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Monetary Policy Spillovers and the Trilemma in the New Normal: Periphery Country Sensitivity to Core Country Conditions

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Abstract

We investigate why and how the financial conditions of developing and emerging market countries (peripheral countries) can be affected by the movements in the center economies - the U.S., Japan, the Eurozone, and China. We apply a two-step approach. First, we estimate the sensitivity of countries' financial variables to the center economies [policy interest rate, **stock market prices**, and the real effective exchange rates (REER)] while controlling for global and domestic factors. Next, we examine the association of the estimated sensitivity coefficients with the macroeconomic conditions, policies, real and financial linkages with the center economies, and the level of institutional development. In the last two decades, for most financial variables, the strength of the links with the center economies have been the dominant factor while the movements of policy interest rate also appear sensitive to global financial shocks around the emerging market crises of the late 1990s and since the global financial crisis of 2008. While certain macroeconomic and institutional variables are important, the arrangement of open macro policies such as the exchange rate regime and financial openness are also found to have direct influence on the sensitivity to the center economies. An economy that pursues greater exchange rate stability and financial openness faces a stronger link with the center economies through policy interest rates and real effective exchange rate (REER) movements. We also find exchange market pressure (EMP) in peripheral economies is sensitive to the movements of the center economies' REER and EMP during and after the global financial crisis. Open macro policy arrangements, especially exchange rate regimes, also have indirect effects on the strength of financial linkages, interacting with other macroeconomic conditions. Thus, trilemma policy arrangements, including exchange rate flexibility, continue to affect the sensitivity of developing countries to policy changes and shocks in the center economies.

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