US Monetary Policy Spillovers

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Summary

In this paper, we empirically study the international spillover effects of US monetary policy.

We use monthly panel data from fifteen major emerging market economies (EMEs), in a time-period where the countries have a flexible exchange rate regime and are integrated into global financial markets. Using econometric analysis, we show US monetary policy shocks have significant financial and macroeconomic effects abroad.

In particular, a contractionary US monetary policy shock leads to an increase in long-term country spread and short-term policy rate, and a depreciation of the exchange rate, of EMEs. Also, domestic stock prices and capital inflows into these countries decline. These adverse financial effects are accompanied by a contraction in EME output and an increase in their external balance.

In addition, we find there is heterogeneity in these spillover effects across different EME groups. The contraction in economic output is stronger, and the increase in external balance weaker, for countries that raise their monetary policy rate by more in response to the US monetary policy shock. These results suggest that US monetary policy spillovers lead to a non-trivial monetary policy trade-off for EMEs and that the classic open economy policy trilemma might be morphing into a policy dilemma.