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-RESEARCH ARTICLE-

A SYSTEMATIC REVIEW OF THE GLOBAL LITERATURE ON ARBITRAGE CHANNELS AND THE FED'S MONETARY TIGHTENING

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─Abstract─

This study examines the transmission mechanisms of the United States Federal Reserve's monetary policy tightening and its broader implications for global capital movements and arbitrage pathways, employing a systematic literature review (SLR) methodology. The analysis concentrates on the influence of interest rate disparities in driving cross-border capital flows and shaping policy decisions in both developed and developing economies. The findings indicate that periods of Federal Reserve tightening tend to redirect capital towards advanced economies—particularly the United States—while simultaneously triggering capital outflows from emerging markets. These dynamics contribute to diminished global liquidity and depreciation of emerging market

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currencies. Furthermore, the study explores the spillover repercussions of U.S. monetary actions, highlighting the heightened vulnerability of emerging economies to capital flight and systemic financial instability. It argues that macroprudential tools, including capital flow regulation measures and foreign exchange reserve buffers, are vital for mitigating volatility in these regions. Additionally, the research advocates enhanced international coordination of monetary policies to address cross-border spillovers and reinforce global financial resilience. The paper concludes by calling for further investigation into the effectiveness of regulatory interventions and the extent to which regional policy responses diverge in reaction to shifts in U.S. monetary strategy.

Keywords: Monetary Policy, Federal Reserve, Short-term Capital Flows, Arbitrage Channels, Spillovers Effects.

INTRODUCTION

Contemporary global finance is characterised by a high degree of interdependence, with capital movements reacting promptly to shifts in monetary policy. The United States Federal Reserve (Fed), as the nation's central banking authority, significantly influences short-term transnational capital flows. As noted by Arteta et al. (2022), the Fed initiated a monetary tightening cycle from 2015 onward, raising interest rates from near-zero levels to 2.5%. This policy intervention contributed to stabilising inflation and lowering unemployment. However, it also precipitated declines in equity markets, depreciation of currencies, and diminished capital inflows in emerging economies. These effects are largely attributable to the Fed's interest rate increases, which alter the relative interest rate differentials between countries and consequently open arbitrage avenues.

When economic agents engage in cross-border lending and borrowing, disparities in interest rates generate conditions conducive to arbitrage, wherein market participants redistribute financial surpluses to optimise returns (Kruschwitz et al., 2019). Thomas and Macchiavelli (2018) highlight that the Fed's primary monetary instrument is the interest on reserves (IOR) rate. Nonetheless, not all financial institutions qualify to receive IOR. As a result, certain lenders provide overnight wholesale funding at rates below the IOR, enabling profit-making opportunities through reserve balance holdings. These arbitrage transactions, typically free from credit or interest rate risk, incentivise investors to shift capital from low-yield markets to those offering higher returns, thereby influencing capital dynamics in both developed and emerging markets.

Countercyclical capital flow management policies are designed to address these dynamics, capturing both the extensive and intensive dimensions of monetary interventions (Zehri & Madjd-Sadjadi, 2023). Such policies are particularly crucial for countries with less robust financial systems, as the associated volatility poses risks to macroeconomic stability. This study employs a SLR to analyse the function of arbitrage

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mechanisms in mediating the effects of Fed monetary tightening on global short-term capital flows. Emphasis is placed on the asymmetric nature of these flows, where advanced economies often benefit from capital inflows during tightening phases, whereas emerging markets face adverse outcomes such as currency devaluation, liquidity stress, and inflationary trends. These disparities highlight the imperative for internationally coordinated policy responses.

The SLR also aims to identify existing research gaps within this domain and to offer recommendations for policy refinement. The investigation centres on arbitrage activities driven by interest rate differentials and their influence on cross-border capital mobility, alongside the ensuing economic consequences. To this end, the paper is structured into the following sections: Literature Review, Methodology, Findings, Discussion, and Conclusion. The insights derived are intended to assist regulators and policymakers in managing the externalities of Fed policy actions, thereby promoting financial resilience amid increasing global interconnectedness.

