Monetary Policy Transmission in Emerging and Latin American Economies

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Abstract

This paper summarizes existing work by Kalemli-Ozcan and others on monetary policy making and transmission in emerging market economies (EMEs), with a particular focus on Latin America. Central banks in EMEs broadly follow Taylor-type reaction functions and adopt countercyclical stances in recessions, including during global "risk-off" episodes and exogenous U.S. monetary tightening. Yet, short-term market rates stay disconnected from domestic policy rates to a degree rarely observed in advanced economies (AEs). This short-rate wedge is systematically countercyclical and strongly related to external financing premia and domestic banks' external liability exposures. A simple model can rationalize these findings in a partial-equilibrium setting with segmented short-term bond markets where domestic banks, who are key holders of local-currency sovereign debt and gatekeepers to international funding, face country-specific dollar funding costs. The model highlights how the global financial cycle can impair the pass-through from policy rates to market rates even when central banks react countercyclically. I discuss policy implications for monetary autonomy, the trilemma versus dilemma debate, and the design of prudential tools in financially open EMEs.

[1] Brown University, NBER, and CEPR

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1. Introduction

Do monetary policy making and its transmission differ between developing and developed countries?If so, why, and what role do U.S. policies play? These questions have preoccupied academics and practitioners alike, especially in light of the global financial cycle and the increasing financial openness of EMEs. On the one hand, a classic New Keynesian view emphasizes that a credible inflation-targeting central bank can control domestic nominal conditions and, through expectations, real activity. On the other hand, the transmission of policy depends critically on domestic financial structures and external financing conditions that are shaped abroad.

A highly visible debate centers on the feasibility and scope of monetary autonomy for financially open economies. Woodford (2010) argues that it is difficult to construct plausible scenarios in which globalization undermines a central bank's ability to control inflation dynamics. Rey (2013) famously contends that the trilemma becomes a dilemma: with free capital mobility, monetary policy independence from the U.S. (or the global financial cycle) requires capital controls. Obstfeld (2015) offers a middle ground: monetary independence is feasible even for financially open EMEs, but there are meaningful limits to what it can achieve. This paper summarizes recent research by Kalemli-Ozcan and others that contributes to this debate with systematic evidence on the *stance* of monetary policy in EMEs and on the *pass-through* from policy to short-term market rates, and with a parsimonious model that connects external funding premia and domestic exposures to the short-rate wedge.

Preview of findings. Below, I summarize the results from de Leo, Gopinath, Kalemli-Ozcan (2025). These authors document that EME central banks, on average, *lower* policy rates in downturns and during U.S. monetary tightening. Policy rates in EMEs comove positively with domestic activity and inflation, consistent with Taylor-type principles comparable to those in AEs. However, short-term market rates (e.g., 3-month treasury bill yields) in EMEs frequently decouple from policy rates in a *countercyclical* manner, rising in downturns even as policy rates are cut. The resulting wedge between market and policy rates widens when external financing conditions tighten and when domestic banks are more reliant on external dollar funding. These facts matter for how we assess the cyclical stance of monetary policy and speak to well-known constraints on monetary autonomy in financially open EMEs.

2. Definitions and Stylized Facts

The policy rate is the central bank's target short-term rate. The relevant market rate is the three-month treasury bill yield in local currency. The external financing premium is measured by the EMBI/CEMBI spread—the difference between the yield on EMUSD-denominated sovereign (or corporate) debt and the U.S. Treasury yield of similar maturity. External exposure is proxied by domestic banks' foreign-liability share.

2.1. What do EME central banks do? Reaction functions and cyclicality

A standard Taylor-type reaction function in a panel with country fixed effects can be estimated with the following equation:

$$i_t^P = \alpha + \beta_1 i_{t-1}^P + \beta_2 \pi_t + \beta_3 y\text{-}gap_t + \varepsilon_t, \tag{1}$$

where i_t^P is the policy rate, π_t is inflation, and $y\text{-}gap_t$ is the output gap or a proxy such as GDP growth. de Leo (2024) shows that estimates are remarkably similar across EMEs and AEs, with substantial interest-rate smoothing ($\beta_1 \approx 0.8\text{–}0.9$), positive responses to inflation, and smaller but significant responses to activity. These estimates imply effective Taylor-rule coefficients ($\rho, \varphi_\pi, \varphi_y$) consistent with adherence to the Taylor principle in both groups.[2]

