Taper Tantrums as News to Emerging Markets*

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Abstract

US Federal Reserve announcements gives rise to *expected* interest rate moments in the financial center. We study the consequences of expected (and/or realized) changes in the credit conditions of international lenders for outcomes in emerging markets, in terms of domestic activity, borrowing costs, and welfare. In the data, tight monetary policy in the US is associated with high spreads and depressed activity in emerging markets. We find that a standard sovereign default model, augmented with news shock about lenders' default-risk-free short-term rate, cannot replicate these patterns: in equilibrium yields rise but spreads fall, as the sovereign endogenously reduces issuance. Introducing domestic financial frictions in production allows the model to generate recessions and debt crises caused by (expected) high rates abroad.

Keywords: emerging markets, sovereign default, news shocks, global financial cycle
JEL classification: F34, F41, E52

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