The divergence of monetary policies in the advanced economies continues to roil financial markets. The Federal Reserve has reacted to better labor market conditions by ending its quantitative easing policy. The Bank of Japan, on the other hand, will expand its purchases of securities, and the European Central Bank has indicated its willingness to undertake unconventional policies if inflation expectations do not rise. The differences in the prospects between the U.S. and Great Britain on the one hand and the Eurozone and Japan on the other has caused Nouriel Roubini to liken the global economy to a jetliner (http://www.project-syndicate.org/commentary/us-growth-and-weakening-global-economy-by-nouriel-roubini-2014-10) with only one engine still functioning.

The effect of U.S. interest rates on international capital flows is well-documented. Many countries are vulnerable to changes in U.S. policies that can reverse financial flows. Countries that have relied on capital flows searching for a higher yield to finance their current account deficits are particularly susceptible. Declining commodity prices reinforce the exposure of commodity exporters such as Brazil and Russia.

U.S. markets affect capital flows in other ways. Erlend Nier, Tahsin Saadi Sedik and Tomas Molino of the IMF have investigated the key drivers of private capital flows in a sample of emerging market economies during the last decade. They found that changes in economic volatility, as measured by the VIX (http://www.investopedia.com/terms/v/vix.asp) (the Chicago Board Options Exchange Market Volatility Index, which measures the implied volatility of S&P 500 index options), are the “dominant driver of capital flows to emerging markets” during periods of global financial stress. During such periods, the influence of fundamental factors, such as growth differentials, diminishes. Countries can defend themselves with higher interest rates, but at the cost of slowing their domestic economies.

When the IMF’s economists included data from advanced economies in their empirical analysis, they found that the impact of the VIX was higher in those economies. They inferred that as countries develop financially, “capital flows could therefore be increasingly influenced by external factors.” Financial integration, therefore, will lead to more vulnerability to the VIX.

Volatility in U.S. equity markets drives up the VIX. Moreover, empirical analyses, such as one by Corradi, Distaso and Mele (http://www.antoniomele.org/files/macro_vol.pdf), find that U.S. variables, such as the Industrial Production Index and the Consumer Price Index, explain part of the changes in the VIX. U.S. economic conditions, therefore, affect global capital flows through more linkages than interest rates alone.

What are the implications for U.S. policymakers? The Federal Open Market Committee does not usually consider the impact of its policy directives on foreign economies. On the other hand, the Fed is well aware of the feedback from foreign economies to the U.S. Moreover, there are measures the U.S. could undertake to lessen the impact of its policy shifts on foreign markets.
During the global financial crisis, for example, the Federal Reserve established swap arrangements for 14 foreign central banks, including those of Brazil, Mexico, Singapore and South Korea. These gave the foreign financial regulators the ability to lend dollars to their banks that had financed holdings of U.S. assets by borrowing in the U.S. However, not all emerging markets’ central banks were deemed eligible for this financial relationship, leaving some of them disappointed (see Prasad (http://www.amazon.com/Dollar-Trap-Tightened-Global-Finance/dp/0691161127/ref=la_B00HMBQYGE_1_1?s=books&ie=UTF8&qid=1415978578&sr=1-1), Chapter 11).

Federal Reserve officials have signaled (http://www.ft.com/intl/cms/s/0/b46b9ac8-5ea6-11e4-b81d-00144feabdc0.html#axzz3J3KvVvmv) that they are not interested in serving again as a source of liquidity. One alternative would be to allow the IMF to take over this capacity. But the U.S. Congress has not passed the legislation needed to implement long-overdue governance reforms at the Fund, and it is doubtful that the results of the recent elections will lead to a different stance (http://www.businessinsider.com/afp-imf-reforms-threatened-by-republican-electoral-sweep-2014-11). Not many foreign countries will be in favor of enabling the IMF to undertake new obligations until the restructuring of that institution’s governance is resolved.

Volatile capital flows have the potential of sabotaging already-anemic recoveries in many emerging market countries. The global financial architecture continues to lack reliable backstops in the event of more instability. The U.S. should cooperate with other nations and international financial institutions in addressing the fallout from its economic policies, either by directly providing liquidity or allowing the international institutions to do so.