A complementary reduced-form exercise relates i_{t+h}^P to current domestic GDP growth, controlling for lagged rates. Policy rates rise when growth is high, with somewhat weaker pro-growth sensitivity in EMEs than in AEs, consistent with a greater prevalence of supply shocks in EMEs. Event studies around episodes of global distress—the Global Financial Crisis (GFC) and COVID-19—show that EME policy rates were cut substantially as risk-off conditions intensified. Finally, local projections around high-frequency U.S. monetary surprises (following Gertler and Karadi 2015) indicate that a one percentage point exogenous increase in the federal funds rate is followed by *declines* in EME policy rates as activity and capital inflows weaken (see also Miranda-Agrippino and Rey 2020; Dedola et al. 2017; Degasperi et al. 2023; Kalemli-Ozcan and Unsal 2024).

[2] See also othe papers such as Taylor (1993); Carvalho et al. (2021); Frankel (2010).

2.2. Short-term market rates and the policy–market disconnect

The benchmark short-term market rate is the three-month treasury bill yield. In AEs, market and policy rates move together tightly at business-cycle frequencies. In EMEs, by contrast, market rates often move *oppositely* to policy rates, rising as policy rates are cut during downturns. This can be shown with:

$$i_{t+h} = \alpha_h + \beta_h \Delta GDP_t + \gamma_h i_{t-1} + \varepsilon_{t+h}, \tag{2}$$

for policy and market rates separately. In AEs, both rates are procyclical and track each other closely. In EMEs, market rates are more strongly procyclical while policy rates are countercyclical, implying an expanding wedge in downturns.

Define the short-term wedge as $w_t \equiv i_t^M - i_t^P$. The wedge is *countercyclical* in EMEs and acyclical in AEs. In local projections around U.S. monetary surprises, policy and market rates move in opposite directions in EMEs: policy rates fall while market rates *rise*. This "short-rate disconnect" complicates inference about the monetary stance from market rates alone and points to constraints in policy transmission operating through domestic financial intermediation and external funding conditions.

3. External Exposure, Financing Conditions, and the Wedge

The short-rate wedge varies with two key features of EME financial structure: (i) *external exposure*, measured by domestic banks' external liability share; and (ii) *external financing conditions*, mea-sured by EMBI/CEMBI spreads. Domestic banks play a central role in sovereign bond markets and act as a gateway to external funding for the economy. When global risk premia rise, the marginal funding cost for banks with dollar liabilities increases, and the higher cost is passed through to the pricing of short-term local-currency bonds that banks hold and intermediate.

3.1. Bond holding patterns and external funding

A substantial fraction of sovereign debt in EMEs is held by *domestic* investors, notably resident banks. Foreign investors are nonetheless material, particularly nonbanks in local-currency sovereign markets and banks in foreign-currency corporate markets. These patterns are consistent with a "home-bias" portfolio split and imply that resident banks' balance sheets are a key locus where external shocks meet domestic markets.

3.2. Regression evidence linking the wedge to external factors

Panel regressions of the form

$$w_{c,t} = \gamma_c + \gamma_t + \beta_1 External\ Premium_{c,t} + \beta_2 External\ Exposure_{c,t} + \varepsilon_{c,t} \quad (3)$$

show that both the external premium and banks' external exposure load positively and significantly on the wedge.

4. Latin America: A Focused Look

Latin American economies exhibit the same qualitative patterns: policy rates are countercyclical; short-term market rates are strongly procyclical; and the wedge is countercyclical across countries and monetary policy frameworks. The role of external factors is especially salient given the region's history of sudden stops and the prevalence of dollar intermediation. Regression results show these clearly.

To rationalize the short-rate disconnect, one can envision a model of the domestic banking sector in which risk-neutral resident banks intermediate between policy-rate deposits and short-term local-currency sovereign bonds, while also borrowing in dollars at a *country-specific* external funding rate. Banks hedge foreign-currency liabilities using FX forwards at the forward rate Ft, taking policy rates, dollar funding rates, and exchange rates as given.

