The Role of US Monetary Policy in Banking Crises Across the World

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MAIN IDEA OF THIS PAPER

- Question:
  Do changes in US monetary policy trigger banking crises in other countries?

- Approach:
  Run panel regressions on data from 67 countries spanning the period 1870-2010

- (Short) answer:
  Yes

SUMMARIZED IN ONE EQUATION

$$\log\left\{\frac{C_{it}}{1-C_{it}}\right\} = \beta_1 \, \text{exposure}_{it} + \beta_2 \, \text{exposure}_{it} \times \text{MP}_t + \text{controls} + \text{FE} + \varepsilon_{it}$$

▶ C_{it}: banking crisis indicator in country i

▶ exposure_{it}: country i's exposure to the US

$\rightarrow$ indirect & direct

$\rightarrow$ trade openness, trade intensity with US, USD liabilities

▶ MP_t: US monetary policy change (shock)

MAIN FINDINGS

▶ 1pp tightening in US monetary policy increases banking crisis probability by 1-7pp

▶ Being 'globally' integrated – and only indirectly with the US – does not increase banking crisis probability

HIGHLIGHTS OF THE PAPER

- ▶ Great data effort

  - ▶ Combine Reinhart-Rogoff banking crises data base, US monetary policy changes (numerous approaches), exposure measures from various sources, . . .

- ▶ Authors carefully address conceptual and data challenges

  - ▶ Exploit different methods to identify monetary changes/shocks
  - ▶ Exogenous trade openness based on gravity IV approach
  - ▶ Zoom in on regimes, e.g. Gold Standard
  - ▶ . . .

- ▶ Results are very nicely organized

PLAN FOR THIS DISCUSSION

1. Mechanism and relevant control variables

2. Is US monetary policy "special"?

3. Boom-bust timing

- ▶ Let me jump in right on the authors' discussion of the mechanism

- ▶ The authors postulate the following channels (driving the strong direct effects)

  1. Trade channel
  2. Capital flows channel
  $\rightarrow$ USD liabilities exacerbates capital flows channel

- ▶ To what extent should we control for variables that are part of the mechanism?

▶ <u>Trade channel:</u> FFR ↑ ⇒ US demand for imports ↓ ⇒ country i's exports ↓ ⇒ country i's economic activity ↓ ⇒ $prob$(banking crisis in country i) ↑

▶ Capital flows channel: FFR ↑ ⇒ US demand for investments abroad ↓ ⇒ country i's economic activity ↓ ⇒$prob$(banking crisis in country i) ↑

▶ **Adding GDP as a control sweeps out variation that is part of the theoretical channel, so should we control for it?**

  ▶ An analogous point could be made about inflation
  ▶ It could be that the actual effect is much bigger when not controlling for the *relevant* variation in activity and inflation

- An alternative way to construct controls that I have thought about:
    - Run a country-level SVAR in output and inflation
    - Identify demand and supply shocks à la Blanchard-Quah
    - Use identified shocks as controls in cross-country panel regression

- Would be an attempt to capture 'exogenous shifters' in activity and inflation, instead of variation through which US monetary policy may operate

- Could be a useful suggestion for other approaches in which panel regressions are run to answer macro questions . . .

IS US MONETARY POLICY "SPECIAL"?

▶ The <u>direct</u> mechanisms laid out in the paper apply to any two countries

▶ Possible interpretation of the weak <u>indirect</u> results: US is not "special"

▶ However recent research suggests that there should be indirect channels through which US monetary policy matters

  ▶ In particular, USD is common invoicing currency in global trade
    (Gopinath et al., 2020 AER)

▶ How can we square paper's results with these recent discussions?

IS US MONETARY POLICY "SPECIAL"?

- ▶ If I understoof correctly, the paper interprets the importance of USD liabilities mainly as an amplifier of the (direct) capital flows channel
  - ▶ But maybe this exposure measures the special role of the USD
  - ▶ Countries with high degree of USD credit also likely to invoice in USD?

- ▶ Could investigate this more directly:
  - ▶ Collect exposure measures related to invoicing
  - ▶ Run baseline with another country as the center, as 'placebo'

TIMING

- It may be worthwhile thinking more explicitly about timing

- To me it is plausible that EM results shine through strongly

  - Many of these economies experience sharp capital flow reversals

- It could be that same goes on in advanced economies, but at lower frequency

- Could construct *impulse response functions*, by adding on LHS:

$$\log\left\{\frac{C_{it+k}}{1-C_{it+k}}\right\} \quad k=1,\ldots,K$$

SUMMING UP

▶ Important question and impressive effort

▶ Gives us food for thought to dig deeper

▶ Perhaps my suggestions are helpful for the next paper