

Comment on “The Role of U.S. Monetary Policy in Global Banking Crises”

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Summary of the paper

- It examines the effect of U.S. monetary policy on global financial stability with data from 69 countries over the period 1870-2010.
- Finding: U.S. monetary tightening raises the probability of banking crises for those countries with direct linkages to the U.S.,
 - in the form either of trade links or
 - large share of \$-denominated liabilities.
- But if a country is integrated globally, without direct US exposure, the effect is ambiguous.

Motivation: Will rise in US interest rates trigger a new EM crisis?

- History

- 1980-82 Volcker tightening => international debt crisis.
- 1994 Greenspan tightening => Mexican peso crisis.
- Last 5 years of advance tremors,
as US monetary ease reverses & interest rates rise:
 - Spring 2013 “taper tantrum”
 - Mid-2014 rise in \$ & fall in commodity prices
 - Mid-2015 RMB shock
 - Mid-2018 Argentina-Turkey turbulence.

Some literature

- Rey (2013), Forbes & Warnock (2012), Jordà, Schularick, Taylor & Ward (2018)...
 - US i \uparrow \Rightarrow VIX \uparrow \Rightarrow Capital outflows from EMs
 - VIX allows including 2008 GFC on the list of US-origin EM crises.
- “Prominent early examples include...(1998)...(1999).”
- But it did not start with them.
 - Among many possible precedents,
 - consider Calvo, Leiderman & Reinhart (1992, 93, 94)
 - = prescient warnings from the IMF Research Dept.
 - CLR (1993) -- two years before the Mexican peso crisis:
“The importance of external factors suggests that a reversal of those conditions may lead to a future capital outflow.”

Verdict on the paper: Good job.

- Congratulations, for example, on the length & breadth of the data set:
 - Crises deemed unforecastable “black swans” with a data set of only a few decades or countries, can be seen as well inside the knowable probability distribution when using a 140-year sample of 69 countries.

Independent variables

- Shocks: increases in US 3-month T bill interest rates,
 - including surprises, from Romer & Romer (2004) & others.
- interacted with cross-border integration
 - bilateral vs. global.
 - Trade integration:
 - bilateral trade intensity with US
 - Vs. overall trade/GDP,
 - both instrumented by gravity-based geographical determinants. (I approve.)
 - Financial integration:
 - \$ liabilities/GDP (choosing to focus on currency mismatch)
 - Vs. overall capital account openness index of Chinn-Ito.
- Tried-and-true.

Dependent Variable

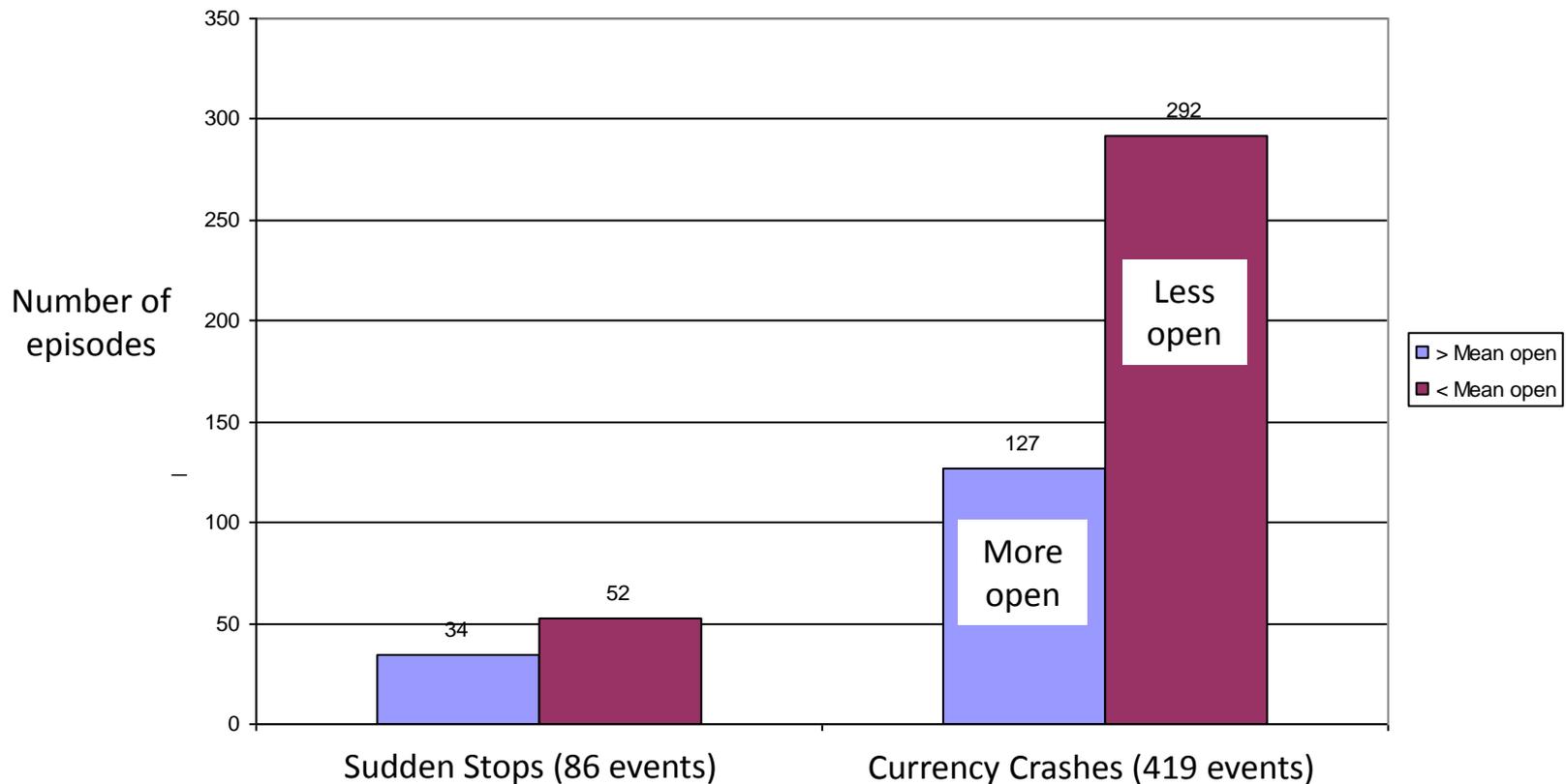
- Systemic banking crises
 - from Reinhart & Rogoff (2009) in logit form.
 - Also other crisis databases, as robustness check.
- Also, to test the channel of transmission:
 - Portfolio capital outflows.
- Controls include:
 - growth,
 - inflation, and
 - institutional quality.

