Tim Phillips [00:00:00]:
Today on VoxTalks Economics, breaking the link between Fed rate hikes and financial crises. Welcome to the first of a series of VoxTalks recorded live at the Centre for Economic Policy Research, Paris Symposium 2023. My name is Tim Phillips. Now, you might have noticed that the Federal Reserve has been rapidly raising rates, and in the recent past this would have caused a red alert in central banks of emerging markets and developing economies, but not this time. So why not? Şebnem Kalemli-Özcan of the University of Maryland is one of the authors of a new paper that explains why this time it's different. And she gave a keynote on this topic, and she's also joining me now. Şebnem, welcome back to VoxTalks.

Şebnem Kalemli-Özcan [00:00:57]:
Hi, Tim. It's a pleasure to be back here.

Tim Phillips [00:00:59]:
I'm standing between you and your dinner. For context on this, let's go back to May 2013, and that's the period we now know as taper tantrum. Taper tantrum. I love that phrase. What did the Fed do at this time to cause this tantrum?

Şebnem Kalemli-Özcan [00:01:18]:
So in May 2013, Tim, Ben Bernanke, the chair of Federal Reserve that time, made a speech, and the speech wasn't about hiking the interest rates or Fed monetary policy, it was about Fed monetary policy, but it was a mere signal of start of Fed hikes. So it's kind of like he indicated that Federal Reserve may start tightening the monetary policy, and just that signal caused capital outflows, exchange rate depreciations, and on several important emerging markets, some significant stress.

Tim Phillips [00:01:54]:
In this paper, you've compared the impact of the taper tantrum in Mexico just below the United States, Canada sitting just on top of the United States. Why did you pick those two economies?

Şebnem Kalemli-Özcan [00:02:06]:
We thought Mexico and Canada really provides a very good narrative. They are the two closest neighbors of the United States. That's obvious. But something that is maybe not that obvious is they're under a trade agreement, NAFTA, with the US, and they have a lot of trade with the US. So this trade channel of US monetary policy transmission probably work the similar way on Mexico and Canada. But what we focus on this paper, the financial channel of US monetary policy transmission, is going to work very differently on those countries, just because Mexico is an emerging market and Canada is not.

Tim Phillips [00:02:39]:
I can't really describe in a podcast what the graphs look like, but the lines go in different directions, don't they? What was the impact?

Şebnem Kalemli-Özcan [00:02:46]:
Exactly! So again, during Taper Tantrum, this event, May 2013, a speech of Bernanke and that whole quarter, we show in the paper that even both Mexican exchange rate and Canada exchange rate vis a vis the United States dollar depreciated. The risk premium was very different in both countries. Both ten year government bond spreads, which picks up the long term risk premium, and also UIP wage, which is what is known as uncovered intersperity wage, which is a short term risk premium. They both increase in Mexico but not Canada during that taper tantrum event.

Tim Phillips [00:03:26]:
So let's try and explain this. So at this time, and there have been previous episodes, haven't there, where the US Fed has raised policy rates or signaled it's going to raise the rates. Why is this transmitted to emerging market economies like Mexico?

Şebnem Kalemli-Özcan [00:03:41]:
You're exactly right, Tim. There are different episodes that this happened. Taper Tantrum, the most recent one to today, 2013. But there are very famous episodes like in the 70s and 80s. Volker disinflation that led to Latin American debt crisis, the '94 fed hiking, that led to Asian crisis. So these events happened a lot historically. So after showing this Mexico Canada example from 2013 taper tantrum event, we go back to 1990s and take all the data from 1990s till 2020 and then ask why is it that emerging markets affected worse from these fed hikes during these historical episodes? And we discovered the importance of two facts. Ofcourse, there might be many, many reasons emerging markets have a lot of problems compared to advanced countries, but these two facts really stand out to them. And this is monetary policy credibility, or actual lack of monetary policy credibility, and the extensive dollar denominated debt in these countries that made emerging markets so called a risky asset class for investors. And that's why when Fed tightened, when Fed hiked the interest rate, historically, global investors took their money out from emerging markets as they are risky.

Tim Phillips [00:04:56]:
Yeah, explain this to me in a bit more detail. So let's say there's an emerging market central bank, it's got a lot of dollar denominated debt, and the rates go up from the Fed and it decides not to match those rate rises. What happens next?

