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Capital Flows and Monetary Policy in Emerging Markets around Fed Tightening Cycles

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Emerging markets have responded foremost to domestic inflation when raising rates during U.S. tightening cycles.

The Federal Reserve's interest rate hikes in 2022-23 raised concerns about spillover effects on smaller emerging market and developing economies. Historically, a higher U.S. federal funds rate has been associated with international investors withdrawing capital from emerging markets, which can lead to lower economic activity and depreciating exchange rates in these markets—and, in turn, greater financial vulnerability. To reduce capital outflows, central banks in emerging markets can tighten their own monetary policy rates to increase yields on debt securities. But raising interest rates comes with trade-offs, and how central banks in emerging markets respond to tighter U.S. monetary policy remains an empirical question.

Johannes Matschke, Alice von Ende-Becker, and Sai A. Sattiraju examine the three most recent U.S. policy tightening cycles to analyze when and why central banks in emerging markets raised their own policy rates. They find that while emerging markets sometimes raised rates in response to capital outflows or a depreciation of their currency resulting from U.S. monetary policy, they more frequently raised rates in response to domestic inflationary pressures. Their findings provide new descriptive evidence on the conduct of monetary policy in emerging markets.

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