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Global contagion of market sentiment during the US subprime crisis

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Abstract

This paper investigates how global market sentiment propagates among the markets and how the interdependency through the propagation changes during the course of the US subprime crisis. We adopt a bivariate generalized autoregressive conditional heteroskedasticity (GARCH) model, and use a sample of eight global markets: Japan, Korea, Taiwan, Belgium, Germany, Netherlands, UK, and the Eurozone in our investigation. Our results identify that (1) a long-run equilibrium relationship existed between market sentiment in the US and other major global markets during the subprime crisis period; (2) a global contagion of market sentiment occurred from the US market on September 15, 2008 to Japan, Korea, Belgium, Germany, Netherlands, and the Eurozone; and (3) the major global markets are all interrelated.

JEL classification: G12; G13

Keywords: Subprime crisis; Volatility indices; Market sentiment; Bivariate GARCH model

1. Introduction

The global financial markets have been suffering huge losses from the US credit crisis. The US credit crisis was first caused by extensive defaults by subprime borrowers in the mortgage markets, and soon had led to massive portfolio losses held by many global financial institutions.

Thus, the issue of financial contagion has become even more important, and there has been an extensively growing literature addressing its causes and effects. The important recent papers include Allen and Gale (2000), Kyle and Xiong (2001), Kodres and Pritsker (2002), Kiyotaki and Moore (2002), Kaminsky, Reinhart, and Vegh (2003), Allen and Gale (2004), Brunnermeier and Pedersen (2005, 2007), Poshakwale and Aquino (2008), Dungey, Milunovich, and Thorp (2010), Berger and Turtle (2011), Siklos (2011), and many others.

In the literature, three possible contagion channels are identified, where shocks in one market transmit into other markets: (1) contagion occurs as information transmits from liquid (or more-price-discovery) markets to other markets.¹ In this channel, negative shocks in one market represent the arrival of economic news which affects security values in other markets;

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¹ See Kiyotaki and Moore (2002) and Kaminsky, Reinhart, and Vegh (2003).

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