Home banks operate in the short-term home-currency bond market. On the asset side, they hold one-period market bonds yielding market rate. On the liability side, they raise home-currency deposits at the policy rate and dollar debt at the country-specific dollar funding rate (as in Bianchi and Lorenzoni 2022). Banks hedge FX exposure at the forward rate against the spot. Market segmentation implies CIP need not bind for *market* bond returns.

Optimality and no-arbitrage within the domestic banking sector yield the equilibrium market return, and the short-rate wedge (to first order in logs) rises with the *external premium* and with the *external exposure*. Market segmentation—only home banks access the cash market for local-currency short-term bonds, and they cannot borrow at the international deposit rate—prevents arbitrage from eliminating the wedge.[3]

[3] See De Leo, Keller, and Zou (2024) on local banks' advantage in EM cash markets and de Giovanni et al. (2022) for causal evidence on bank funding shocks and sovereign yields.

The model yields three implications aligned with the facts: (i) cuts in policy rates need not translate into lower market rates when external premia are high or when banks are heavily externally funded; (ii) the wedge widens in downturns, when global risk premia and dollar funding costs tend to rise; and (iii) U.S. monetary tightening raises EME short-term market rates through the external-premium channel even as domestic central banks cut policy rates.

5. Discussion and Conclusion

The evidence suggests that EME central banks generally *do the right thing* cyclically but face imperfect transmission to market rates due to external funding frictions. This has several policy implications. First, judging the monetary stance from market rates alone can be misleading in EMEs; policy rates and communication remain essential indicators. Second, prudential regulation that limits excessive dollar funding by resident banks (reducing ω_t) can strengthen pass-through. Third, building credible domestic-currency sovereign debt markets and reliable local investor bases can mitigate segmentation and reliance on external dollar intermediation. Finally, macroprudential tools targeted at currency mismatches may complement interest-rate policy during risk-off episodes without compromising inflation objectives.

EME central banks generally follow systematic, countercyclical policy rules comparable to those of AEs. However, short-term market rates often move in the *opposite* direction in downturns, producing a countercyclical short-rate wedge that reflects external financing premia and banks' external liabilities. A simple banking-sector model with segmented markets rationalizes these patterns and clarifies the conditions under which the global financial cycle constrains monetary transmission. The analysis informs an evidence-based view of the trilemma–dilemma debate and underscores the importance of prudential tools that reduce exposure to volatile external funding.

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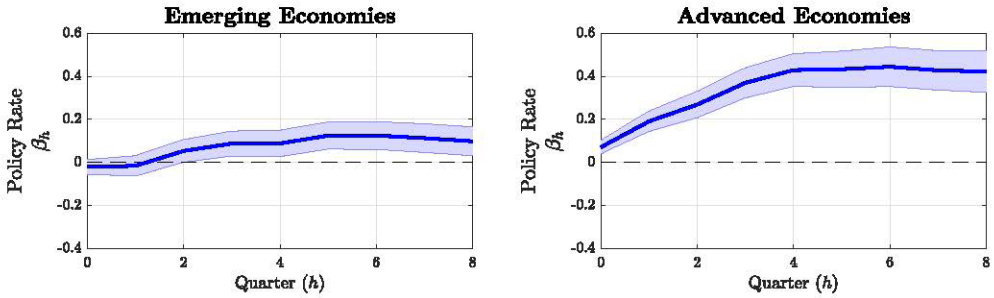
Cyclicality of Policy Rates (Panel)

$$i^P_{t+h} = \alpha_h + \beta_h \Delta \text{GDP}_t + \gamma_h i^P_{t-1} + \epsilon^P_{t+h}$$

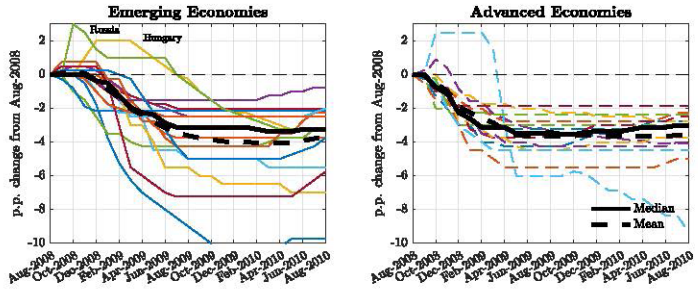


- policy rate increases when domestic GDP growth is high...

