Fed Tapering and the Fortunes of Nations

This event was chaired by Guillermo Calvo, former Chief Economist of the Inter-American Development Bank and Director of the Program in Economic Policy Management at Columbia University’s School of International and Public Affairs (SIPA). The panelists were Jan Svejnar, Director of the Center on Global Economic Governance at Columbia SIPA, and Andrés Velasco, Professor of Professional Practice in International Development at Columbia SIPA, and former Finance Minister of Chile. Miguel Urquiola, Vice Dean for Academic Affairs and Associate Professor of Economics and International and Public Affairs at Columbia SIPA opened the discussion and introduced the panelists.

"Once again, we are witnessing a surprisingly large and surprisingly widespread shock stemming from the capital market. The shock came out of the blue, no conventional fundamental was directly involved, and the shock impacted all corners of the world” said Guillermo Calvo to start the discussion.

The characterization of the shock, the extent of its impact, the government policies to deal with it, and the prevention of future episodes were some of the foremost topics of the panel discussion sponsored by the Program in Economic Policy Management (PEPM) and Center on Global Economic Governance (CGEG), Columbia SIPA.

In his introductory remarks, Professor Calvo discussed issues such as: “What caused the shock? Was it the threat of Fed Tapering? Or was it the belief that the U.S.
recovery was well on its way, which, in the minds of investors, was confirmed by the talk about tapering at the Fed?” He then focused on the extent of the shock’s impact and the existence of major financial vulnerabilities that emerging markets have not been able to remedy, despite their sizable accumulation of international reserves.

In line with this, Andrés Velasco stated: “All financial systems, almost by definition, are vulnerable to a shift toward pessimistic expectations. But not all financial systems are created equal. In emerging markets (EMs), the fundamental vulnerability comes from the combination of dollarized liabilities and current account deficits. Together, these cause balance sheet shocks and credit contractions”.

Velasco also commented on the shock’s impact on Latin America, and the region’s future perspectives given its long-term productivity stagnation. “In recent years, growth decomposition shows growth from labor and capital, very little from productivity. And productivity is procyclical, so it will fall in the future”.

**Reactions to QE**

According to Jan Svejnar, “the Quantitative Easing (QE) that we have observed in the last two, three years started having effects as people suddenly had more money in developed countries, and they started moving money to EMs. The first QE had mostly effects on prices of bonds and stocks in the United States, or in the advanced economies. Whereas the second one, boosted equity prices worldwide”.

How did countries react to this? Svejnar cited the case of Latvia, which –in his opinion– decided to address the crisis in a very orthodox way, maintaining fixed exchange rates towards the euro. Latvia’s GDP plunged by 20 percent, but managed to resume growth relatively quickly. “To the other extreme, most countries that did not have flexible exchange rates adopted them, in order to be able to respond flexibly both in the short run and in terms of the export generation that comes with the depreciation of the exchange rate.”
Global Central Bank

The discussion of this global crisis led to the consideration of a global central bank. “Several countries were hit at the same time. It is not very different than what happened at the national level in the nineteenth century. And countries invented a national central bank to take care of that. But we don’t have a global central bank. And it is very hard to set up one, because the International Monetary Fund is very limited”, Calvo commented.

Is the Federal Reserve Bank the global central bank? Svejnar indicated: “It is. And along with the European Central Bank, they could be a good tandem if they coordinated more. During the crisis –at the beginning– they did not coordinate much. However, the markets coordinated for them”. Velasco added: ”Crisis prevention at the global level is our first best, but we have not done enough. At the national level, we need to move from the inflation-targeting framework”, he said, advocating for macro-prudential policies. Velasco concluded: “The crisis reminded us that at a time of panic, financial markets don’t work as usual. And standard tools do not work as usual; textbooks do not work at times of economic crisis”.

- Dariela Sosa, Research Assistant, CGEG

Watch the discussion here