

Accepted Manuscript

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PII: S0165-1889(18)30092-7
DOI: [10.1016/j.jedc.2018.03.001](https://doi.org/10.1016/j.jedc.2018.03.001)
Reference: DYNCON 3569

To appear in: *Journal of Economic Dynamics & Control*

Received date: 10 March 2017
Revised date: 29 January 2018
Accepted date: 7 March 2018

Please cite this article as: Pu Chen, Willi Semmler, Financial Stress, Regime Switching and Spillover Effects: Evidence from a Multi-Regime Global VAR Model, *Journal of Economic Dynamics & Control* (2018), doi: [10.1016/j.jedc.2018.03.001](https://doi.org/10.1016/j.jedc.2018.03.001)

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January 12, 2018

Abstract

The globalization process leads to increasing synchronization of business cycles among different countries. As a consequence, many policy makers and Central Banks are afraid of vulnerabilities of their countries arising from external risk drivers. In this paper we develop a multi-regime global VAR model to study the spillover effects in financial markets, in goods markets and between financial markets and goods markets across countries, which are assumed to be either in a high financial stress regime or in a low financial stress regime. It turns out that in both the high and the low stress regimes financial shocks to a country, big or small one, can have large and persistent impacts on financial markets of other countries, and only in the high stress regime financial shocks to a country can have some negative output effects on other countries. In the high stress regime output shocks of a big country can have larger effects on financial conditions than those of a small country, while in the low stress regime output shocks of a country, big or small, have little impact on financial conditions. Further, we study the effects of global and regional shocks, as well as the spillover effects of national monetary policies and internationally coordinated policies on the financial and real sectors.¹

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¹This paper had been presented as an invited paper in a special session on Carl Chiarella at the CEF Conference, June 28-30, 2017 New York. The paper is dedicated to Carl Chiarella's work. It is exploring in a large scale regime change model the real-financial interaction that Carl had pursued in much of his work for lower dimensional systems, see Chiarella, Flaschel, and Semmler (2015) and Charpe, Chiarella, Flaschel, and Semmler (2011)). Here we thank the anonymous reviewers for constructive comments and suggestions in shaping the final version.

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