Şebnem Kalemli-Özcan [00:05:13]:
Yes, I mean, of course that's one option that emerging market central bank has, right? They can also increase their interest rate. So to match that US rate rise to prevent the depreciation in their currency. Because if they don't do that, you are right, if there's a lot of dollar debt now, their currency is going to depreciate vis a vis the US dollar, that dollar debt is going to be increasing in its burden. Right? So there were emerging markets that tried to mimic the Federal Reserve interest rate hikes in order to prevent that. But unfortunately, if their economies, at the same time were also slowing down because capital flows are also getting out of the economies. Then increasing the interest rate in their own economy is just going to make everything worse, right?

Because a slowing down economy is going to call for lower interest rate and a depreciating currency, of course, going to make these central banks to want to increase the interest rates. And they always had this dilemma. And then most of the time, actually, we show in another paper that they decreased interest rates in their own country because their economies also slowed down. And then of course, in that situation, dollar debt makes your life very difficult. In fact, without the dollar that you wouldn't be increasing the interest rates, right? You wouldn't have any incentive to mimic the Fed hikes. But that ties their hand and that made their life very difficult. So what we actually show in the paper, one of the key reasons that this time is different, these economies reduce the amount of dollar debt in their economy and they also increase the monetary policy credibility. Meaning when fed hike happens and their exchange rate depreciate and capital flows out, they can actually meet the expectations and the situation in their own economy by lowering their interest rates, because they don't have that much dollar debt. So depreciation is not going to hurt them that much and their economy is slowing down. So by lowering the interest rate, they are going to stimulate the economy.

Tim Phillips [00:07:02]:
But the reason why we talk about emerging markets for this and the transmission is different for advanced economies.

Şebnem Kalemli-Özcan [00:07:09]:
Because of the risk premium channel in the advanced economies. Of course, as going back to the Canada example, the Canadian dollar also depreciated vis a vis, the US dollar. But the issue is investors don't price this as a risk premium for Canada, but they price it as a risk premium for Mexico. And the reason is because Canada doesn't have that much dollar debt and their central bank have way more credibility than the emerging market central banks. That's exactly why investors don't price this as a risk premium on Canada.

Tim Phillips [00:07:36]:
So let's wind this forward nine years from the taper tantrum and we're in 2022, US inflation tops out at 9.1%. For anyone who hasn't been paying attention over the last year and a half, what did the Fed do?

Şebnem Kalemli-Özcan [00:07:51]:
Fed start hiking the interest rates.

Tim Phillips [00:07:53]:
Yes, quite a lot. And very regularly.

Şebnem Kalemli-Özcan [00:07:57]:
Exactly. Actually, people keep forgetting this, but it's unbelievable. They increased the interest rate 5.5 percentage points in less than 15 months. That's quite an aggressively tightening monetary policy on the US part.

Tim Phillips [00:08:09]:
So given this history of transmission of rate hikes in late 2022, you and your colleagues, you're looking at the possible impact on emerging markets. Are you worried for them?

Şebnem Kalemli-Özcan [00:08:22]:
Actually I wasn't. I wrote an early piece on finance and development for IMF and I actually had a question mark, a new taper tantrum? Because of exactly this. Because I was looking at this data for quite some time and I realized not all emerging markets, but many of them, their central banks, were doing a very good job. They were ahead of the curve. In fact, some of them started increasing their own interest rate before the US because they also were affected from global inflation linked to Covid and supply chain issues. So this also goes back to central bank credibility. Because you have an inflation problem, you address it. Right? And then I wasn't that worried given that they do their job right, and also they reduce their dollar debt. And then fed also kept, especially in 2000 and 2021 monetary polls easy before they start hiking. So there was a lot of leeway that, okay, we don't have a global liquidity problem and these guys are on top of their job. So probably this wasn't going to turn into a taper tantrum this time around.

Tim Phillips [00:09:23]:
So we've mentioned that they reduced their dollar debt. The other thing that we've mentioned is that they've done better about credibility.

