International Effects of US Uncertainty

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Abstract

We study empirically and theoretically the international spillover effects of US financial uncertainty. Using monthly panel data from fifteen major emerging market economies, we show that an unanticipated rise in US stock market uncertainty has persistent and large effects on both financial and macroeconomic variables of the emerging market countries. In particular, a rise in US uncertainty sharply depreciates the exchange rate of these countries, leads to a decline in their local stock market, and capital flows out from them. Moreover, these financial effects are accompanied by large and persistent macroeconomic effects as there is a significant drop in output and a rise in net exports to the US from these countries. Using our empirical framework, we also assess the heterogeneity in responses among the fifteen emerging market economies. Theoretically, we present a small open economy model with financial frictions that can account for our empirical findings. In the model, a negative external shock that increases the interest rate spread faced by the small open economy, the difference between the interest rate faced by the small open economy and the rest of the world, produces responses of output, exchange rate, rate of return on capital, capital flows, and trade balance that are consistent with our estimated responses. Our results thus strongly suggest that developments in the US financial markets have substantial financial and macroeconomic effects abroad.

Keywords: US financial uncertainty; International spillovers; Emerging markets; Financial frictions; Small open economy model

JEL Classifications: E3; F3