



# Monetary policy and financial spillovers: Losing traction? <sup>☆</sup>



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## ARTICLE INFO

### Article history:

Available online 22 March 2017

### JEL classification:

E43

E50

F30

G15

## ABSTRACT

Has financial globalisation compromised central banks' effectiveness in managing domestic financial conditions? This paper tackles this question by studying the dynamics of bond yields encompassing 31 advanced and emerging market economies. To gauge the extent to which external financial conditions complicate the conduct of monetary policy, we isolate a "contagion" component by focusing on comovements in measures of bond return risk premia that are unrelated to domestic economic fundamentals. Our contagion measure is designed to more accurately capture, relative to simple yield correlation, spillovers driven by exogenous global shifts in risk preference or appetite. In contrast to what simple comovements in bond yields suggest, emerging market economies appear to be much less susceptible to global contagion than advanced economies and the overall sensitivities to contagion have not increased after the global financial crisis. The extent to which financial spillovers have compromised policy traction thus appears to be lower relative to studies based on common variation in bond yields.

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## 1. Introduction

Has financial globalisation compromised central banks' effectiveness in managing domestic financial conditions? In a provocative paper, [Rey \(2013\)](#) argued that the emergence of a global financial cycle has meant that for small open economies "... independent monetary policies are possible if and only if the capital account is managed, directly or indirectly via macroprudential policies" ([Rey, 2013](#), p. 287). This view suggests that the conventional monetary "trilemma" has morphed into a "dilemma" between monetary autonomy on the one hand and capital mobility on the other. This is in contrast to [Woodford \(2010\)](#) who argued that central banks' control over inflation has not diminished, and has in some respects been strengthened, by globalisation. [Obstfeld \(2015\)](#) and [Kamin \(2010\)](#) meanwhile take the middle road by acknowledging that financial spillovers complicates the task of monetary policy but independent monetary policy remains feasible for financially open

<sup>☆</sup> We would like to thank Claudio Borio, Dietrich Domanski, Andy Filardo, Shin-ichi Fukuda (discussant), Hans Genberg, Peter Hördahl, Mikael Juselius, Jonathan Kearns, Giovanni Lombardo, Renee McKibbin (discussant), Aaron Mehrotra, Paul Mizen (discussant), Madhusudan Mohanty, Andreas Schrimpf, John Sequeira (discussant), Livio Stracca (discussant), Vlad Sushko, and seminar participants at ABFER, ADBI, BIS, Bank Indonesia-BIS conference, Cass Business School, and Reserve Bank of New Zealand for helpful comments and discussions. We thank the anonymous referee for many suggestions that have improved the paper. We are grateful to Silvia Miranda-Agrippino and Helénè Rey for kindly sharing their global factor reproduced in the paper. Giovanni Sgro provided excellent research assistance. All remaining errors are ours. The views expressed are those of the authors and do not necessarily represent those of the Bank for International Settlements or the Bank of Thailand.

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emerging economies with flexible exchange rates. Similarly, Banerjee et al. (2016) argue that in the presence of financial frictions, spillovers from centre countries whose currency dominate cross-border financial capital flows to periphery countries can be substantial, but independent monetary policy is still possible without capital controls and moreover helps to mitigate the negative effects of financial spillovers.

At the same time, many studies such as Fratzscher (2012), Miranda-Agrippino and Rey (2014), Bruno and Shin (2013), Cerutti et al. (2014) highlight the important role for “push factors” such as the VIX in driving financial flows. This is corroborated by a growing literature documenting the presence of a global factor driving comovement in bond yields and other asset prices across countries (e.g. Aizenman et al., 2016; Diebold et al., 2008; Bauer and de los Rios, 2012; Abbritti et al., 2013; Jotikasthira et al., 2015). Taken at face value, this suggests that the traction that monetary policy has over domestic financial conditions has diminished.

