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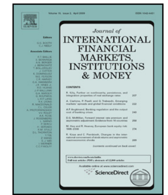

Reverse spillover: Evidence during emerging market financial turmoil in 2013–2014☆

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ABSTRACT

As emerging market countries are more deeply integrated with the global economy, it is more likely that financial shocks in those countries can spill over into advanced economies, which we call "reverse spillover". We examine whether emerging market financial turmoil in 2013–2014, caused mainly by the expectation of future US monetary policy tightening, created such spillover. Panel fixed-effects regression suggests that emerging market financial instability reduces portfolio fund flows to advanced economies and increases their sovereign CDS premia. In addition, Granger causality network analysis indicates that the influence of emerging market economies in the global financial network significantly increased during the period of interest.

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1. Introduction

Contagious events are often found in recent history of the international financial markets. However, each of those event has a different origination and influence, especially regarding the relationship between the advanced economy (hereafter "AE") and the emerging market economy (hereafter "EME"). First, there are intraregional crises, more frequently among EME countries, such as the Mexican Tequila crisis and the Asian financial crisis in the 1990s. Second, there are spillovers from AE financial crises to EME financial markets, as in the case of the 2007–2008 global financial crisis. Finally, there are cases when financial turmoil in EMEs causes instability in AE financial markets. Our study focuses on this last type of spillover, from EMEs to AEs, which we simply call "reverse spillover".[1]

One can argue that the financial exposure of AE countries to EMEs relative to their total assets is not sufficiently large for an EME financial turmoil to significantly affect AEs. However, the Russian financial crisis in 1998 and the ensuing collapse of LTCM indicate that an EME financial crisis can spill over and exacerbate financial instability in AEs. Moreover, the integration of EME countries into the global economy has continued in the past several decades, and their importance in global trade

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[1] In the G-20 meeting in 2013, Korean finance minister Oh-seok Hyun mentioned reverse spillover to stress the negative impact of the EME financial turmoil on the global financial markets and called for international policy coordination. Recently, "spillbacks" appeared in an IMF official communiqué to imply the same concept, with more emphasis on feedback loops (Wall Street Journal, April 12, 2014).

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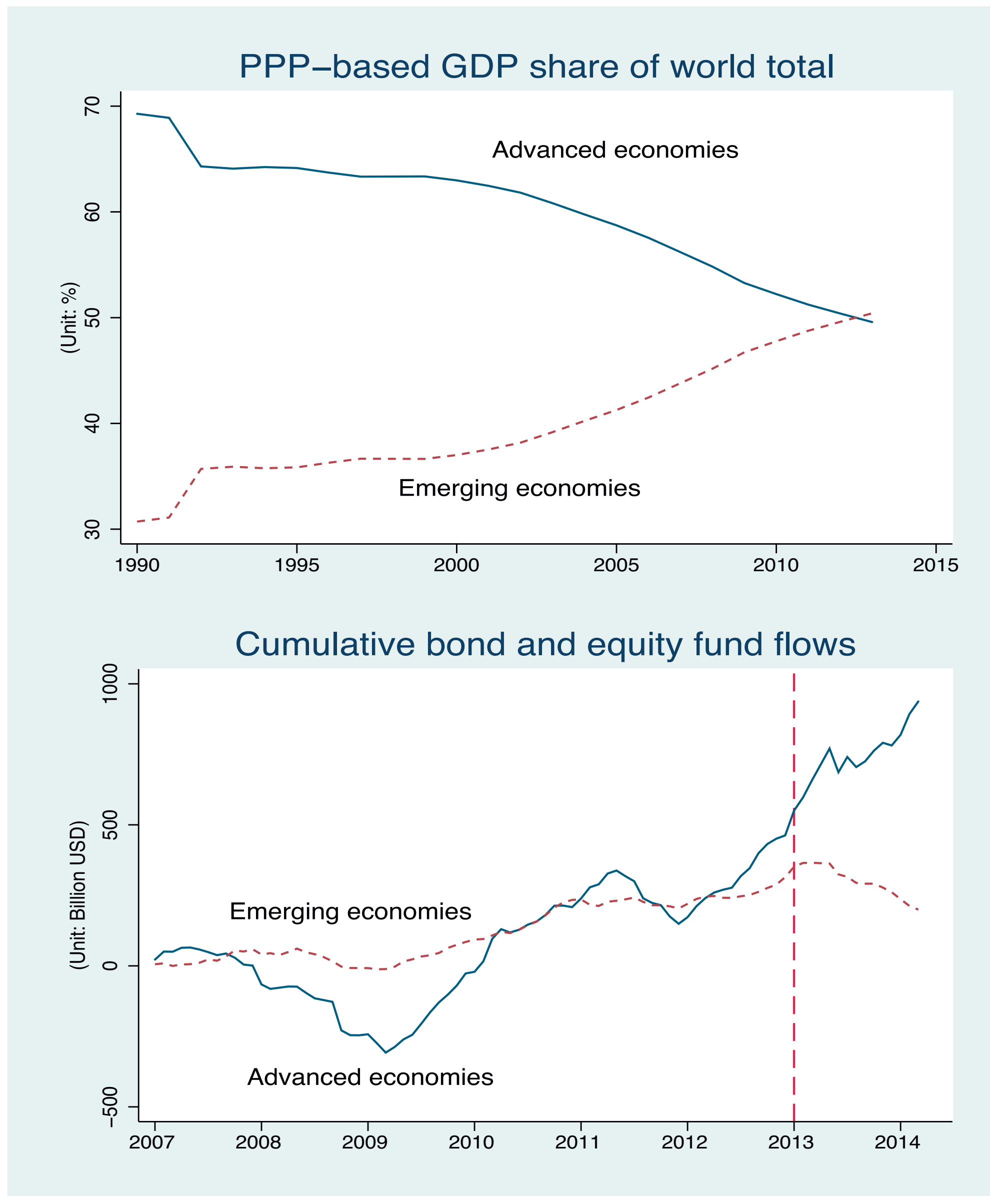

Fig. 1. Growing presence of emerging market countries in the global economy. *Note*: Cumulative bond and equity fund flows since January 2007. *Source*: IMF WEO (World Economic Outlook) and EPFR (Emerging Portfolio Fund Research).

and financial investment has become substantial. In fact, they were relatively resilient to the 2007–2008 global financial crisis and have driven the global economic recovery since then, while the United States, Europe and Japan have suffered from their own fragility in the financial sector. As indicated in Fig. 1, EME countries' share of world GDP (gross domestic product) based on purchasing power parity (PPP) increased from 37% in 2000 to 54% in 2013. In addition, while EME countries were under-represented in the global financial market, affluent global liquidity from unconventional monetary policy in major AE countries and strong economic growth in EMEs led to the surge in financial flows into the EMEs. The cumulative bond and equity fund flows to EMEs from January 2007 to December 2012 is approximately two-thirds of the inflows to AEs during the same period.

This recent presence of EMEs in the global economy brings a new dimension of interconnectedness in the global financial markets to our attention. In addition, it can reinforce the mutual feedback effects between AE and EME financial markets. For example, monetary surprises in AEs can cause financial instability in EMEs, and this can in turn increase volatility in AE financial market as a consequence of reverse spillover. International policy coordination to prevent this reverse spillover was one of the key discussion agendas of the G-20 finance minister meeting in July 2013. In addition, IMF (2014) and Ollivaud et al. (2014) warn of the possible negative impact of an emerging market slowdown on the global economy.

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