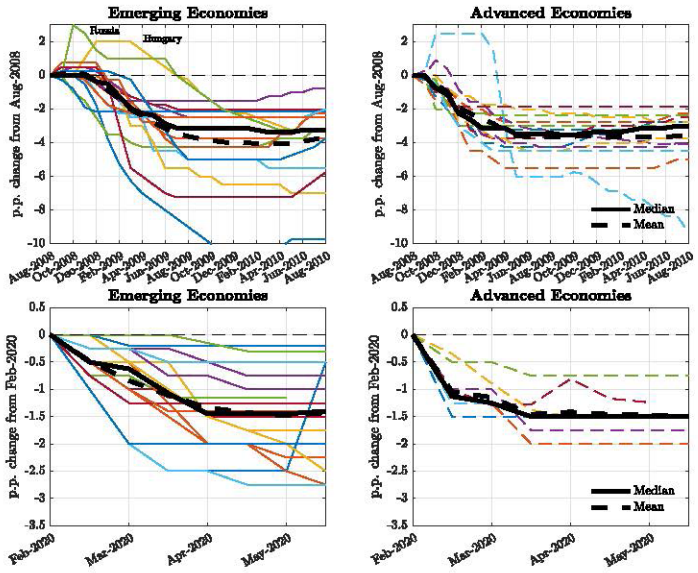
...less in EMEs than in AEs, possibly due to prevalence of supply shocks in EMEs

(consistent w/ Taylor-rule estimates, Frankel 10)

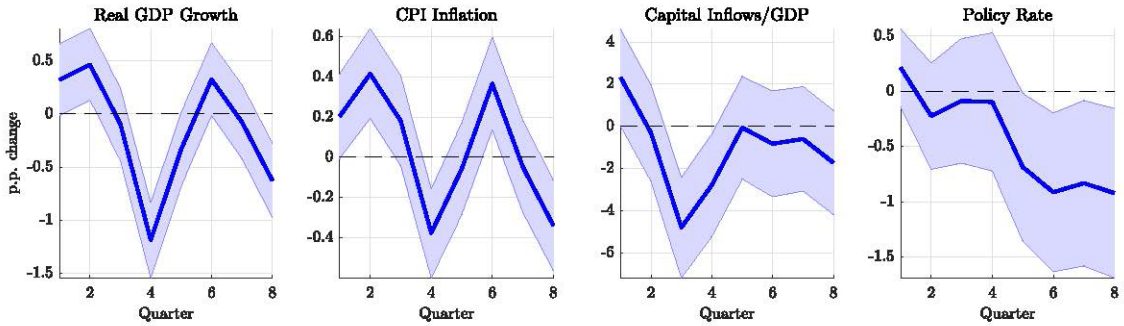
Monetary Policy Rates Around Episodes of Global Distress



Monetary Policy Rates Around Episodes of Global Distress



U.S. Mon. Pol. Tightening & Policy Rates in Emerging Economies

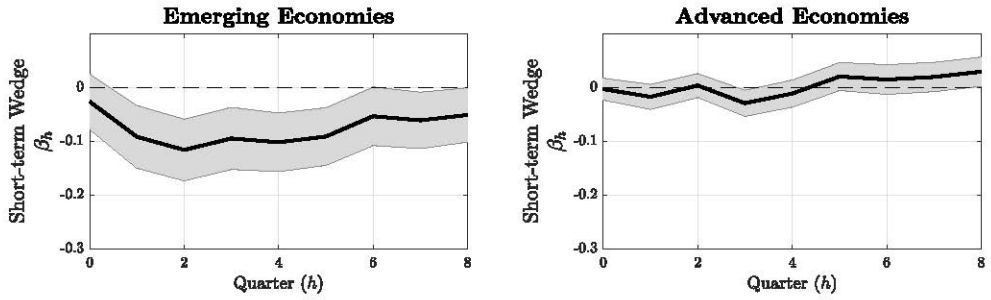


Impulse: 1 p.p. exogenous increase in Fed Funds Rate (Gertler & Karadi 15)

- policy rate declines after U.S. mon. pol. tightening (among lower GDP and capital inflows)
  (see also Miranda-Agrippino & Rey 20, Dedola et al. 17, Degasperi et al. 23, Kalemli-Ozcan & Unsal 24)

