Accepted Manuscript

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PII: S0022-1996(17)30139-3
DOI: doi:10.1016/j.jinteco.2017.11.005
Reference: INEC 3094

To appear in:

Received date: 28 October 2016
Revised date: 28 October 2017
Accepted date: 24 November 2017

Please cite this article as: Xuehui Han, Shang-Jin Wei , International Transmissions of Monetary Shocks: Between a Trilemma and a Dilemma. The address for the corresponding author was captured as affiliation for all authors. Please check if appropriate. Inec(2017), doi:10.1016/j.jinteco.2017.11.005

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ACCEPTED MANUSCRIPT

International Transmissions of Monetary Shocks: Between a Trilemma and a Dilemma

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October 28, 2017

Abstract

This paper re-examines international transmissions of monetary policy shocks from advanced economies to emerging market economies. In terms of methodologies, it combines three novel features. First, it separates co-movement in monetary policies due to common shocks from spillovers of monetary policies from advanced to peripheral economies. Second, it uses revisions in growth and inflation and the Taylor rule to gauge desired changes in a country's interest rate if it is to focus exclusively on growth, inflation, and real exchange rate stability. Third, it proposes a specification that can work with the quantitative easing episodes when no changes in US interest rates are observed. In terms of empirical findings, we differ from the existing literature and document patterns of "2.5-lemma" or something between a trilemma and a dilemma: without capital controls, a flexible exchange rate regime offers some monetary policy autonomy when the center country tightens its monetary policy, yet it fails to do so when the center country lowers its interest rate. Capital controls help to insulate periphery countries from monetary policy shocks from the center country even when the latter lowers its interest rate.

Key Words: Interest rate shocks, fixed exchange rate, flexible exchange rate, dilemma, trilemma, capital flow management

JEL Classifications: E42, E43, E52

Acknowledgements: The views expressed in this paper are those of the authors and do not necessarily reflect the views and policies of the Asian Development Bank (ADB) or its Board of Governors or the governments they represent. The authors are grateful for excellent research assistance to Joy Glazener, Orlee P. Velarde, Lea R. Sumulong, and Nedelyn C. Magtibay-Ramos, Yinxi Xie, and for comments to Abdul D. Abiad, Joshua Aizenman, Atish R. Ghosh, Sebnem Kalemli Ozcan, Diwa Guinigundo, Arief Ramayandi, and participants at the research seminar at ADB, the Joint Central Bank of Turkey – Bank of England Workshop on "The International Monetary and Financial System: short term challenges and long term solution," and the 7th Meeting of the International Policy Advisory Group. The authors are responsible for any remaining errors in the paper.

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