Economics Group

Special Commentary

Taper Tantrum Redux for Emerging Markets?

Executive Summary

The “taper tantrum” that began in 2013 was associated with sharp depreciation of many emerging market currencies and lower prices for sovereign bonds in those economies. Prospects of fiscal stimulus and monetary tightening in the United States have ramped up in the wake of the U.S. presidential election, which has led to some renewed pressure on prices of financial assets in emerging markets. Are developing economies facing another taper tantrum and its attendant negative consequences?

Currency depreciation and falling bond prices in emerging markets could clearly continue for some time. However, we believe that most developing countries are less susceptible to another taper tantrum than they were in 2013 because economic fundamentals in most of those economies have improved at the margin over the past three years. Their current account deficits and their external debt-to-GDP ratios have generally receded since 2013, and most developing economies, with the notable exception of China, are less leveraged today than they were three years ago.

Taper Tantrum Led to Turmoil in Emerging Markets

In May 2013, Ben Bernanke, who was chairman of the Federal Reserve at the time, hinted that the Fed would soon begin to taper (i.e., gradually wind down) its purchases of Treasury and mortgage-backed securities that formed the basis of its quantitative easing (QE) program. Over the course of the subsequent four months, the yield on the benchmark 10-year Treasury security rose more than 100 bps. This episode of sharply rising bond yields in the United States has become known as the “taper tantrum.”

As yields in the United States rose, sovereign bonds in emerging markets became relatively less attractive to investors, which sparked a selloff in those bond markets. As shown in Figure 1, yield spreads on emerging market bonds relative to U.S. Treasury securities had widened between 100 bps to 200 bps by the autumn of 2013. Moreover, spreads have continued to drift higher over the past three years.

Investors also soured on emerging market equities in 2013, which were flat on balance over the course of that year, significantly underperforming the American stock market. (The S&P 500 index shot up more than 25 percent in 2013.) This generalized outflow of capital from the emerging world beginning in 2013 caused the currencies of most developing economies to weaken markedly. The Fed’s “Other Important Trading Partners” index, which measures the value of the U.S. dollar vis-à-vis some of the largest and most important developing economies in the world, has risen about 25 percent since May 2013 (Figure 2). In sum, the taper tantrum had negative consequence for most of the developing world.

Fast forward three years. The recent election of Donald Trump and the Republican sweep of Congress has raised expectations of significant fiscal stimulus in the United States over the next few years through tax cuts and/or increased spending on infrastructure and the military. The yield on the 10-year Treasury security has shot up about 40 bps since Election Day, and the U.S. dollar has appreciated vis-à-vis most emerging market currencies over that period. If prospects of
fiscal stimulus cause the Fed to tighten policy more aggressively over the next few years than most investors currently expect, are developing economies facing another taper tantrum and the negative consequences associated with it?

**Figure 1**

Yield Spreads in Emerging Markets
(Over U.S. Treasury Securities)

**Figure 2**

U.S. Trade Weighted Emerging Currency Index
March 1973=100

**Source:** Bloomberg LP and Wells Fargo Securities

**Economic Fundamentals Have Improved at the Margin Recently**

We wrote two reports on the outlook for developing economies at the time of the taper tantrum three years ago.¹ We found at the time that economic fundamentals in many developing economies had deteriorated at the margin in the years leading up to the taper tantrum. The countries with the weakest fundamentals were most at risk of sharply higher interest rates and currency depreciation when long-term interest rates in the United States rose markedly in 2013.

Because countries with current account deficits must finance those deficits via capital flows from abroad, which can abruptly dry up, we were most concerned at the time with emerging market economies with red ink in their current account positions.

The aggregate current account deficit in the developing world (excluding China and OPEC economies) has receded a bit over the past few years (Figure 3).² The current account surplus in emerging Asia (less China) has risen modestly, while the gaping current account deficit that emerging Europe incurred a few years ago has receded noticeably. In contrast, the aggregate current account deficit in Latin America is essentially unchanged over the past few years, while Sub-Saharan Africa has incurred increasingly more red ink. The exchange rate depreciation that we noted above and which we will discuss in more detail subsequently has contributed to the modest improvement in the aggregate current account position of the developing world.

In that regard, the real effective exchange rate, which measures the inflation-adjusted value of a country’s currency vis-à-vis its trading partners, has declined about 15 percent since 2013 in the developing world (Figure 4).³ In other words, the price competitiveness of goods and services in developing economies (excluding China and OPEC) has improved about 15 percent since 2013. Moreover, the real effective exchange rate has fallen back to levels that prevailed before many emerging market currencies started to appreciate sharply about a decade ago. Although emerging

---

¹ See “Are Developing Economies Heading for a Crash?” (October 28, 2013) and “Developing Economies and Crisis Vulnerability” (Oct. 30, 2013). Both reports are available upon request.