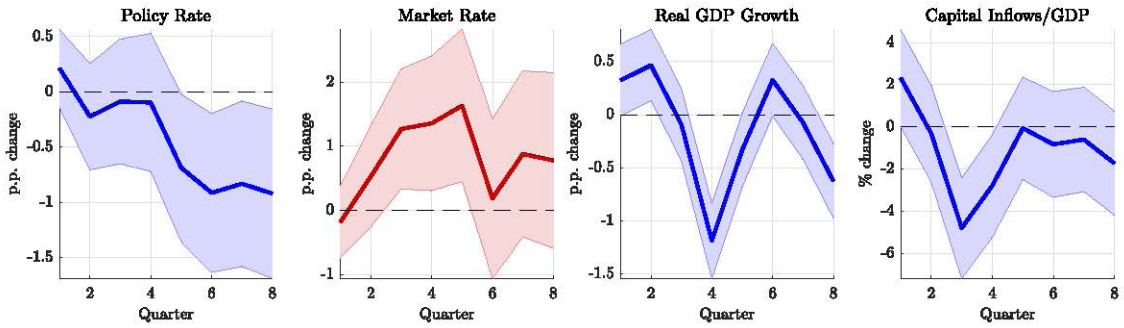
Cyclicality of Short-rate Wedge

Short-term Wedge: $i_t^M - i_t^P$



- Short-term wedge is countercyclical in EMEs, acyclical in AEs

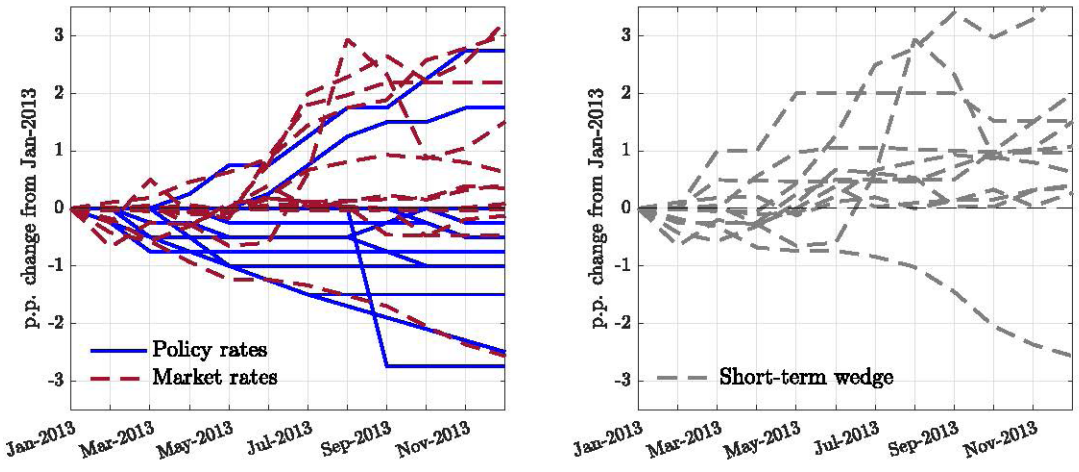
U.S. Monetary Policy Tightening, Policy Rates & Market Rates



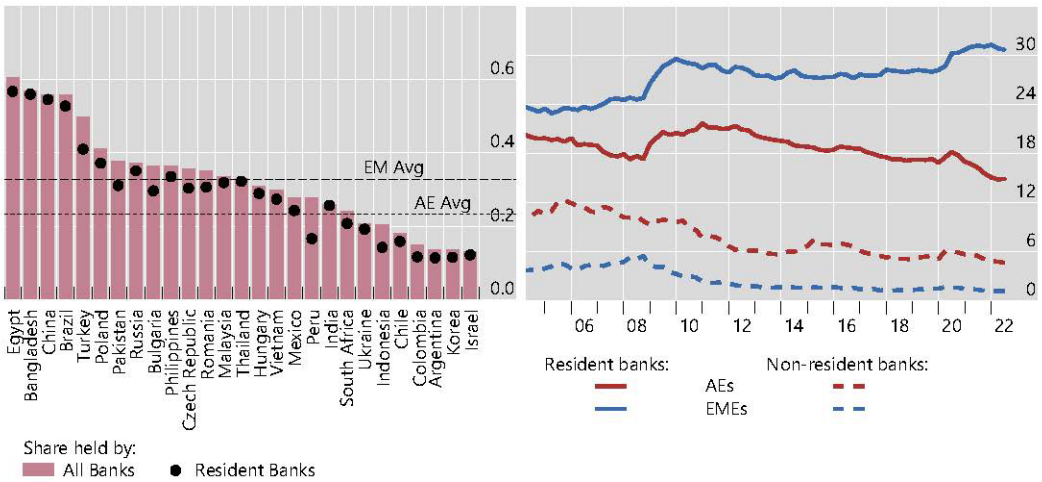
Impulse: 1 p.p. exogenous increase in Fed Funds Rate (Gertler & Karadi 15)