Finding: EM exposure to US & \$ increases crises,
but general global exposure does not.

- The absence of negative effect for global exposure may seem surprising.
- The authors' explanation is that perhaps open countries without direct bilateral US exposure benefit when capital flows are diverted away from those who do have it.
- Cavallo & Frankel (2008), which the authors kindly cite,
 - found that trade/GDP openness *reduced* crisis vulnerability.
 - Our interpretation was that a large tradable sector
 - 1) “gives hostages” to trade partners, re-assuring creditors, or
 - 2) reduces the percentage of demand contraction necessary to adjust to a given cut-off in foreign funding.

Sudden stops & currency crashes are less frequent in open economies

Sudden Stops & Currency Crashes by trade/GDP



Cavallaro & Frankel (2008), "Does Openness to Trade Make Countries More Vulnerable to Sudden Stops, or Less? Using Gravity to Establish Causality," *JIMF*.

Quibble & suggestions

- Quibble:
The authors use “negative monetary policy shock” to mean monetary *expansion*.
 - It can be confusing, if “negative” makes you think of either “adverse” or a reduction in money supply.
- Suggestion for future work:
Explore some possible transmission mechanisms --
 - The role of the VIX.
 - The role of the \$ exchange rate, esp. for \$-debtors.
 - The role of commodity prices, for commodity-exporters.

The authors' policy conclusion

- “Countries could diversify their global trade exposure and also reduce their dependence on \$-denominated debt.”
- The advice to reduce \$-denominated debt has been standard at least since the 1990s.
 - Some EM governments have heeded it, to their benefit,
 - though EM corporates seem to have forgotten it,
 - which is likely to cause trouble.
- The solution is *not* to borrow in other foreign currencies,
 - but to issue local-currency debt, or equity, or FDI.
 - Or do without.
- Final note: The advice to diversify trade away from the US suddenly seems wise, on other grounds!

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References

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Appendix:

Trade openness may reduce EM vulnerability to crises

Dependent variable: Crisis episodes.

IV Probit

| | |
|--|---------------------|
| Trade openness _{<i>t</i>-1} | -1.48 (0.54) *** |
| Ln reserves in months of imports _{<i>t</i>-1} | -0.3 (0.07) *** |
| Exchange rate rigidity index _{<i>t</i>-1} | 0.15 (0.08) * |
| Regional dummies? | YES |
| Year fixed-effects? | YES |
| Observations | 583 |

Robust standard errors reported in parenthesis: *significant at 10%; **significant at 5%; and ***significant at 1%.

Cavallo & Frankel (2008), "Does Openness to Trade Make Countries More Vulnerable to Sudden Stops, or Less? Using Gravity to Establish Causality," *JIMF*. 14