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Spillovers of U.S. Unconventional Monetary Policy to Emerging Markets: The Role of Capital Flows

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Abstract

We employ a structural global VAR model to analyze whether U.S. unconventional monetary policy shocks, identified through changes in the central bank’s balance sheet, have an impact on financial and economic conditions in emerging market economies (EMEs). Moreover, we study whether international capital flows are an important channel of shock transmission. We find that an expansionary policy shock significantly increases portfolio flows from the U.S. to EMEs for almost two quarters, accompanied by a persistent movement in real and financial variables in recipient countries. Moreover, EMEs on average respond to the shock with an easing of their own monetary policy stance. The findings appear to be independent of heterogeneous country characteristics like the underlying exchange rate arrangement, the quality of institutions, or the degree of financial openness.

Keywords: Unconventional monetary policy, International capital flows, Global financial cycle, Global VAR

1 Introduction

Since the onset of the global financial crisis, large and volatile capital flows into emerging market economies (EMEs) have triggered a renewed interest in the determinants and consequences of such cross-border flows. A growing literature perceives a “global financial cycle” to be a key determinant of capital flows into EMEs (see Nier et al., 2014). This cycle is described as co-movement in gross capital flows, credit conditions, and asset prices across countries (see Rey, 2013, or Passari and Rey, 2015).\textsuperscript{2} Rey (2013, 2016) argues that one of the main drivers of the cycle is monetary policy by the U.S. Federal Reserve, whose interest rate decisions are transmitted to EMEs’ financial conditions through international capital flows. Moreover, she reasons that, as a consequence, U.S. interest rate decisions influence the conduct of monetary policy in EMEs. Responding to the financial crisis and the subsequent sluggish recovery, however, the Federal Reserve (Fed) repeatedly engaged in unconventional monetary policy measures such as large-scale asset purchases. While many

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\textsuperscript{2}Passari and Rey (2015) and Miranda-Agrippino and Rey (2015) provide empirical evidence for the existence of a global financial cycle by showing that prices of stocks and other risky assets as well as credit, leverage, and gross capital flows around the world are related to a common global factor.
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