- Policy and market rates display opposite response to US MP in emerging economies
- Policy rates decline, while market rates increase after US MP tightening (Kalemli-Ozcan 19)

Policy and Market Rates Around Taper Tantrum

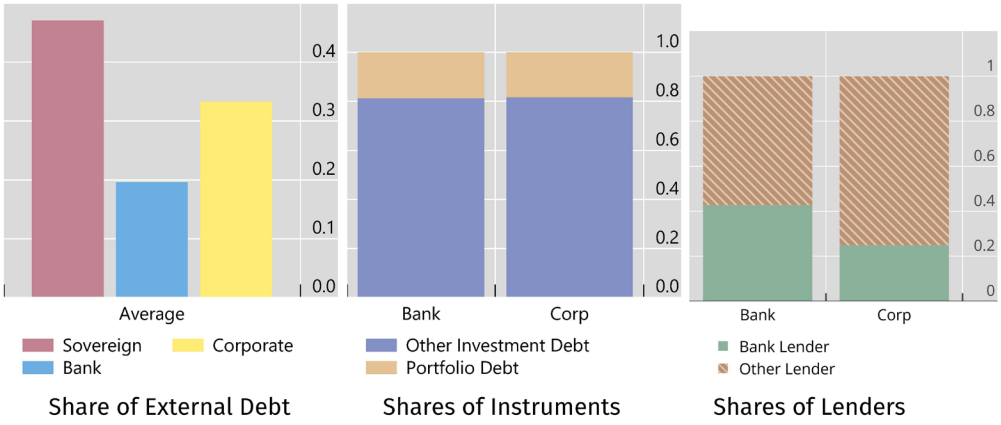


Domestic banks are important investors in EMEs government bonds



Source: Fang, Hardy, and Lewis (2023) and Hardy and Zhu (2023)

Non-Sovereign external borrowing of EMEs mainly shaped by domestic and global banks (2022)

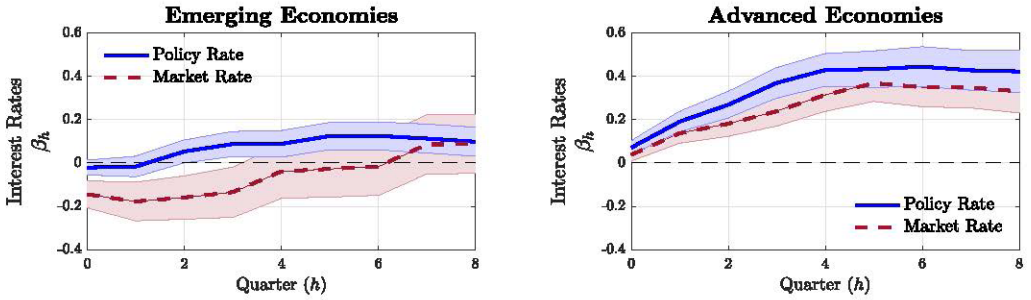


Notes: The source of the data for these figures is Avdjvev et al. (2022). See also Fang, Hardy, and Lewis (2023), Hardy and Zhu (2023), and Arslanalp and Tsuda (2022).