Şebnem Kalemli-Özcan [00:09:32]:
Yes, and this is super important. In fact, they are related. They couldn't have reduced dollar debt if they didn't improved their monetary policy credibility. Let me explain this to you, with monetary policy credibility, in this paper, we are using actually a new data set on this put together by the IMF. And my co author Filiz Unsal and her team put this together by going over thousands and thousands of legal documents and state central bank statements from all these emerging markets. And the idea here is to really measure the monetary policy making another regime. So when we talk about monetary policy credibility, people think about independent central bank, inflation targeting, floating exchange rates, like regime type of classifications. Right. All important. That's of course where you start. But the problem was even you start with that, even your intentions were good. And you say, I have an inflation targeting regime, I have an independent central bank. This might just stay on the paper, right? When you look at the action, it might be something very different. And Turkey is a very good example for that. Turkey is an inflation targeting country, US is an inflation targeting country. And monetary policy credibility cannot be as different between these two countries. So in that sense, monetary policy credibility is really about the actions of central bankers, monetary policy making. Simply put, are they doing what they say? Exactly. Do what you say you are doing. So that's really how we measure this.

Tim Phillips [00:10:53]:
Right. And in this measurement, you've actually managed to transform this into some kind of data. This isn't any more opinion. They're doing what they say they're doing. You're measuring

it.

Şebnem Kalemli-Özcan [00:11:02]:
Exactly. So this is this whole process of my co author, Filiz Unsal and her colleagues at IMF went through by reading all these documents and really comparing these. Okay, this is what is on the paper de jure and de facto, were they following it, how much they were deviating, like for example, inflation targeting regime, how transparent it is when they have these monetary policy meetings, were they also issuing a statement? If in the statement are they saying things like, we are going to tighten the monetary policy because inflation expectations being deanchored, which would be a credible action, or they are saying something like, oh, we want to stop the depreciation of the exchange rate. That wouldn't be credible because an inflation targeting central bank wouldn't use monetary policy rate for exchange rate purposes. Right. So these are the things. Exactly. They were looking and measuring and turning these documents into an index. And this is an index between zero and one and higher you are, it means your actions are really very transparent, very accountable, and exactly what you say on the paper, as opposed to if you are below. That's not the case.

Tim Phillips [00:12:02]:
So we have some excellent news. The emerging market economies seem to have been managed well. There was no taper tantrum this time. You were right. And we have enhanced policy credibility as well. Has this worked just to avoid a crisis this time? Or is this policy credibility having another beneficial effect on the economies? We had some pretty dire predictions about what was going to happen to growth. Have those predictions been borne out or have they done better than expected?

Şebnem Kalemli-Özcan [00:12:36]:
I think growth question is more complicated because there are many more things happening, right? I mean, from AI to the supply shocks, energy shocks. So there's a lot like goes directly to investment and the production side of many, many economies. But in terms of the benefits of this monetary policy credibility, of course that goes to the stabilization of the policies, short run stabilization, right. If you have monetary policy credibility, then both controlling the inflation and now when inflation turns and starts coming down, if the economy slowed down, then turning back and then helping your economy to stabilize, if something also goes back to monetary policy credibility. So in that sense, they can smooth out these bumps and shocks better. Right. And that's actually the first step before growth if you think about it, because I mean, no economy is going to grow if you have a lot of uncertainty in your economy and it's kind of a bumpy ride all the time. So monetary policy credibility is going to help to smooth out that bumps. But I also want to say nothing happened so far, but we are talking about emerging markets. There's also these poorer countries, developing countries. They actually came a lot under stress because they have a lot of sovereign debt. This is now government debt. And of course, now the servicing of that debt is at a higher cost because interest rates globally are higher. Right. So that's still an issue of concern. We can have still crisis that part of the world. I mean, it's more linked to sovereign debt than what we're trying to focus in this paper, the corporate sector,

private sector dollar debt being less and central banks being more credible among the emerging markets, not poorer developing nations.

Tim Phillips [00:14:08]:
Yes. So we would hesitate to say that there's a huge amount of good news in global economies at the moment, but at least some of the really bad news was avoided.

Şebnem Kalemli-Özcan [00:14:18]:
That's exactly right.

Tim Phillips [00:14:19]:
Şebnem, thank you very much.

Şebnem Kalemli-Özcan [00:14:20]:
Thank you very much.

Tim Phillips [00:14:30]:
If you want to read some more detail on this, then the paper Şebnem and Filiz Unsal 2023 Global transmission of Fed hikes: The role of policy credibility and balance sheets. And that's got all the graphs that I didn't describe to you.

[Voiceover] [00:14:49]:
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