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

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Abstract

We assess the importance of economic fundamentals in the transmission of international shocks to financial markets in various emerging market economies (EMEs), covering the so-called taper-tantrum episode of 2013 and seven other episodes of severe EME-wide financial stress since the mid-1990s. Cross-country regressions lead us to the following results: (1) EMEs with relatively better economic fundamentals suffered less deterioration in financial markets during the 2013 taper-tantrum episode. (2) Differentiation among EMEs set in relatively early and persisted through this episode. (3) During the taper tantrum, while controlling for the EMEs' economic fundamentals, financial conditions also deteriorated more in those EMEs that had earlier experienced larger private capital inflows and greater exchange rate appreciation. (4) During the EME crises of the 1990s and early 2000s, we find little evidence of investor differentiation across EMEs being explained by differences in their relative vulnerabilities. (5) However, differentiation across EMEs based on fundamentals does not appear to be unique to the 2013 episode; it also occurred during the global financial crisis of 2008 and, subsequently, during financial stress episodes related to the European sovereign crisis in 2011 and China's financial market stresses in 2015.

Keywords: Emerging market economies, financial spillovers, economic fundamentals, vulnerability index, depreciation pressure, taper tantrum, financial stress.

JEL classifications: E52, F31, F32, F65.

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