LITERATURE REVIEW

Arbitrage mechanisms play a pivotal role in exploiting international interest rate disparities. In theory, such arbitrage activities contribute to the maintenance of covered interest parity (CIP) across markets (Du et al., 2018). Typically, when interest rates are comparatively low in advanced economies, capital tends to move from lower-yielding to higher-yielding currencies through arbitrage strategies commonly referred to as carry trades (Burnside, 2012). These trades are especially profitable during periods marked by wide interest rate differentials, though the gains usually carry a risk premium due to the inherent uncertainty. Despite their potential for returns, carry trades often increase financial fragility, as abrupt reversals—often triggered by monetary tightening—can induce considerable volatility in exchange rates and asset valuations (Bernanke & Gertler, 2012; Devereux et al., 2006; Galí & Monacelli, 2005; Lastrapes, 1989). In this context, adherence to interest rate parity (IRP) conditions becomes essential, particularly in the setting of integrated financial systems (Wu & Chen, 1998). Deviations from expected cross-currency returns may invite speculative capital flows, heightening systemic risks during periods of monetary transition.

The global transmission of monetary policy decisions—especially those originating from the United States—does not impact all countries uniformly. U.S. policy shifts are transmitted through several conduits, including international investor sentiment, currency valuations, and asset pricing structures (Ha, 2021). It is also important to acknowledge that advanced economies benefit from more mature financial systems and deeper capital markets. These attributes enable them to absorb financial shocks more effectively and sustain capital inflows even amidst tightening monetary conditions. Mabeba (2024) emphasises that deeper financial markets are positively correlated with economic growth in developing economies. Advanced economies, owing to their

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institutional resilience, often engage in portfolio rebalancing during episodes of Fed rate increases, thereby maintaining financial stability (Forbes & Warnock, 2012). This is largely due to the presence of well-capitalised and competent financial institutions. In contrast, emerging markets lack such institutional advantages. Capital flows to these regions exhibit a pro-cyclical nature, amplifying financial vulnerabilities during economic downturns (Kaminsky et al., 2004). When the Fed raises interest rates, emerging markets are typically subjected to capital flight, currency depreciation, and inflationary pressures (Davis et al., 2021).

Additionally, the cross-border transmission of monetary shocks generates significant spillover effects. Summers (2000) argues that global financial cycles can compromise the monetary policy autonomy of individual countries. Consequently, capital mobility appears to be more responsive to global liquidity dynamics than to domestic macroeconomic fundamentals, rendering many economies highly sensitive to U.S. monetary policy adjustments. A case in point is the 2013 "Taper Tantrum," which saw a spike in market volatility following signals of Fed tightening. According to Sahay et al. (2014), the episode led to sharp depreciations in currency values and declining asset prices, disproportionately affecting emerging markets. Even nations with stable macroeconomic indicators suffered due to massive outflows and exchange rate instability. This incident demonstrates the limitations of interest rate tools in shielding economies from externally induced financial turbulence.

A key concern for policymakers lies in mitigating capital flow volatility driven by arbitrage dynamics. While exchange rate regimes can offer a degree of insulation, their effectiveness remains contested. Eichengreen et al. (2020) contend that flexible exchange rate systems are better positioned to absorb external shocks than fixed regimes. Nonetheless, countries with flexible systems are not entirely safeguarded. In response, Zehri, C. (2020) tested countries with capital controls, whose effectiveness is yet to be determined, and which can create distortions if their effectiveness is unclear.Some research advocate for the accumulation of foreign exchange (FX) reserves as a buffer against capital flow disruptions (Manuel et al., 2023; Zehri, C., 2020). They propose that FX reserves be deployed particularly when capital accounts are fully liberalised. Moreover, they suggest that FX reserves can be employed in tandem with capital controls to counteract global financial disturbances. While reserve holdings are a critical defensive measure, their accumulation is not without cost. It may result in diminished domestic investment and increased fiscal burdens. However, Mahraddika (2019), through a dynamic panel analysis of 58 countries from 2000 to 2014, found no evidence that reserve accumulation displaces private sector investment. When strategically managed, reserve build-up can thus be beneficial. Despite this, existing literature remains fragmented, prompting a growing interest in alternative measures such as macroprudential policies. These instruments aim to reduce systemic vulnerabilities and can lower bank funding costs (Ćehajić & Košak, 2021). Macroprudential tools, including capital controls, are designed to regulate both capital

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inflows and outflows. Nevertheless, the efficacy of such measures continues to be a topic of academic and policy debate.

