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Volatility Spillover Between the US-China Tension and Emerging Foreign Exchange Markets

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Abstract

Proper understanding of the system or mechanism by which financial risk are transferred has become imperative due to the preponderance of international crises in recent years. The strife between the US and China has been going on for decades with many factors shaping the relationship. The tension between the two nations can trigger volatilities in their currencies and also affect their trading partners. For example, the imposition of retaliatory tariffs could impact investors expectations and weaken their currencies. The Chinese monetary authorities anticipate a decline in Yuan similar to 2018 Sino-US trade tensions' experience in the wake of Donald Trump returns to the White House in 2025. Similarly, the US-China trade partners are prone to exchange rate volatilities. Nevertheless, the ripple and risk transmission effects of the US-China tension (UCT) on foreign exchange market has received limited research attention. We investigate the volatility spillover between the UCT index and emerging forex markets. As the enduring tension between the two nations is multidimensional, rather than focusing on one element of the tension, the UCT index dated back to 1990 enables us to address the multidimensional impact, thereby contributing new insight to the debate. In addition, we apply time-varying parameter vector-autoregressive model and connectedness matrix to capture the dynamic time-varying features and provide comprehensive understanding of the spillover effects of UCT. Understanding risk transmission mechanism between exchange rates and US-China index among US-China and their trading partners is crucial for the stability of international economy.

Keywords: US-China tension, foreign exchange market, emerging market