² China has incurred massive current account surpluses for the past decade or so, and the current account positions of many OPEC countries are heavily influenced by oil prices. By excluding the special cases of China and OPEC in the rest of this report, we are attempting to zero in to the financial position of the “typical” developing economy.

³ We construct the index shown in Figure 4 by calculating the arithmetic average of the real effective exchange rates of 18 developing economies as calculated by the Bank for International Settlements (BIS). See [http://www.bis.org/](http://www.bis.org/). These 18 economies account for about 40 percent of the GDP that is produced in the developing world.
market currencies could clearly drop further, they do not appear to be as overvalued today as they were at the advent of the taper tantrum.

**Figure 3**

**Figure 4**

*Source: International Monetary Fund, Bank for International Settlements and Wells Fargo Securities*

Because developing countries are generally incurring smaller current account deficits today than they were a few years ago, those countries generally do not need to borrow as much from the rest of the world as they did a few years ago. Consequently, the stock of debt that those developing economies owe to the rest of the world, which is known as their external debt, should have hit an inflection point. As shown in **Figure 5**, the external debt-to-GDP ratios in most regions of the developing world have edged lower since 2013. The notable exception to this rule is Latin America where the ratio rose from 24 percent in 2013 to nearly 30 percent last year. Much of this increase in Latin America’s ratio is due to Brazil. Not only has the stock of Brazil’s external debt increased on balance over the past few years, but the deep recession that country has endured has caused nominal GDP (in dollar terms) to decline. That said, the external debt ratio in Latin America does not appear to be grossly out of line with ratios in other regions of the developing world.

**Figure 5**

**Figure 6**

*Source: The World Bank, International Monetary Fund, Bank for International Settlements and Wells Fargo Securities*

Speaking of debt, we noted in our reports three years ago that borrowing by the private sector in the developing world had ramped up in the early years of this decade due largely to increasing leverage in China. As shown in **Figure 6**, the leverage ratio, which we define as debt in the private nonfinancial sector as a percent of GDP, has edged lower in most regions of the developing world...
since 2013. Everything else equal, lower leverage in an economy should be associated with less investor angst and less capital flight from that economy.

That said, leverage in China, which is not shown in Figure 6, continues to skyrocket. We have some concerns about the mushrooming amount of debt in the Chinese business sector that we have discussed at length in other reports, so we will not repeat those concerns in this report. But the deleveraging that appears to be occurring in many other developing economies is welcome.

**Conclusion**

At the start of the taper tantrum three years ago, we wrote that the economic fundamentals of many developing economies had deteriorated at the margin, which made some countries vulnerable to difficulties in financing their current account deficits. However, we also wrote that we did not believe that a wave of financial crises sweeping through the developing world à la 1997-1998 was imminent. Three years later, this prognostication has proven to be largely correct. Although many emerging market economies have had to live with weaker currencies and higher bond yields over the past few years, most countries in the developing world have not experienced the degree of economic and financial pain that they did during the so-called “Asian economic crisis” of 1997-1998.

Prospects of fiscal stimulus and monetary tightening in the United States in the wake of the recent presidential election has caused the dollar to strengthen versus most emerging market currencies and bond yields in those countries to rise. However, we do not believe that we are on the cusp of another taper tantrum and its attendant negative consequences for the developing world.

For starters, most emerging market currencies have already depreciated significantly vis-à-vis the U.S. dollar since 2013. How much farther can they realistically fall? Moreover, the economic fundamentals of many developing economies have improved at the margin since the taper tantrum in 2013. Their current account deficits and their external debt-to-GDP ratios have generally receded, at least somewhat, since 2013. Most developing economies, with the notable exception of China, are less leveraged today than they were three years ago. Although currency depreciation and falling bond prices in emerging markets could clearly continue for some time, we believe that most developing economies are generally less susceptible to the negative consequences of potential monetary tightening in the United States than they were at the start of the taper tantrum more than three years ago.

---

4 See “Does China Face a Japanese-Like “Lost Decade”? (March 15, 2016) and “Are SOEs a Millstone Around China’s Neck?” (May 18, 2016). Both reports are available upon request.
Important Information for Non-U.S. Recipients

For recipients in the EEA, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority. The content of this report has been approved by WFSIL a regulated person under the Act. For purposes of the U.K. Financial Conduct Authority’s rules, this report constitutes impartial investment research. WFSIL does not deal with retail clients as defined in the Markets in Financial Instruments Directive 2007. The FCA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. This report is not intended for, and should not be relied upon by, retail clients. This document and any other materials accompanying this document (collectively, the "Materials") are provided for general informational purposes only.