Latin America

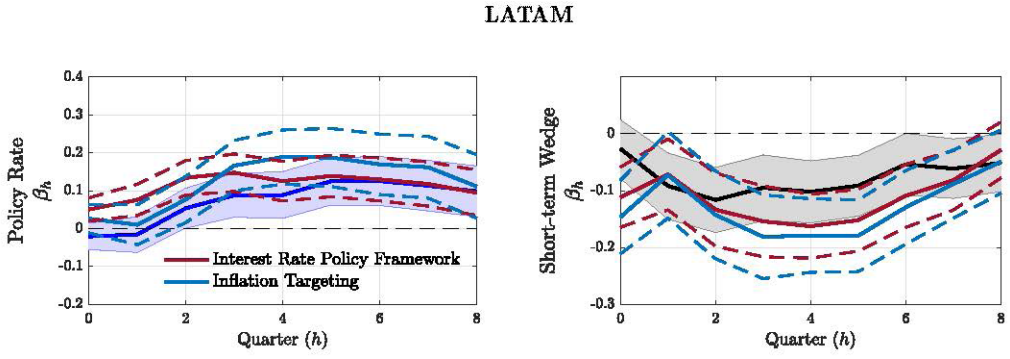
Cyclicality of Policy Rates & Market Rates

$$i_{t+h} = \alpha_h + \beta_h \Delta \text{GDP}_t + \gamma_h i_{t-1} + \epsilon_{t+h}$$



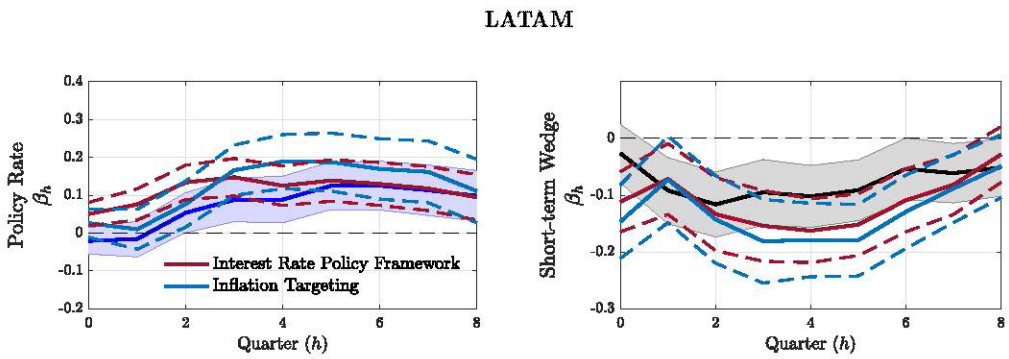
- Market & policy rates display opposite cyclicality in EMEs, but track each other in AEs
  - Important for assessing the cyclical stance of monetary policy in EMEs

Cyclicality of Short-rate Wedge



- Short-term wedge is countercyclical in LATAM, regardless of MP framework

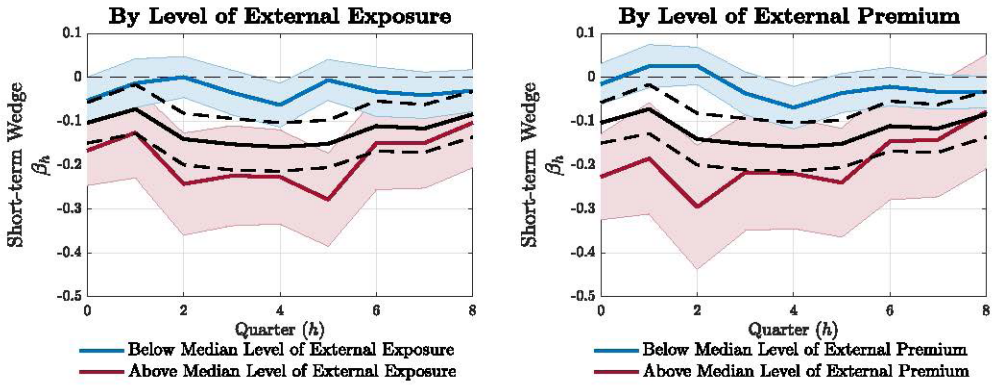
Cyclicality of Short-rate Wedge



- Short-term wedge is countercyclical in LATAM, regardless of MP framework

Cyclicality of short-rate wedge by external factors

Short-term wedge: $(i^M - i^P)_{t+h} = \alpha_h + \beta_h \Delta \text{GDP}_t + \gamma_h stw_{t-1} + \epsilon_{t+h}$



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