** 0.032
Fiscal bal. / GDP	-0.027*** 0.009	-0.037*** 0.013	-0.030** 0.015	-0.081*** 0.025	-0.089** 0.04
LCDebt serv. / GDP	0.179*** 0.021	0.152*** 0.033	0.217*** 0.041	0.341*** 0.062	0.478*** 0.091
FCDebt / GDP	1.174*** 0.247	0.939** 0.364	0.726 0.547	1.451 0.962	1.332 1.339
GDP growth	-0.012 0.010	-0.006 0.011	-0.040*** 0.013	-0.041** 0.016	-0.047* 0.028
US GDP growth	-0.049*** 0.014	-0.037** 0.018	0.040* 0.022	0.062** 0.027	0.014 0.048
FX reserves / imports	-0.135 0.084	-0.260** 0.113	-0.704*** 0.194	-0.928*** 0.3	-1.240*** 0.449
RER appreciation	-0.029*** 0.005	-0.033*** 0.005	-0.034*** 0.006	-0.040*** 0.008	-0.050*** 0.019
log of VIX	0.369*** 0.061	0.494*** 0.079	0.712*** 0.082	0.806*** 0.119	0.948*** 0.238
slope of US yield curve	0.107*** 0.016	0.123*** 0.022	0.179*** 0.025	0.261*** 0.038	0.275*** 0.067
estimation method	quantile reg.	quantile reg.	quantile reg.	quantile reg.	quantile reg.
fixed effects	yes	yes	yes	yes	yes
observations	937	937	937	937	937
pseudo R2	0.4310	0.4184	0.4077	0.4387	0.4923

Note : Estimates based on quarterly data. Sample period goes from 2000 Q1 to 2015 Q3. All explanatory variables are lagged. \*, \*\* and \*\*\* denote statistical significance at 10%, 5% and 1%, respectively. Standard errors obtained via bootstrapping.

## Building resilience

- Address vulnerabilities and increase flexibility
- Macroeconomic policies to smooth adjustment
  - Deficits and high debt may limit fiscal space
  - Market response may limit monetary accommodation
  - International reserves provide some insulation, especially for countries with higher sovereign risk premia



## Determinants of sovereign risk premia in EMEs

D.V.: 5 yr sovereign CDS spread

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## The stabilizing role of official reserves

- Signal firepower
- FX liquidity insurance
  - Outright swaps or repos (eg Korea, Brazil, Russia)
  - NDFs (Brazil, Peru, Mexico)
  - Options (Colombia)
- But usage may undermine effectiveness: the case of Korea



## The stabilizing role of private foreign asset holdings

- Foreign asset holdings of EME residents have increased significantly
- But how useful are they as buffers?
  - Holders of assets are not necessarily those most in need of FX liquidity
  - ➔ Need incentives to repatriate these assets in case of need
    - Fallen asset valuations could signal opportunity to buy
    - May work if shock is temporary or residents are more optimistic than foreigners
  - ➔ Foreign asset holdings could serve as a buffer under some shock constellations but not under others

## Building resilience

- Address vulnerabilities and increase flexibility
- Macroeconomic policies to smooth adjustment
- Regional integration in times of global disintegration?

