Transmission of Financial and Real Shocks in the Global Economy Using the GVAR

by

Hashem Pesaran

Comment

by

Mike Wickens

University of York

GVAR Approach

Very promising new tool for analysing the effects of global shocks on different countries without using too much economic theory

Nice way of linking economies and defining world variables in an internally consistent way

This paper is one of the first applications

I could talk about the results for a very long time

Specification issues

- Using trade weights is probably appropriate only for trade effects such as goods and goods prices (inflation)
- But not for asset prices (equity, interest rates and FOREX) or asset stocks where the US is dominant
- Need to consider how the large current account surpluses of China and the Mid East oil producers and their dollar balances affect the world financial system
- For strategic financial management need to allow for time-varying residual correlation

Correlations

- Clear from the correlations that country asset prices are much more closely linked than either output growth or inflation
- Known that negative US shocks to GDP and equity produce larger inter-country correlations that positive shocks
- Are the correlations due to common shocks (eg oil prices) or contagion (residual correlation)?

Positive Oil Price shock

- Was the oil price endogenous – due to increases in world demand – and not an exogenous shock?
- Why did countries respond differently?

- Japanese output rose
- UK and Norwegian output fell
- Wrong way round?

- Why did UK inflation rise least? Due to output?

cont

- Why did equity markets and long rates respond so differently?
- UK and Norwegian equity rose – due to being oil suppliers?
- Is this as sample period effect?
- But Austrian and Netherlands equity rose too.

Negative US output shock

- Why did US inflation rise? Supply shock?
- Why did Norwegian inflation rise?
- Why did only Spanish long rates rise?

- Why are no output or equity responses reported?

Negative Real Equity Shock

- Large effects on equity and long rates
- Effect completed in 2 quarters
- Shows the inter-relatedness of financial markets and their speed of adjustment
- Financial markets are forward-looking. So for a VAR to quickly and correctly capture equity shocks there must be high residual correlation (i.e. contagion).

Conclusion

- Great new tool
- But is a VAR really suitable for financial markets?
- And what about the recycling of current account surpluses?
- Generates lots of puzzles - and puzzles means papers.