Karolina Konopczak, Michał Konopczak

Warsaw School of Economics

karolina.konopczak@sgh.waw.pl, michal.konopczak@sgh.waw.pl

Capital inflows to emerging markets – is greater vulnerability to sudden stops embedded in the sovereign risk premium?

Foreign capital plays a crucial role in fuelling the rapid development of many emerging economies whose relatively scarce domestic savings are insufficient to cover their financing needs. As a result, a number of developing countries have significantly increased their reliance on non-residents. In recent years, the process gained momentum with an extensive search for yield by international institutional investors driven by near-zero interest rates and unconventional monetary policy pursued by a number of major central banks. Such appetite for emerging markets' assets, sovereign bonds in particular, should push yields down, lowering the fiscal costs of acquiring market financing. On the other hand, systematic inflows of foreign capital to emerging economies may lead to greater vulnerability to sudden stops. Hence, an inflow of foreign capital induces two opposing effects on sovereign bond yields: a downward pressure of increased demand (the demand effect), and an upward pressure reflecting higher probability of default (the vulnerability effect), with the overall impact being the net effect of both. It can be argued that the net effect of capital inflows changes with time-horizon, with the demand (vulnerability) effect expected to be relatively stronger in the short run (long run).

Using data on 14 emerging markets covering the period of 2004–2015, we seek to examine the impact of changes in the share of public debt held by non-residents on the sovereign risk premium at different time-horizons. To this end, panel cointegration analysis has been applied. The sovereign risk premia, especially in the case of emerging economies, are under strong influence of global risk aversion (Forbes and Warnock 2012), resulting in their considerable co-movement (Cerutti et al. 2015). In the context of panel cointegration, this poses risk of cross-sectional dependence and, consequently, inconsistent estimates. Therefore, the cointegration analysis has been performed by applying the common correlated effects (CCE) methodology proposed by Pesaran (2006) and extended by Kapetanios et al. (2011), Pesaran and Tosetti (2011), and Chudik et al. (2011).