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Determinants of global spillovers from US monetary policy

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ABSTRACT

This paper assesses the global spillovers from identified US monetary policy shocks in a global VAR model. US monetary policy generates sizable output spillovers to the rest of the world, which are larger than the domestic effects in the US for many economies. The magnitude of spillovers depends on the receiving country's trade and financial integration, de jure financial openness, exchange rate regime, financial market development, labour market rigidities, industry structure, and participation in global value chains. The role of these country characteristics for the spillovers often differs across advanced and non-advanced economies and also involves non-linearities. Furthermore, economies that experience larger spillovers from conventional US monetary policy also displayed larger downward revisions of their growth forecasts in spring 2013 when the Federal Reserve upset markets by discussing tapering off quantitative easing. The results of this paper suggest that policymakers could mitigate their economies' vulnerability to US monetary policy by fostering trade integration as well as domestic financial market development, increasing the flexibility of exchange rates, and reducing frictions in labour markets. Other policies – such as inhibiting financial integration, industrialisation and participation in global value chains – might mitigate spillovers from US monetary policy, but are likely to reduce long-run growth.

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1. Introduction

Over the last decades the global economy has witnessed a substantive deepening of trade and financial integration. The associated growing importance of spillovers from shocks in other economies has given impetus to academics and practitioners alike to devote more efforts to understand the relevant transmission channels (see, for example, [IMF, 2013a](#)). It has even been argued that financial conditions and growth worldwide are driven by a global financial cycle, which in turn appears to be determined to a large extent by monetary policy in the US ([Bekaert et al., 2013](#); [Rey, 2013](#)). This paper advances our understanding of cross-country spillovers by quantifying the global effects on real activity of conventional US monetary policy and by shedding light on the channels through which these materialise.

I find that the spillovers from US monetary policy are substantial; in fact, for many economies, the spillovers are larger than the domestic effects in the US. Furthermore, I find that in line with existing literature the magnitude of spillovers depends on a number of country characteristics, including financial integration, trade openness, the exchange rate regime, industry structure, financial market development and labour market rigidities ([Broda, 2001](#); [Calvo et al., 2008](#); [Cavallo and Frankel, 2008](#); [Edwards, 2004, 2007a, 2007b](#); [Edwards and Levy Yeyati, 2005](#); [Milesi-Ferretti and Tille, 2011](#); [Rey and Martin, 2006](#)). For example, economies that are more integrated in global capital markets and less in trade, which feature more rigid labour and less developed domestic financial markets, and that have a high share of output accounted for by manufacturing industries experience larger spillovers. Moreover, there appear to be some differences in the determinants of the magnitude of spillovers across advanced and non-advanced economies. In particular, advanced economies that limit the flexibility of their exchange rate experience larger spillovers; more de jure financially open non-advanced economies experience larger spillovers. The magnitude of spillovers from US monetary policy is also determined by the joint constellation of country characteristics. For example, some results suggest that in non-advanced economies trade integration amplifies spillovers if their industry structure is tilted towards the production of manufactured goods, if they participate in global value chains and allow only limited flexibility of their exchange rate. Also, exchange rate liberalisation tends to magnify spillovers if non-advanced economies do not trade much. And financial integration is associated with larger spillovers if non-advanced economies have an inflexible exchange rate. Finally, even though in this paper I focus on the spillovers from conventional US monetary policy, I obtain some tentative evidence suggesting that the transmission channels of global spillovers from exit from quantitative easing may be similar: there is a statistically significant positive correlation between the global spillovers from conventional US monetary policy and the revisions in countries' growth forecasts in spring 2013 when Federal Reserve chairman Bernanke upset financial markets by discussing tapering off quantitative easing.

The results of this paper suggest that economies could reduce their vulnerability to US monetary policy by fostering domestic financial market development, trade integration, the liberalisation of exchange rates, and reducing frictions in labour markets. Other policies that may mitigate the spillovers from US monetary policy are likely to conflict with the pursuit of other important objectives of policymakers. For example, participation in global value chains through trade in intermediates has helped economies to raise their potential growth (see [IMF, 2013c](#)); similarly, capital market integration and financial openness allow economies to reap collateral benefits from financial globalisation (see [Kose et al., 2009](#); [Binder et al., 2013](#)). Clearly, a completely closed economy will not experience any spillovers whatsoever, but is likely to grow more slowly in the long run. In these cases, the trade-offs should be carefully considered before any measures are taken (see, for example, the IMF's institutional view on capital flow management, [IMF, 2012](#)).

The paper is related to and contributes to four strands of the literature. First, several papers investigate the global output spillovers from conventional US monetary policy (see, for example, [Kim and Roubini, 2000](#); [Kim, 2001](#); [Faust and Rogers, 2003](#); [Faust et al., 2003](#); [Canova, 2005](#); [Nobili and Neri, 2006](#); [Mackowiak, 2007](#); [Bluedorn and Bowdler, 2011](#)). The empirical approach in these papers is based on two-country VAR models that involve the US and domestic macroeconomic variables of one additional economy (or vice versa) and that are estimated for a few countries only. The results of this literature suggest that US monetary policy has substantial global spillovers across both advanced and emerging market economies, and that these arise mainly through spillovers in interest

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