International Financial Spillovers to Emerging Market Economies: How Important Are Economic Fundamentals?

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Key Questions

- Do economic fundamentals of EMEs affect their heterogeneous responses in financial market during global financial crisis?
- What kind of characteristics can explain the degree of financial condition deterioration?
- Do investors differentiate EMEs according to their fundamentals or characteristics?

Answers/ Key Takeaways

- Do economic fundamentals of EMEs affect their heterogeneous responses in financial market during global financial crisis?
  - better economic fundamentals ⇒ less deterioration in financial markets in the 2013 taper-tantrum period
  - differentiation set in early and persisted
- What kind of characteristics can explain the degree of financial condition deterioration?
  - larger capital inflows and greater exchange rate appreciation earlier ⇒ financial conditions deteriorated more
- Do investors differentiate EMEs according to their fundamentals or characteristics?
  - No - in 1990s and early 2000s
  - Yes - after the mid-2000s
  - differentiation is not unique to the 2013 episode

Contributions

This paper

- documents the deterioration in the financial conditions of EMES during the 2013 taper-tantrum episode
- contributes to growing literature exploring explanations of EMEs' heterogeneous responses in financial markets
- treats the taper tantrum as a single episode instead of looking at market daily reactions
- suggests that policies to strengthen economic fundamentals could help the EMEs mitigate impacts from AE

Major Points

- Understanding the results deeper:
  - Is the less deterioration in financial markets of EMEs with better fundamental because they suffer smaller impacts from AE or they are more capable of resisting compression?
  - Why didn't investors care economic fundamentals before mid-2000's and what caused the shift?

Major Points (Cont'd)

- The logic behind the results
  - Following Conclusion 5, international investors care EMEs fundamentals $\Rightarrow$ more capital inflow and greater currency appreciation in EMEs with better fundamentals $\Rightarrow$ following Conclusion 3, these countries should suffer more during taper-tantrum episode $\Rightarrow$ inconsistent with Conclusion 1 that EMEs with better fundamentals suffer less

Major Points (Cont'd)

- The logic behind the results
  - Alternative: investors do not choose EMEs with better fundamentals at the beginning, but they only care how to make quick money $\Rightarrow$ they choose countries with more arbitrage opportunities $\Rightarrow$ less developed countries with unmatured financial markets are their targets $\Rightarrow$ more-in-more-out of capital in these countries $\Rightarrow$ consistent with Conclusion 3 $\Rightarrow$ but lack of empirical evidence

Major Points (Cont'd)

- The logic behind the results
  - Alternative: investors choose countries with better fundamentals at the beginning $\Rightarrow$ large capital inflow in these countries $\Rightarrow$ greater currency appreciation $\Rightarrow$ less competitive trade sector + foreign capitals do not enter production but only boost consumption prices and accumulate asset bubble $\Rightarrow$ worse fundamentals + inefficient domestic policies $\Rightarrow$ large capital outflow and financial market deterioration $\Rightarrow$ still lack of empirical evidence

Major Points (Cont'd)

- The vulnerability index
  - construction details (with mean 23? weight to each variable?)
  - What's the advantage of using ranks? How about other aggregation methods, e.g., extract common factors?
  - What's the relation to others' methodologies in the literature? - e.g., How do others deal with small sample problem? Do they construct indices of the similar purpose? Are these indices comparable?
  - What's the correlation between the index and the fundamentals?

Minor Points

- What's the role of domestic policies?
  - monetary policy: central bank credibility / capability / institutional issues
  - capital control: e.g. Brazil
  - fiscal policy
  - political stability

Minor Points (Cont'd)

- Regression tables: clear however could be better
  - Results reported seem a little arbitrary since different regressions report different combinations of results:
    - e.g., dummies are not included in Regression (3) in Table 4, but are included in Table 2 and 3.
  - More clarifications in table captions:
    - e.g. "market cap" in Table 1
- The VIX index: HP filtered
  - Is this a convention in the literature?
  - Is there a clear trend in VIX index?
  - What's the value of the smooth parameter?

Suggestions

- Investigate the logics among results and give a complete story
- Make the tables consistent and easier to read
- Control policy issues in regression, (e.g., adding central bank credibility, foreign exchange regimes, and capital control dummies), and consider policy stability index as an independent variable.
- Describe the construction details of the vulnerability index and report correlation matrix of the vulnerability index and the six fundamentals.

Conclusion

- This is a very interesting and topical empirical exercise on first order issue.
- This paper highlights connections between country-specific characteristics and the degree of financial market deterioration in EMEs.
- This paper constructs an aggregate vulnerability index, which at least partially solves the small sample problem.
- Simple extensions could make it more robust and more useful for researchers, investors, and policy makers.
- **Thank you!**