METHODOLOGY

The SLR employed in this study involves a rigorous and methodical selection of scholarly sources. Emphasis was placed on peer-reviewed publications that bear direct relevance to the core research objective. Specifically, the selected literature either examines the influence of the Federal Reserve's monetary policy on international capital flows through arbitrage mechanisms or explores contributory factors related to such transmission channels. The search process was conducted using established academic databases, namely Google Scholar, JSTOR, and Scopus, each known for their extensive repositories of economics and finance literature. These platforms were deemed appropriate due to their broad access to high-quality academic content. To ensure the search remained well-targeted and thematically specific, a carefully curated combination of keywords was employed. These keywords were aligned with the research scope and were selected to capture the intersection between monetary policy, capital movement, and arbitrage dynamics.

- Arbitrage Channels
- Federal Reserve
- Monetary Policy
- Interest Rate Hikes
- Monetary Tightening
- Spillover Effects
- Interest Rate Differentials
- Emerging Economies

To refine the search results, Boolean operators such as "AND" and "OR" were applied in various combinations of keywords. This approach enhanced the precision of the literature selection by ensuring that the retrieved studies either examined the interplay between Federal Reserve policy shifts and arbitrage prospects or simultaneously addressed these variables along with short-term capital movements. Additionally, the temporal scope of the literature search was confined to publications released between 2010 and 2023. This time-bound restriction was adopted to enhance the contemporary relevance of the findings, as including studies beyond this range might have reduced the applicability of older economic contexts to the present global financial landscape. An essential component of the SLR process involved the establishment of clear inclusion and exclusion criteria. These criteria served to filter the literature in a manner consistent with the primary objectives of the review, namely, to derive policy insights capable of mitigating the adverse consequences of global monetary volatility and to

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identify under-researched areas warranting further scholarly exploration. The criteria are outlined as follows:

Inclusion Criteria

- Publications must appear in peer-reviewed academic journals and have been released between 2010 and 2024.
- Selected studies must examine, whether explicitly or implicitly, the effects of Federal Reserve monetary policy actions—particularly interest rate increases—on capital movements and arbitrage mechanisms.
- Research must contribute substantive insights into the dynamics of short-term capital flows, particularly in response to phases of monetary policy tightening.
- Articles should explore the spillover implications of U.S. monetary policy on emerging markets, with comparative consideration of impacts relative to those experienced by advanced economies.

Exclusion Criteria

- Research that lacks any direct connection to monetary policy, arbitrage activities, or capital flow dynamics.
- Studies concentrating primarily on long-term capital movements or on monetary policies implemented by central banks other than the Federal Reserve.
- Articles centred chiefly on non-financial themes, including political or social consequences, rather than economic or financial market factors.
- Publications that fall outside the disciplinary boundaries of economics and financial market analysis.

After the selection of all pertinent articles, relevant data was systematically extracted and synthesised into a summary table presented in the following section (Table 1). This process facilitated a thorough appraisal of each chosen study's relevance and offered a concise overview of their research aims, methodologies, and principal findings. Following data extraction, the results were categorised into distinct thematic clusters. These thematic areas included:

- The effects of Federal Reserve interest rate increases on short-term international capital movements.
- The role of interest rate differentials in shaping arbitrage activities within global financial markets.
- Variations in capital flow patterns and behaviours between advanced economies and emerging markets.
- Documented spillover impacts and associated financial vulnerabilities in markets considered to be at higher risk.

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FINDINGS

The studies reviewed in this paper are succinctly summarised in Table 1, comprising a total of 23 selected articles. These works collectively highlight the significant influence of Federal Reserve interest rate policies on short-term global capital movements and the functioning of arbitrage channels across both advanced and emerging economies. The SLR identifies several recurring themes prevalent throughout the literature, illustrating the mechanisms by which interest rate adjustments—particularly during Fed tightening phases—affect international markets. For instance, Koepke (2018) emphasises how shifts in policy expectations markedly influence capital flows, with tighter cycles leading to diminished capital inflows into emerging markets.

Similarly, Ahmed and Zlate (2014) reveal that increases in interest rates trigger capital outflows from emerging economies, thereby intensifying their financial fragility. A consistent observation across multiple studies is that weaker financial systems are vulnerable to abrupt reversals in portfolio investments, reflecting the asymmetrical nature of capital flow dynamics. Kai, (2021) demonstrate that monetary easing policies often induce temporary surges in capital inflows to emerging countries; however, the withdrawal of such policies or heightened expectations of future rate hikes tend to generate volatility and highlight the transient characteristics of these flows. Such movements are frequently propelled by arbitrage trading.

