Emerging market bond flows and exchange rate returns

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Summary

Focus

We study the relationship between international bond portfolio flows and exchange rate returns across a range of emerging market economies (EMEs). In particular, we investigate whether international bond flows are correlated with subsequent exchange rate changes, and if such a relationship could be exploited as a portfolio strategy.

Contribution

We contribute to the literature on the predictability of exchange rate returns by studying a novel leading indicator: international portfolio flows to funds investing in bonds. Our focus is on EMEs, which helps shine a light on the importance of portfolio flows for exchange rate fluctuations in such economies. As a result, we identify a new flow-based risk factor that is priced in the cross section of EME currencies.

Findings

Using a portfolio approach, we find evidence of a positive relationship between bond flows and future exchange rate returns of EMEs, which is not present for advanced economy currencies. EME currencies tend to depreciate following large bond outflows, while they tend to appreciate following inflows. A dollar-neutral portfolio that goes long in inflow currencies and shorts outflow currencies earns large excess returns that are not correlated with ones from known international portfolio strategies. This reflects the existence of a flow-based risk factor that is priced in EME currencies. It is consistent with investors requiring compensation for the risk that countries experiencing large portfolio inflows today could be facing a future tightening of their aggregate financial conditions.

Abstract

We study the relationship between international bond flows and exchange rate returns for a panel of emerging market economies (EMEs). Specifically, we investigate whether international net bond flows are correlated with subsequent changes in the value of the local currency against the US dollar. Using a portfolio approach, we find evidence of a positive relationship between bond flows and future exchange rate returns of EMEs, which is not present for advanced economy currencies. EME currencies tend to depreciate following large bond outflows, while they tend to appreciate following inflows. A dollar-neutral portfolio that goes long in inflow currencies and shorts outflow currencies earns large excess returns that are not correlated with ones from known international portfolio strategies. Moreover, using an asset pricing approach, we find strong evidence that a risk factor implied by this result is priced in the cross-section of currencies. These findings are consistent with investors requiring compensation for the risk that countries experiencing large portfolio inflows today could be facing a future tightening of their aggregate financial conditions.

JEL classification: F31,G12, G23, G24.

Keywords: Bond ows, exchange rate dynamics, financial conditions.