Comments on *U.S. Monetary Policy and Fluctuations of International Bank Lending* by Stefan Avdjiev and Galina Hale

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The key finding in the paper is the asymmetry result. Let me explain this result. The authors show that the effect of US monetary policy on banking flows is going to differ not only by the different banking flow regimes, like boom/bust, but also what the US monetary policy captures. During the boom regimes, if the federal funds rate is high then there's going to be 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 fund rate. This captures high cost of funding, flight to safety, and hence the monetary policy stance component.

These boom and bust 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 deprecation 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 go up and if this increase captures fundamentals, then there is more flows into the emerging markets, and the dollar depreciates. When federal funds rate go down, and if this decrease captures monetary policy stance, then there is 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 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 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 “i” country is going to be correlated with US monetary policy and will not be *caused* by the US monetary policy.

The interpretation needs some scrutiny. During the dollar appreciations when the monetary policy captures the stance, emerging markets have capital falls 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. That's a quantity shock to your balance sheet.

What is the evidence on the currency mismatch on the emerging market balance sheets? Sovereigns used to have this problem but not anymore and for corporate balance sheets it depends on which emerging market are we talking about? There are emerging markets where 50% of firms’ borrowing are in dollars, but there are others where it is only 10%. This heterogeneity is clear 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.

One reason for this is the fact that emerging markets manage their exchange rates. Alternatively, there can be a violation of UIP, where emerging market interest rate is going to be a function of US interest rate, expected depreciation, and a country specific risk premium, where this country specific premium moves with VIX.

To sum up, the asymmetric result is a nice result, it's new and interesting. What channel explains this result is the big open question. More work is needed to pin down the endogeneity of the regimes which will help to the interpretation in terms of what channel being behind the result.