Moreover, the SLR uncovers arbitrage prospects stemming from interest rate differentials. Edwards (2012) and Fong et al. (2010) explore carry trade strategies and the principle of interest rate parity, showing how investors capitalise on these opportunities by reallocating capital towards higher-yielding assets. Nonetheless, arbitrage channels are not without obstacles. Mitchell and Pulvino (2012) argue that during periods of financial distress, profitable arbitrage opportunities may collapse due to liquidity limitations. Their findings underscore the pivotal role of capital availability and leverage in determining investors' capacity to exploit these opportunities effectively.

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Table 1: Shortlisted Studies and their Corresponding Findings

Article	Objective	Methodology	Findings
Edwards (2012)	To explore how changes in the Fed's policy rates transmit to short-term domestic interest rates in seven emerging Latin American and Asian countries.	Empirical study using weekly 2000s data to examine rate transmission, capital controls, and US yield curve dynamics.	Rates pass through from the Fed to emerging markets, creating arbitrage opportunities as capital is reallocated in response to rate differentials. The study highlights that capital controls fail to shield economies from global interest rate movements, underscoring the importance of yield curve changes for arbitrage channels and cross-border capital flows.
Fratzscher et al. (2018)	To analyse how the Federal Reserve's QE policies, affect global financial flows, prompt portfolio reallocations, and shift risks between economies	Uses empirical data on portfolio flows and asset prices during QE1 and QE2 across advanced and emerging markets.	QE policies prompted capital reallocation during QE1, with funds flowing out of emerging markets into the US, and the reverse occurring during QE2. The study emphasises the risk spillovers and the limited effectiveness of foreign exchange or capital account policies in mitigating the impact of US policy spillovers.
Du et al. (2018)	To examine how persistent deviations from Covered Interest Rate Parity (CIP) create systematic arbitrage opportunities in global financial markets.	Empirical analysis using forward contracts, repo rates, and interbank rates to assess arbitrage opportunities and regulatory effects on bank behaviour.	Deviations from CIP create arbitrage opportunities that are largely unaffected by credit risk or transaction costs. Banking regulations, particularly at quarter-end, significantly impact these deviations. Currencies with higher interest rates offer profitable arbitrage trades, with deviations linked to nominal interest rates and liquidity risks.
Koepke (2018)	To analyse how expectations of U.S. Federal Reserve interest rate policies affect portfolio flows to emerging markets.	Uses high-frequency fund flow and balance-of-payments data with econometric models to assess effects of expected vs. unexpected Fed policy shifts.	Changes in Federal Reserve policy expectations markedly influence portfolio flows to emerging markets. Expectations of tightening reduce inflows, whereas easing expectations increase them. The effects are asymmetric, with tightening exerting a stronger negative impact. Retail investors display greater sensitivity to these policy changes compared to institutional investors.
Mitchell and Pulvino (2012)	To explore how financial crises, disrupt arbitrage, focusing on hedge funds' capital constraints and their failure to maintain relative pricing during the 2008 crisis.	Empirical study using hedge fund and prime broker data to assess pricing gaps and leverage effects, with case studies on convertible bond and merger arbitrage.	Hedge funds faced sudden capital constraints when debt financing was withdrawn, causing mispricing in related securities. Arbitrage funds sold assets at significant discounts, intensifying market disruptions. The study highlights that swift changes in debt capital access are crucial in arbitrage breakdowns.
Arteta et al.	To examine the rationale,	Applies event study methods and	NIRP transmission channels resemble those of conventional

