

## KEY POINTS

- **International spillovers of unconventional monetary policies have been an important discussion item in G20 meetings over the past few years. While the current Australian presidency has managed to ease some of the initial tension on this topic, it will remain a subject of conversation in forthcoming G20 meetings, given the expected US Fed tightening and the possibility of the European Central Bank's own quantitative easing.**
- **Our research shows that US monetary policy has had both positive and negative spillover effects on international financial asset prices from 2008 to 2013. We suspect that domestic policy responses to the global environment, including monetary policy communication, have been important factors in taming financial asset price movements.**

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## KEEPING UP WITH THE CHALLENGES FROM GLOBAL MONETARY POLICY SPILLOVERS

The unprecedented actions of central banks in major advanced economies over the past six years have been a continuing source of concern in both advanced and emerging market economies around world. It is usually assumed that announcements associated with unconventional monetary policies (UMPs) have a negative impact on emerging market economies, as financial market participants reach for assets with higher yields. In contrast, the same announcements are often treated as having a positive influence in advanced economies since they are meant to stabilize financial markets and restore robust global growth. However, as the Bank for International Settlements has noted, among others, historically loose monetary policies also appear to contribute to facilitating asset price booms.

Not surprisingly then, spillover effects from UMPs have been a source of debate within the G20 over the past few years. Delegates from emerging market economies, particularly Brazil and India, have argued that after UMPs had addressed economic weakness as well as initial financial stability concerns, continued easing was akin to a beggar-thy-neighbour policy. During a visit to the White House in 2012, Brazilian President Dilma Rousseff expressed concern about currency manipulation leading to a “monetary tsunami” in emerging market economies (Dyer and Leahy 2012). More recently, Governor of the Reserve Bank of India Raghuram Rajan (2014) stated that “disregard for spillovers could put the global economy on a dangerous path of unconventional monetary tit for tat.”

At their meeting in September 2014, in Cairns, Australia, G20 finance ministers and central bank governors discussed monetary policy spillovers, declaring in their communiqué, “[w]e will continue to clearly communicate our actions in a timely way and be mindful of impacts on the global economy as policy settings are recalibrated” (G20 2014). Although G20 finance ministers and central bankers have recognized the increasingly important role of communication in monetary policy, particularly when policy rates are at their zero lower bound, some member countries do not see this as enough. For example, Rajan (2014) has argued that major central banks should go a step further in actually incorporating international spillovers considerations into their decision making. Such proposals downplay, however, the fact that governments and central banks have at their disposal both micro- and macroprudential instruments that, ostensibly, can serve as one of the policy responses in the presence of monetary policy spillovers.

Before determining an appropriate standard for central bankers to follow, however, a question that must be addressed is whether the UMPs in the major advanced economies have actually led to capital outflows to the rest of the world. In a CIGI-sponsored research project, we have examined the behaviour of financial asset prices in advanced and emerging market economies in response to monetary policy surprises in the United States. Our results suggest that, in general, monetary policy surprise easings have actually decreased yields in most economies since financial turmoil began in October 2008. The size of the response varies considerably across the economies examined, but for 10-year government bonds, they range from a 15 to 30 basis points reduction in yields in the United States, the United Kingdom and the euro zone. The impact was found to be larger on long-term sovereign bonds than on shorter-term assets, and stronger in major economies, such as the United Kingdom and the euro zone, and in Canada.

The fact that surprise monetary easings in the United States decreased longer-term yields abroad, likely reflects the systemic importance of the US economy for the global outlook. The outcome also lends further support to the post-crisis understanding that US monetary policy can still be effective at the zero lower bound. There were some notable exceptions in our empirical results, however, as in a few cases US monetary policy surprise easings were found to increase yields abroad. Specifically, during the initial crisis period — which spans from October 2008 to September



2009 in our analysis — monetary policy surprises increased yields on shorter-term assets in Canada and Chile by less than 5 basis points. In Brazil and Korea, long-term sovereign bond yields increased by approximately 10 and 5 basis points, respectively, in response to US Federal Reserve actions during the crisis. During the post-crisis period examined (until the end of 2013), the impact of monetary policy surprises on all of these asset prices approaches zero. Our results therefore provide some evidence of capital flight caused by US monetary policy surprises during the crisis, particularly for Brazil.

It is difficult to identify the extent to which higher yields in these countries were caused by UMPs as opposed to the domestic policy response at the time. The fact that capital flight seems relatively muted in countries such as Korea, Canada and Chile, could be due to the fact that their domestic policies were more attuned to the global economic and financial circumstances. Indeed, in both economies, preparations were underway some time ago to deploy a combination of monetary and macroprudential responses to the Fed's quantitative easing policies. On the other hand, Brazil's monetary policy stance during the crisis was relatively tight, which leaves it exposed to financial actors that are searching for higher returns. Policy tightening may have been necessary due to rising inflation rates that have repeatedly threatened the upper range of the central bank's inflation target. However, a slowing economy also highlights the fact that interest rate rises can, at times, be a blunt instrument to deal with financial turmoil.

Our analysis also provides evidence that the tone of US Fed communication and a country's own central bank policy statements, constructed using text analysis software, have a significant impact on asset prices. The impact of the tone of these statements has been notably stronger since the start of the crisis, with financial market reactions appearing to be relatively more sensitive to the content of statements during the post-crisis period. However, the response to central bank communication is considerably smaller in magnitude than the reaction to policy surprises. These results suggest that monetary policy communications do provide an important signal to international financial markets; therefore, the G20's emphasis on its role in delivering clear and timely communication of policy actions should not be overlooked.

The US Fed's monetary policies clearly had a significant impact on financial markets and real economies during the crisis and in the ongoing post-crisis period. Although we do find evidence of negative spillovers in some parts of the world, US monetary policy surprises typically reduced yields in most of the economies in our sample. We also find evidence that the domestic policy response to the global environment, including monetary policy communication, is important for taming financial asset price movements.

As the Fed contemplates an exit from the zero lower bound, and the European Central Bank stands ready to possibly introduce its own version of quantitative easing, it is not likely that there will be an end to the debate about global policy spillovers anytime soon. The G20, having publicly expressed its understanding of spillovers as a potential irritant that threatens its mandate, needs to do more than just express that it is mindful of the situation. Of course, this is easier said than done. After all, central banks are sovereign institutions and while cooperation has long been seen as desirable, it cannot proceed unless the G20 accepts that individual country policy responses must also be factored in when the issue of spillovers is raised, rather than simply pointing fingers at loose policies among a few of its members.

## Works Cited

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