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Short Communication

Comments on “U.S. monetary policy and fluctuations of international bank lending”



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The authors show that the effect of the US monetary policy on banking flows is asymmetric. The effect will differ not only by different banking flow regimes, but also what the US monetary policy captures. During the boom regimes, if the federal funds rate is high then there are more flows into the emerging markets. This is the search for yield interpretation and it's going to be captured by the fundamental Taylor rule component of the US monetary policy. During the stagnation phase, there's low activity in the emerging markets with a high federal funds rate. This captures high cost of funding and flight to safety. The interpretation is such that, this is the monetary policy stance component.

These boom and bust banking capital flow regimes are correlated with three usual suspects: change in volatility—VIX, credit spreads and the exchange rate. The authors focus on the exchange rate correlate to interpret their results. During a dollar appreciation episode, emerging markets are depreciating, so they are less credit worthy and capital flows out. During the dollar depreciation episodes emerging markets are appreciating, they are more credit worthy, and receive flows. The reason for the authors' interpretation is because their findings on federal funds rate and the exchange rate go hand in hand. When federal funds rate goes up and if this increase captures fundamentals, then there are more flows into the emerging markets, and the dollar depreciates. When federal funds rate goes down, and if this decrease captures monetary policy stance, then there are less flows to emerging markets, and the dollar appreciates.

The concern here stems from the fact that banking flow regimes are endogenous to fundamentals. Both US fundamentals and emerging market fundamentals will affect capital flows. The authors show that the relationship between US monetary policy and banking flows is time variant. There can be many time variant factors—time variant fundamentals—such as demand for credit by emerging market borrowers, which will determine flows in and out of emerging markets. These type of borrower/lender specific factors will be non-linear and time varying and hence may drive the authors' results.

For example, in the panel regressions, “i” is a borrower, “j” is a lender, and “t” is a quarter. If emerging market “i”'s monetary policy responds to another emerging market “j”'s policy, and if “j”'s policy responds to the US monetary policy, then there will be a correlation between the US monetary policy and the borrowers demand for credit in the emerging market in question, that is “i”. In this case, capital flows into country “i” is going to be correlated with the US monetary policy and will not be *caused* by the US monetary policy.

As a result, the overall interpretation needs some scrutiny. During the dollar appreciations when the monetary policy captures the stance, emerging markets have capital flows coming out and during dollar depreciations, capital flows coming in, if monetary policy capture fundamentals. This interpretation rests on balance sheet currency mismatch in emerging markets. Because only then, when your currency appreciates against the dollar, your debt is now lower value.

What is the evidence on the currency mismatch on the emerging market balance sheets? Sovereigns used to have this type of balance sheet mismatch problem, known as original sin, but they do not suffer from such a problem anymore. The problem of original sin is now acute for corporates but there is also a lot of heterogeneity among emerging markets' corporates. There are emerging markets where 50% of firms' borrowing are in dollars, but there are others where it is only 10%¹.

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¹ What Hinders Investment in the Aftermath of Financial Crises? Insolvent Firms or Illiquid Banks?, with Herman Kamil and Carolina Villegas-Sanchez Review of Economics and Statistics, October 2016, Vol. 98(4), 756–769.

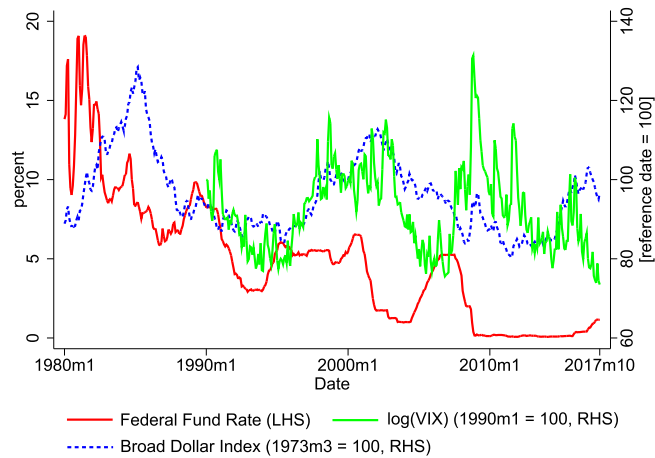


Fig. 1.

And maybe due to this type of heterogeneity, when we plot broad dollar index, the interest rate differential and the VIX, the relation between the three is not as clear as the authors were depicting. An appreciation, high FFR and stagnation do not always go together as argued by the authors (see Fig. 1). This might also be due to the fact that emerging markets manage their exchange rates.

To sum up, the asymmetric result is a nice result, it's new and interesting. What channel explains this result is an important open question. If the problem of the endogeneity of the regimes is solved, then we can know more on the channel that is behind the result.