Measuring Spillovers between the US and Emerging Markets

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Summary

The impact of US unconventional monetary policy (UMP) on emerging market economies (EMEs) is widely debated in both policy circles and the academic literature. In particular, when Chairman Bernanke announced in May 2013 that the US Fed would start an earlier than expected tapered end to UMP (tapering tantrum), EMEs markets plummeted. While the US is commonly regarded as a source of financial spillovers to EMEs, little research has been done on spillovers in the other direction. Spillovers from EMEs to the US could however be large were the US to start tightening monetary policy.

This paper evaluates financial spillovers between the US and EMEs using the methodology advocated by Diebold and Yilmaz (2009). Using a vector autoregression (VAR) of the US and EMEs return of sovereign bonds, equity and foreign exchange, we find that shocks originating from both US and EMEs bond markets are significant. In view of the significant effect of bond shocks, we further find that bond market spillovers between the US and EMEs have strengthened following the tapering tantrum, based on a VAR of 27 long-term sovereign bond yields. Our results suggest that a US monetary tightening would have a significant effect on other economies, and especially on financial markets’ performance outside the US particularly in EMEs, and that the repercussions would generate undue pressure on the US affecting subsequent policy actions.