(2016)	mechanisms, and effects of negative interest rate policies (NIRP) used by central banks.	financial variable analysis to assess NIRP transmission channels across economies and markets.	policies but pose challenges like reduced bank profitability and financial stability risks. Spillover effects on emerging markets mirror other unconventional measures, affecting capital flows. Extended NIRP use may encourage excessive risk-taking and asset bubbles, highlighting the need for careful policy design.
Combes et al. (2012)	To analyse how private and public capital flows affect the real effective exchange rate (REER) and evaluate how exchange rate flexibility mitigates currency appreciation from inflows.	Employs a pooled mean group estimator on data from 42 emerging and developing countries (1980–2006) to assess long- and short-term effects.	Private capital inflows, particularly portfolio investments, have a greater appreciation effect on the REER than public inflows. A more flexible exchange rate helps mitigate real appreciation from capital inflows, thereby supporting competitiveness.
Ahmed and Zlate (2014)	To examine the factors determining private capital inflows to emerging markets after 2002, emphasising the role of U.S. monetary policy and other influences.	Uses panel data on capital flows to 12 emerging markets, examining growth and interest rate differentials, risk appetite (e.g., VIX), and U.S. unconventional policy (e.g., LSAPs).	Growth, interest rate differentials, and global risk appetite are key drivers of capital inflows. Since 2008, capital flows have become more sensitive to interest rate differentials. Unconventional U.S. monetary policy increased portfolio flows to emerging markets, though capital controls proved effective in moderating these inflows when applied.
Albagli et al. (2019)	To examine the channels through which U.S. monetary policy spillovers influence bond yields in developed and emerging markets.	Employs panel regressions on U.S. Treasury yield changes during FOMC meetings, decomposing long-term bond yields into risk-neutral and term-premium components by country.	U.S. monetary policy spillovers strongly impact international bond markets, intensifying after 2008. In developed markets, effects occur via risk-neutral rates, while in emerging markets, term premia are affected. Central banks' exchange rate interventions amplify spillovers, boosting capital inflows into emerging economies.
Hofmann and Takáts (2015)	To investigate the global impact of U.S. monetary policy on interest rates and financial conditions, emphasising spillovers to emerging markets and small advanced economies.	Uses panel regressions on 30 emerging and small advanced economies (2000–2014), controlling for global risk sentiment, domestic conditions, and exchange rate regimes.	U.S. interest rate changes substantially spill over to short- and long-term rates abroad. Exchange rate flexibility does not fully protect countries from these effects. Such spillovers limit policy autonomy in integrated economies, impacting capital flows and financial stability.
Fratzscher et al. (2012)	To analyse the global effects of U.S. quantitative easing on asset prices, capital flows, and exchange rates in 65 countries, emphasising portfolio shifts between developed and emerging	Analyses panel data and high-frequency mutual fund flows to assess QE announcements and operations, comparing impacts of QE1 and QE2 on global markets.	QE1 caused capital to shift from emerging markets (EMEs) to U.S. assets, strengthening the U.S. dollar. QE2 reversed this, directing funds into EME equities and weakening the dollar. Actual Fed actions had greater impact than announcements, highlighting the role of liquidity. QE policies intensified capital flow cycles, especially in markets

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	markets.		with weaker institutions and less active monetary policies.
Anaya et al. (2017)	To examine the impact of U.S. unconventional monetary policy on capital flows and financial conditions in emerging markets.	Applies a structural GVAR model on 39 advanced and emerging economies (2008–2014), focusing on portfolio flows, exchange rates, and interest rate responses to UMP shocks.	UMP shocks cause substantial portfolio inflows into EMEs, boosting equity returns, real currency appreciation, and easing monetary policies. These spillovers last about two quarters, with capital flows as a main transmission channel. Exchange rate flexibility does not effectively protect EMEs from these spillovers.
Kose et al. (2017)	To analyse the impact of U.S. economic policies on global financial markets, emphasising growth, monetary and fiscal policy, and economic uncertainty.	Uses Bayesian VAR and panel regressions to estimate growth and financial spillovers from U.S. shocks across advanced and emerging economies.	U.S. monetary policy produces significant global spillovers, especially via financial markets and capital flows. Emerging economies are particularly vulnerable to U.S. policy changes, with capital flows reacting sharply to tightening. Exchange rate regimes affect spillover intensity, while global integration amplifies these impacts.
Miyajima et al. (2014)	To analyse how U.S. unconventional monetary policy, especially through long-term interest rates, influences financial markets and monetary policy in Asian economies.	Uses a panel VAR model on five Asian economies (2003–2013) to study how U.S. long-term interest rates and term premia transmit across these markets.	U.S. long-term rates strongly affect Asian financial conditions, lowering bond yields and boosting bank credit. Exchange rate flexibility alone cannot prevent spillovers, so central banks require tools beyond interest rates to manage volatility from U.S. policy changes.
Obstfeld (2019)	To investigate how global factors, shape the U.S. Federal Reserve's monetary policy decisions and evaluate the international spillovers from these policy changes.	Utilises theoretical frameworks and data on exchange rates, inflation, and global financial flows to examine the interaction between domestic and international markets and the policy trade-offs faced by central banks.	U.S. monetary policy causes substantial global spillovers, especially affecting financial markets and capital flows. Exchange rate flexibility alone cannot fully mitigate these impacts. Financial and trade linkages amplify spillovers, creating feedback effects on the U.S. economy. Policymakers face the challenge of balancing domestic objectives with international responsibilities.
Kazi et al. (2013)	To examine how U.S. monetary policy shocks, transmit across OECD economies and assess the presence of contagion effects during both turmoil and stable periods.	Applies a time-varying parameter factor-augmented VAR (TVP-FAVAR) on data from 14 OECD countries (1981–2010) to analyse macroeconomic and financial variables.	U.S. monetary shocks affect GDP and asset prices in OECD countries through interest rates, trade, and financial markets. Effects intensify during crises, especially in Canada, Japan, and Germany. Exchange rate flexibility does not prevent contagion, and financial integration amplifies spillovers.
Forbes et al. (2016)	To examine how unconventional monetary policies and regulations affect cross-border bank lending.	Using UK bank-level data from 2008 to 2013, the study examines how microprudential capital requirements and	Higher capital requirements reduce cross-border lending, an effect strengthened by the Funding for Lending Scheme, while quantitative easing shows limited interaction. Countries with strict capital rules faced smaller spillovers

