Living with Financial Globalization: Monetary Policy Spillovers

By Steven J. Davis

My previous post highlights the responsiveness of corporate bond spreads in South Korea to external financial shocks. The Korean case vividly illustrates the force of international interest-rate linkages in a financially globalized economy. While it is easy to see interest-rate linkages at work in extreme episodes, they operate in more tranquil times as well.

To appreciate some of the implications, consider U.S. monetary policy and its spillover effects on other countries. Since the Global Financial Crisis in 2007-09, and earlier by some influential accounts, the United States has pursued a highly accommodative monetary policy. The Fed deployed monetary policy tools to keep rates on short-term U.S. Treasuries near zero, compress risk premiums, lower borrowing costs, and reduce bond yields – all with the aim of supporting U.S. economic recovery. In combination with sluggish growth and the absence of strong inflationary pressures, these monetary policy actions have kept U.S. nominal interest rates at extraordinarily low levels for several years.

Other parts of the world that adopt the dollar as their currency directly inherit these U.S. monetary and financial conditions. The same is true for places like Hong Kong that operate with open capital markets and a credible exchange rate peg to the U.S. dollar. It's also important to recognize that a large volume of dollar-denominated credit transactions occurs outside U.S. borders. Maury Obstfeld observes that dollar-denominated bank credit extended to nonfinancial entities
outside the United States is now 35 percent as large as U.S. domestic bank credit. In turn, U.S. domestic bank lending to nonfinancial entities is nearly as large as U.S. annual GDP. In short, Fed actions directly affect interest rates and credit conditions in much of the world.

Spillover effects from U.S. monetary policy are more complex and indirect for countries that restrict international capital flows or let their exchange rates fluctuate against the U.S. dollar. In principle, a country with open capital markets can conduct an independent monetary policy by allowing its currency value to float freely in foreign exchange markets. In practice, most countries and currency areas operate with a managed float and, in effect, resist large and rapid exchange rate adjustments. They do so, in part, because large exchange rate movements have important effects on the cost of living for domestic consumers and on the ability of domestic producers to export their goods and services. Exchange rate considerations are especially important in smaller, highly open economies.

As Obstfeld explains in his thoughtful paper for the Asian Monetary Policy Forum, the demands of a fully flexible exchange rate regime are not small. For example, to rely on its current exchange rate to fully accommodate a modest compression of risk premia induced by U.S. monetary policy actions, a country must be willing to tolerate a relatively large currency appreciation. Whether for this reason or others, few countries allow their currency values to float freely. As a consequence, U.S. monetary policy decisions influence interest rates and credit conditions throughout the world.
These international spillover effects are a source of concern for two basic reasons. First, mistakes in the conduct of U.S. monetary policy have adverse consequences globally. Second, even if U.S. monetary policy is optimally tailored to macroeconomic and financial conditions in the United States, other countries typically face different – sometimes very different – conditions. The second concern is especially pertinent for policymakers in emerging market economies in recent years. In many cases, they faced stronger inflation pressures than the United States, more pressing concerns about threats to financial stability, and stronger growth prospects.

**Steven J. Davis** is William H. Abbott Professor of International Business and Economics and deputy dean of the faculty at the University of Chicago Booth School of Business.