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The Impact of Large Country Monetary Policy on Small Countries

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It is often argued that small countries are sensitive to shocks originating from large countries. The reactions to these shocks vary, and depend in part on a country's institutional setting and other underlying characteristics of the economy. We are interested in examining the impact of large country interest rate changes on smaller countries and what effect exchange rate regimes have on the transmission of these shocks.

Some small countries find themselves in an uncomfortable situation, whereby they float their exchange rate, but still try to moderate its movements. Further, these countries also chase after capital flows in response to world shocks, and occasionally face excess volatility due to movements in risk premia or devaluation expectations. Alternatively, a small country may fix its exchange rate to a larger one, thereby officially sacrificing monetary autonomy and binding itself to the actions and shocks of the larger country. This project seeks to understand the extent to which large country monetary policy affects interest rates and output growth in smaller countries, as well as the channels through which these effects operate.

Previous work by Shambaugh (2004) and Obstfeld, Shambaugh and Taylor (2004) has demonstrated that pegged countries do in fact seem to have less autonomy than their floating counterparts. Work by di Giovanni, McCrary, and von Wachter (2004) has shown that domestic interest rates instrumented with base interest rates have a palpable effect on the output growth of domestic economies, implying both that smaller countries are following the interest rate of a larger core and that this has an effect on their economy. This project draws insights from both lines of research to explore the connection between interest rates in major industrial countries and interest rates and output growth in smaller countries. Following di Giovanni *et al.* we examine how domestic changes in interest rates, which can be attributed to following a base rate, affect the domestic economy. In particular, we use an instrumental variable approach, where we identify domestic monetary shocks by relying on innovations in base country interest rates, and then examine the effect of these shocks on output growth. We also rely on differences across exchange rate regimes, and the fact that different countries peg to different bases, to examine through what channel changes in large country rates are operating. For example, are the effects of shocks always coming through direct monetary policy responses at the domestic level, or are there broader global impacts stemming from large country monetary policy?

Preliminary analysis indicates that floating countries may not be greatly affected by large country monetary policy. The economies of some emerging floating do respond to movements in US interest rates, for example, but on average, floats do not follow world rates nor are their growth rates dramatically affected by them. On the other hand, pegged countries' interest rates and output growth rates respond to movements in large countries' rates. In sum, the results suggest that while changes in large country interest rates can affect many countries around the world to some extent, the principal channel through which large country interest rates affect other countries is through their effects on monetary policy and these effects are centered on countries with fixed exchange rates.