BROOKINGS

Discussion of Sebnem Kalemli-Ozcan and Filiz Unsal, "Global Transmission of FED Hikes: The Role of Policy Credibility and Balance Sheets"

Gian Maria Milesi-Ferretti
Hutchins Center on Fiscal and Monetary Policy

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What the paper is about

Main question:

a. How have EMDEs coped with US MP tightening over the past 3 decades?

b. How about the ongoing tightening episode?

Answer:

a. EMDEs historically more vulnerable to US MP tightening than AEs

b. Surprisingly well!

Follow-up question: what factors help explain this?

Emphasis on:

- Strength of monetary policy frameworks (MP credibility)
- Reduction in overall FX exposure

Main conclusions

- Interesting new data on central bank frameworks! Hope to see more on these data soon

- Conclusions quite sensible

  - The main EMs have certainly become more resilient
  - Stronger institutions, importantly including MP frameworks, clearly at play
  - Reduction in FX exposures crucial
  - [other correlated factors likely to matter too!]

Main comments and suggestions

1. *Is the response to US MP shocks the same across*
    - *A. different time periods*
    - *B. different country groupings*

2. *Provide more evidence on the trade channel*

3. *Present a more nuanced picture of the latest tightening episode*

4. *Is the full impact of US MP tightening captured by "shock" measures and other comments*

Comments

(i) When did EMs become more resilient?

- Text of paper correctly suggests ongoing process, starting from the 1990s…
- …but empirical work treats the 1990-2020 period as one (with stable coefficients), and then compares with 2021-22
- EM crises declined substantially in frequency since the early 2000s (including during the GFC episode and the taper tantrum).
  - More flexible exchange rates
  - Strengthened MP frameworks and institutions
  - Improving NIIPs
  - Reduced FX exposure
    - Rising external financing through equity instruments (FDI, portfolio)
    - Accumulation of FX reserves
    - Some external borrowing in domestic currency (mostly government)
- Worth considering a comparison of, say, 1990-2004 with 2005-20

Comments

(ii) Samples and the consequences of shocks

- Broad "baseline" sample includes lower-income countries (eg Malawi, Uganda, Zambia) and "frontier" EMs (Moldova, Kyrgyz rep., Tunisia)
  - Concern: *The empirical exercise assumes that the reaction to a US MP shock is the same across all these countries as well as over time. Worth choosing smaller samples that are more homogeneous*
- A lot of different samples to keep track of (baseline sample, sample with CB credibility data, sample with FX exposure data)
- Sample for FX exposure is very limited. 16 countries, of which one is a hard peg (Saudi Arabia), one is an advanced economy (Korea) and one is Argentina
  - *The only use of the FX exposure data is to separate countries in two bins*
  - *Then why not use alternative measures of FX exposure available for more countries? Net FX position in the IIP? Net external debt?*

Comments

(iii) Trade channel

- Theoretical discussion highlights trade and financial channel, but the relevance of the former is dismissed (too cursorily in my view)

- Paper could report the impact of MP shocks on export and import volumes. GDP decline most likely associated with a compression in domestic demand (especially investment and hence imports) but would be nice to check (and would also better complement the theoretical discussion of the channels).

Comments

(iv) The latest episode

- Most large EMs (esp. in Latam) had started MP tightening much earlier
- Other factors concurrent with US MP tightening matter
  - Commodity price increases net positive for EMDEs
  - Global recovery from COVID
- While the main EMs were quite resilient, several frontier EMs and many developing economies in dire straits
  - Many low-income countries in debt distress…
  - …but also EMs (Sri Lanka in default but problems also in Egypt, Pakistan, Tunisia….)

Other comments

- **Relevant measure of US MP to assess macro impact on EMs.** MP "surprises" crucial in assessing responses of asset prices. But is something missed about the impact of "systematic" monetary policy when looking at macro repercussions? MP decisions could be perfectly predicted at the time of the FOMC decision, but be a massive surprise when viewed over a horizon of 6-12 months.
- **Key factors**. Very strong correlation between MP credibility and FX exposures. Are we measuring two different channels? Could other measures of FX exposures help assess whether these factors work separately?
- **Results**. Baseline suggests MP policy *easing* in EMs when US MP tightens. Same as in De Leo et al (2022) but still surprising, especially in a broad sample including countries with low MP credibility. How does this relate to the arguments on reduced MP autonomy by EMs because of global fin. cycle considerations?
- **Risk-off episodes.** This paper is about US MP tightening, not about shifts in risk aversion. In that regard the response to shocks to VIX or EBP seem less relevant to the question the paper asks.