International Trade Finance and the Cost Channel of Monetary Policy in Open Economies

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Summary

This paper models the interaction between international trade finance and monetary policy in open economies and shows that trade finance affects the propagation mechanism of all macroeconomic shocks that are identified to be drivers of business cycles in advanced economies. Bayesian estimation results show that trade finance conditions, which in turn are driven by US interest rates, are critical in explaining economic fluctuations. Quantitatively, trade finance has a larger impact on spillover effects of shocks to foreign countries, implying that incorporation of trade finance is particularly important when modelling small open economies.