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		unconventional policies, such as QE and the Funding for Lending Scheme, affected cross-border lending.	but saw notable declines in cross-border lending.

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Furthermore, the effects of capital flows differ markedly between advanced and emerging economies. Albagli et al. (2019) observe that monetary policy actions originating from the United States exert varying influences on bond markets within emerging economies, where market volatility is significantly heightened. This suggests that the structural characteristics of domestic markets shape both arbitrage strategies and their implementation, as well as affect the stability of capital flows. Advanced economies tend to be better positioned to absorb fluctuations in capital movements due to their more developed financial markets and robust institutions. In this vein, Albagli et al. (2019) also note that investor behaviour in developed nations is largely guided by risk-neutral interest rates, whereas the increased capital market volatility in emerging economies results in a heavier reliance on external financing. These emerging markets often lack sufficient policy instruments to counteract abrupt capital flow reversals.

According to Ahmed and Zlate (2014), changes in US monetary policy contribute to currency depreciations in emerging markets, accompanied by widening sovereign spreads, which further heighten financial risk and capital volatility. Exchange rate dynamics assume a particularly prominent role in emerging economies; Miyajima et al. (2014) emphasise that currency depreciation following Fed rate hikes generates inflationary pressures, thereby constraining monetary policy independence in these nations. In contrast, advanced economies benefit from capital inflows during tightening phases. Fratzscher et al. (2012) argue that Fed policy announcements prompt portfolio reallocations towards US assets, which concurrently suppress bond yields and stabilise financial markets. These findings reveal an asymmetry in capital flow responses, highlighting the vulnerabilities of less resilient economies, which are comparatively less capable of absorbing shocks than their advanced counterparts.

The literature addressing spillover effects is extensive, highlighting how interest rate increases by the Federal Reserve pose considerable threats to financial stability in emerging economies. Within this context, Anaya et al. (2017) demonstrate that adjustments in US monetary policy trigger capital flight from emerging markets, resulting in currency depreciation and elevated borrowing costs in these countries. Hofmann and Takáts (2015) extend this perspective by arguing that the growing integration of global financial markets intensifies such spillovers, thereby complicating policymakers' efforts to protect their economies from external shocks. Even nations with flexible exchange rate regimes experience diminished effectiveness of monetary policy, largely due to heightened volatility in exchange rates and equity markets following rate hikes. Fratzscher et al. (2012) note that quantitative easing measures initially stimulate capital inflows into emerging economies, but their subsequent reversal precipitates capital outflows, culminating in financial instability.

Buono et al. (2023) further observe that capital inflows occurring prior to Fed policy changes tend to exacerbate the severity of outflows during tightening phases, leading to liquidity shortages and currency crises. Consequently, emerging economies are

compelled to implement countercyclical policies, such as interest rate increases or foreign exchange market interventions, which, while stabilising markets, often constrain economic growth. Miyajima et al. (2014) add that exchange rate interventions alone are inadequate to fully counteract spillover effects, highlighting the necessity for macroprudential policies to bolster economic resilience. Collectively, these findings emphasise the critical need for coordinated international policy action to mitigate the adverse consequences of Fed policy spillovers, particularly for vulnerable economies disproportionately affected by capital flow volatility.

