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

by C. Bora Durdu, Alex Martin & Ilknur Zer

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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
  - 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

  – US i ↑ => VIX ↑ => 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,

• 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
  – 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

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

Appendix:
Trade openness may reduce EM vulnerability to crises

Dependent variable: Crisis episodes.

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<th>IV Probit</th>
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Robust standard errors reported in parenthesis: *significant at 10%; **significant at 5%; and ***significant at 1%.