

of liquidity or small changes in interest rates in advanced countries. This reflects the accumulation of a huge pool of footloose assets responsive to small changes in expected returns.

The composition of these investment portfolios is interest-rate sensitive and likely to respond sharply to differences in expected rates of economic growth in recipient countries. An example is the massive capital flows to emerging markets in 2010 in response to the growth slowdown and record-low interest rates in major advanced countries.

Policy spillovers to the rest of the world can be sizeable in the case of the United States, which hosts branches of some 160 foreign banks whose main function is to raise wholesale dollar funding in capital markets. Foreign bank branches collectively raise over one trillion dollars of funding, of which over 600 billion dollars is channeled to their headquarters outside the United States.¹⁹

Although the United States is the single largest net debtor, it is a substantial net creditor in the global banking system. In effect, the US borrows long through the issue of treasury and other securities while lending short through the banking sector. This is in contrast to countries like Ireland and Spain that financed their current account deficits through their respective banking sectors, which subsequently faced runs by their wholesale creditors.

Some borrowed dollars will find their way back to the United States. But many will flow to Europe, Asia, and Latin America, where global banks are active local lenders. At the margin, the shadow value of bank funding will be equalized across regions through the portfolio decisions of global banks, making global banks the carriers of dollar liquidity across borders. In this way, permissive US liquidity conditions are transmitted globally, and US monetary policy becomes *global* monetary policy.²⁰

An additional channel of transmission is through commodity prices. Low interest rates in the G-3 countries have a tendency to push up primary-commodity prices, both because the associated low borrowing costs mean high consumption and investment demand for these products, including from emerging markets, and because a low interest rate reduces the financial cost of holding stocks of storable commodities, thus making them more attractive as investment vehicles.

From the point of view of a commodity-producing country, lower world interest rates thus improve the terms of trade and increase local wealth and creditworthiness. A rating upgrade may follow. All this makes the country even more attractive for footloose international capital, creating pressures for currency appreciation.

These cross-border effects can be magnified by differences in exchange rate regimes. In recipient countries with freely floating exchange rates, standard theory suggests that the local currency should appreciate in response to a cut in foreign interest rates. It could even appreciate beyond its new steady-state level on impact, before then depreciating until reaching its new equilibrium level.

But if the country in question has a managed float or semi-fixed exchange rate, the required appreciation will not occur on impact. Even so, expectations of appreciation will eventually set in, making it more attractive to shift capital toward the country. This may bring forth additional inflows, in turn creating additional pressure for the exchange rate to strengthen.

The situation is even more complicated if intervention in the foreign exchange market is sterilized. The need to issue local bonds to mop up the liquidity resulting from the purchase of foreign exchange may cause local interest rates to rise, attracting even more

¹⁹ Bank for International Settlements (2010).

²⁰ See also Cetorelli and Goldberg (Forthcoming).