DISCUSSION

Policy Implications

The findings highlight important policy implications for central banks and regulators, especially during Fed tightening periods. Emerging economies are highly vulnerable to capital outflows amid Fed rate hikes, necessitating strong macroprudential frameworks to mitigate volatility. Since exchange rate interventions alone are inadequate to address broad financial spillovers (Hofmann & Takáts, 2015), capital flow management tools such as capital controls and liquidity buffers are essential to stabilise markets (Anaya et al., 2017). Central banks should build foreign exchange reserves and devise contingency plans to counter capital flight, while fostering deep domestic financial markets to reduce reliance on external capital and vulnerability to sudden reversals. Diversifying external financing sources can further insulate markets from Fed-induced shocks.

Advanced economies, particularly the US, must acknowledge the global impact of their monetary policies. Unconventional measures like quantitative easing, while stabilising domestically, generate spillovers by encouraging excessive risk-taking and capital inflows into emerging markets, which may overheat economies and heighten vulnerabilities (Kai, 2021; Zehri & Madjd-Sadjadi, 2023). Hence, international coordination of monetary policy is vital to limit adverse spillovers on emerging markets. The review stresses the need for macroprudential cooperation globally, enabling alignment of national policies with the international financial environment, so that stabilisation burdens do not rest solely on emerging economies. Advanced economies might support this through swap agreements and credit lines to ease liquidity pressures during tightening phases, reducing financial contagion risks. Finally, regulators should closely monitor arbitrage activities and cross-border capital flows to detect systemic risks early and implement preventative measures to preserve financial stability.

Future Research Prospects

The SLR identifies several gaps in the literature. One key area is the limited empirical evidence on the effectiveness of macroprudential measures, such as capital controls and liquidity buffers, in managing volatility during monetary policy tightening—especially

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in highly integrated financial markets. Future research should prioritise comprehensive case studies assessing the impact of macroprudential policies across diverse market conditions to better evaluate their efficacy. Another underexplored domain concerns the interaction between monetary and regulatory policies. Gerko and Rey (2017) suggest that combining monetary tightening with regulatory interventions may create unintended frictions, such as reduced capital mobility and constrained liquidity, which could amplify financial instability. Hence, further investigation is required to determine an optimal policy mix that manages spillovers while sustaining economic growth. Future studies might examine various combinations of regulatory tools and monetary policies and their effects on financial stability in economies with differing levels of market intervention.

Additionally, the rise of digital financial platforms and fintech introduces new complexities in arbitrage behaviour and cross-border capital flows. Given the SLR's focus on traditional financial instruments, future research should explore real-time financial transactions facilitated by fintech and their influence on capital movement. Understanding digital arbitrage strategies and their impact on global markets represents a promising avenue, offering valuable insights for regulators and policymakers. Finally, there is scope to analyse regional variations in spillover effects and factors affecting policy effectiveness. Current literature predominantly emphasises Fed policy impacts on emerging markets; therefore, comparative studies across different regions would significantly enrich the field.

CONCLUSION

This paper presents a SLR on the impact of Federal Reserve interest rate hikes on global capital flows through arbitrage channels. The findings highlight that Fed policies significantly influence cross-border capital movements, with asymmetric effects: advanced economies tend to benefit from capital inflows during easing cycles, whereas emerging markets face capital outflows, liquidity constraints, and currency depreciation during tightening phases. Interest rate differentials drive currency and interest arbitrage, reallocating global capital, but arbitrage channels become fragile during financial crises, as seen in the 2013 Taper Tantrum. This poses substantial challenges for central banks and regulators worldwide. Emerging economies must strengthen macroprudential frameworks, deepen financial markets, and build reserves to mitigate currency volatility. Additional tools, including capital flow management and contingency plans, are essential, as exchange rate interventions alone are insufficient. Advanced economies, especially the US, should consider the global spillovers of their monetary policies. Unconventional measures have been linked to excessive risk-taking and asset bubbles, exacerbating financial vulnerabilities and migration pressures in recipient countries. Effective spillover management requires international policy coordination, with advanced economies providing swap lines or credit facilities during tightening phases. Significant gaps remain in the literature, notably on macroprudential

policy effectiveness, interactions between regulatory and monetary tools, and the influence of digital financial platforms on capital flows. The SLR underscores the need for coordinated international policies to mitigate adverse spillovers and maintain financial stability globally. To reinforce these findings, future empirical research is necessary to address current limitations and close prominent gaps in the field.

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