



Financial and Macroeconomic Connectedness: A Network Approach to Measurement and Monitoring

By Francis X. Diebold, Kamil Yilmaz

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Connections among different assets, asset classes, portfolios, and the stocks of individual institutions are critical in examining financial markets. Interest in financial markets implies interest in underlying macroeconomic fundamentals. In *Financial and Macroeconomic Connectedness*, Frank Diebold and Kamil Yilmaz propose a simple framework for defining, measuring, and monitoring connectedness, which is central to finance and macroeconomics. These measures of connectedness are theoretically rigorous yet empirically relevant.

The approach to connectedness proposed by the authors is intimately related to the familiar econometric notion of variance decomposition. The full set of variance decompositions from vector auto-regressions produces the core of the 'connectedness table.' The connectedness table makes clear how one can begin with the most disaggregated pair-wise directional connectedness measures and aggregate them in various ways to obtain total connectedness measures. The authors also show that variance decompositions define weighted, directed networks, so that these proposed connectedness measures are intimately related to key measures of connectedness used in the network literature.

After describing their methods in the first part of the book, the authors proceed to characterize daily return and volatility connectedness across major asset (stock, bond, foreign exchange and commodity) markets as well as the financial institutions within the U.S. and across countries since late 1990s. These specific measures of volatility connectedness show that stock markets played a critical role in spreading the volatility shocks from the U.S. to other countries. Furthermore, while the return connectedness across stock markets increased gradually over time the volatility connectedness measures were subject to significant jumps during major crisis events.

This book examines not only financial connectedness, but also real fundamental connectedness. In particular, the authors show that global business cycle connectedness is economically significant and time-varying, that the U.S. has disproportionately high connectedness to others, and that pairwise country

connectedness is inversely related to bilateral trade surpluses.

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Editorial Review

Review

"Diebold and Yilmaz's timely book develops powerful new network tools for understanding the interdependence of risks in large-scale financial systems. These tools shed important new light on past financial crises and will fill an important gap in the monitoring of systemic risk going forward."

Peter Christoffersen, Professor of Finance, Rotman School of Management, University of Toronto.

"The aftermath of the Lehman bankruptcy revealed that economists lacked understanding of the linkages within the financial industry and across the different sectors of the economy. The book by Frank Diebold and Kamil Yilmaz has many fresh ideas and new tools to study this very important topic. It is a must-read for anybody interested in this burgeoning area of research."

Eric Ghysels, Bernstein Distinguished Professor of Economics and Professor of Finance, University of North Carolina, Chapel Hill

"We live in a highly integrated world economy with much stronger cross-border connections today than any other time in history. We need to have a better grasp of these connections as they are now at the heart of everyday macroeconomics and finance. Diebold and Yilmaz provide a masterful framework that greatly enhances our understanding of these connections. They also open new research avenues by showing practical applications of their framework in different contexts. And all of these make their book a classical reference on the topic."

Ayhan Kose, Director, Development Prospects Group, The World Bank

"To increase understanding of the origins and spread of global economic disturbances, Diebold and Yilmaz begin this book with an introductory chapter describing their methodology for measuring connectedness among a wide assortment of micro- and macroeconomic variables and comparing their findings to the works of other researchers. Recommended."

-- *CHOICE*

About the Author

Francis X. Diebold is Paul F. and Warren S. Miller Professor of Economics, and Professor of Finance and Statistics, at the University of Pennsylvania and its Wharton School. He has published widely in

econometrics, forecasting, finance, and macroeconomics, and he has served on the editorial boards of leading journals including *Econometrica*, *Review of Economics and Statistics*, *Journal of Business and Economic Statistics*, *Journal of Applied Econometrics*, and *International Economic Review*. He is an NBER Faculty Research Associate, as well as an elected Fellow of the Econometric Society, the American Statistical Association, and the International Institute of Forecasters. He has also been the recipient of Sloan, Guggenheim, and Humboldt fellowships; Co-Director of the Wharton Financial Institutions Center; and President of the Society for Financial Econometrics. His academic research is firmly linked to practical matters: During 1986-1989 he served as an economist under both Paul Volcker and Alan Greenspan at the Board of Governors of the Federal Reserve System, during 2007-2008 he served as an Executive Director of Morgan Stanley Investment Management, and during 2012-2013 he served as Chairman of the Federal Reserve System's Model Validation Council. Diebold also lectures widely and has held visiting professorships at Princeton, Chicago, Johns Hopkins, and NYU. He has received several awards for outstanding teaching, and his academic "family" includes nearly 75 Ph.D. students.

Kamil Yilmaz holds PhD (1992) and MA (1990) degrees in Economics from the University of Maryland, College Park, and a BA degree in Economics from Bogaziçi University, Istanbul, Turkey (1987). He has been a faculty member at Koç University, Istanbul, Turkey, since 1994. He was a visiting professor at the University of Pennsylvania in 2003-2004 and 2010-2011 academic years. He is the recipient of the 2003 Turkish Academy of Sciences (TÜBA) Encouragement Award for Social Sciences; and a member of the American Economic Association, and the Econometric Society. His areas of research include financial econometrics, international economics and macroeconomics.

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