Economic Contagion

Economic contagion is also known as Financial Contagion. In economics, contagion is a situation where an adverse occurrence in a particular economy or region spreads to other economies or regions through co-movements in stock prices, exchange rates, sovereign spreads and capital flows.

What are the causes of an Economic Contagion?

There are several reasons that explain why financial contagion occurs. They are spillover effects and a financial crisis. These, in turn, are caused by four major economic agents. The four agents that influence financial globalization are governments, financial institutions, investors, and borrowers.

According to economists one of the fundamental causes of an economic contagion includes macroeconomic shocks that have repercussions on an international scale that are transmitted through trade links, competitive devaluations and financial links.

Competitive devaluation is also associated with financial contagion. Also knowns as a currency war, it is a situation in which multiple countries compete with each other for an economic edge over each other by devaluing their currency by undermining their exchange rates. The consequences are that market participant will sell their shares elsewhere or refuse to lend short-term loans to borrowers in those countries.

Consequences of financial contagion

Financial contagion can cause financial volatility in markets. They can also damage the financial systems and economies of countries. Global investment and cross-border trade make economic contagions more likely, particularly in emerging economies.

In such markets, financial contagions are often aggravated by asymmetric information, that leads to both unsustainable investments and reactionary market downturns in reaction to the collapsing or weakening of nearby or closely correlated markets. Bigger and established markets are better able to cope with financial contagions than developing markets.

Examples of Financial Contagion

A recent example of a domestic financial contagion occurred in the United States in 2008 when the bankruptcy of global financial services firm Lehman Brothers set off a financial crisis there.

In a domestic market, if a large bank engages in fire sales, the confidence of investors and customers in other large banks can drop significantly. Similarly, in the international market, a market crash in one country can affect other countries and banks in other countries as well because of increased cross-border investments and trade. Sometimes, the disturbances can spread like wildfire - very quickly. If any government has debt troubles, investors can land their focus on governments with unbalanced books.