Normalizing Central Banks’ Balance Sheets

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The views contained in this presentation are that of the author and not necessarily GIC Pte Ltd.
EM assets in the long run

- Over a long horizon, the biggest driver of returns is the compounding of earnings
- Stability of institutions and predictability of policy frameworks more important in the long run

![Snapshot Breakdown of EM LCY Index Returns: 31/12/95 to 31/12/16](image)

- Ann. Return
- Snapshot Breakdown of EM LCY Index Returns:
- 31/12/95 to 31/12/16
- 7.3% Earnings Growth
- 2.8% Dividends
- 1.2% Valuation
- 8.9% Total Return
- 3.2% FX
- 5.7% USD Return

- 31/12/95 to 31/12/16
Crisis are a prevalent feature of EM

- Price controls, leverage buildups, currency and maturity mismatches, thin markets and reliance on external financing introduce non-linearities in macro and market responses to shocks.

Notes: This graph shows the average number of financial crises in respective decades.

Source: Claessens and Kose
Policy frameworks have been changing

- Price flexibility provides some buffers
- Investors are more discerning across EMs

Source: Levy-Yeyati and Sturzenegger (2016)
Taper Tantrum 2013

• Impact was large, but did not lead to traditional “crises”

• Two main drivers:
  1. EM Fundamentals
  2. Policy signalling channel

Source: Federal reserve Bank of San Francisco (2014)
FX moves were in line with fundamentals

- **Vulnerability Index:**
  - Current Account to GDP ratio
  - Gross Govt Debt to GDP
  - Average inflation over past 3 years
  - Ratio of external debt to exports
  - Ratio of FX reserves to GDP

*Source: Monetary Policy Report, February 2014*
Policy signalling also mattered

- Fed policy = \( f(r^*, \text{output gap, inflation vs target, "X"}) \)

- Uncertainty over “\(X\)” factor:
  - Asset prices?
  - Financial stability?
  - Credit growth?
  - Change in preferences or reaction function?
Managing expectations

Fed Longer-Term Dot vs OIS

25-Jan-12  08-Jun-13  21-Oct-14  04-Mar-16  17-Jul-17

5y5y OIS  Longer-term Dot
The situation today (1)

• Vulnerabilities have fallen for “Fragile 5”, but risen elsewhere
The situation today (2)

- EMs remain vulnerable to the global risk environment, DM interest rates, and the US dollar

Source: Jon Anderson, EM Advisors
China remains a key risk factor for EMs

Source: Jon Anderson, EM Advisors
Conclusion

• EMs have undergone structural changes over the past 20 years that have resulted in more robust policy frameworks

• But, EMs remain vulnerable to the global risk environment. Issue is not so much about interest rate increases per se but a spike in global risk aversion and a sharp moves in the USD

• China remains a source of risk. Will it amplify or dampen Fed shocks?