Focusing on bond yields as a measure of domestic financial conditions, we attempt to reconcile the various views by proposing an organising principle that delineates external influences on domestic bond yields along three dimensions. *Monetary autonomy* is the ability of central banks to achieve desired targets for their instruments, abstracting from how those targets are set as well as the factors that may influence them. The issue here has to do with the operational capability of central banks. *Financial dependence* is the extent to which local bond yields vary with external financial shocks through their influence on domestic fundamentals. This predominantly reflects changes in current and expected setting of monetary policy, as well as macroeconomic developments more generally, in response to foreign developments. As such, financial dependence entails reactions by domestic central banks and embodies both their ability and willingness to set policy rates at levels deemed appropriate. Finally, *financial contagion* represents changes in domestic bond yields driven by external financial shocks that do not impinge directly on domestic fundamentals. One can think of this as external shifts in risk appetites or preferences that results in arbitrary variations in local financial conditions unrelated to domestic economic developments.

Together, financial dependence and financial contagion constitute the overall impact of external financial developments on domestic financial conditions, which in the literature is commonly referred to collectively as *financial spillovers* and often proxied by comovements in asset prices. Our paper attempts to go beyond these simple comovements and makes the critical distinction between *financial dependence* and *financial contagion*, focusing on the latter to highlight the influence of external financial shocks on financial conditions that do not work through domestic fundamentals. From a policy perspective, whether comovement in yields reflects reactions to correlated fundamentals and uncertainty about those fundamentals, or reactions to exogenous changes in risk appetite and preferences has vastly different implications. In the former, the bond market is acting simply as a messenger about expected future economic developments whereas in the latter case, it is a conduit of exogenous financial shocks unrelated to domestic fundamentals.

At the end of the day, what matters is whether and to what extent financial globalisation has worsened policy trade-offs. Has monetary policy becomes less effective in delivering price stability, promoting stable economic growth, or leaning against the build-up of financial imbalances? Such trade-offs depend on both the transmission mechanism that dictates how the economy responds to external financial shocks, as well as the nature of those shocks. We focus on the latter, taking the former largely as given. Our methodology aims to single out foreign financial shocks that are unrelated to domestic fundamentals to provide a gauge of how financial globalisation affects the degree of effort needed by central banks to achieve the desired financial conditions. We refer to this as *policy traction*. We conjecture that in countries where financial contagion shocks are prevalent, monetary policy has to work harder against arbitrary shifts in local financial conditions, translating into lower policy traction.

Our empirical exercise aims to disentangle global comovements in bond yields, and assess the role of financial contagion shocks in driving the overall correlation. The starting point for our measure of global financial contagion is the bond return risk premium, namely the expected excess return from investing in a long-term bond over a short one.<sup>3</sup> By looking at bond risk premium, we purge the direct influence of the expected path of monetary policy – and hence anticipated fundamental economic developments implicit therein – on bond price movements. Any comovement in monetary policy across countries, which could result in correlated bond prices and yet be fully consistent with individual monetary autonomy, is thus removed from our measure of global financial contagion.

Term premia may still be affected by domestic fundamentals, not least monetary policy through the risk-taking channel. To the extent that global macroeconomic risks are correlated with domestic ones, for example, it is natural to expect comovements in risk premia. Indeed, Diebold et al. (2008), Jotikasthira et al. (2015) document the importance of global factors in driving co-variation in risk compensation for long-term bonds across countries. We therefore proceed to refine the term premia by controlling for these influences. In the final step, we then extract the common component from these “cleansed” term premia to obtain our measure of global financial contagion. This measure essentially captures comovements in bond returns unrelated to the expected path of monetary policy and domestic economic fundamentals. This is the component that arguably impinges directly on policy trade-offs by introducing arbitrary noise to local financial conditions. In reacting to it, policy may need to deviate from what would have been justified purely based on domestic fundamentals.

Our analysis yields some novel results. First, our estimate of global financial contagion contains significant information not present in other popular global risk appetite measures such as the VIX. We argue that our measure is a more accurate metric to gauge the extent of monetary policy traction because it reflects the prevalence of shocks that arbitrarily shift finan-

<sup>3</sup> Throughout the paper, “risk premium” and “term premium” will be used interchangeably in reference to such expected excess return.

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