

TURBULENT PROCESSE IN FINANCIAL MARKETS - CONTAGION MECHANISM -

Pricopi Alexandra *

ABSTRACT

The current economic crisis, present in all major economies, had as a starting point the subprime crisis in United States. From a financial markets crisis, it has turned into a real economy crisis and due to the globalization it has spread worldwide.

The extent of recent financial crisis and consequences of contagion effect have drawn attention from economists worldwide.

The crisis is spreading from one country to another leading to the phenomenon of contagion. Common feature of all financial crises is that a specific country event is quickly transmitted in markets around the globe. Global financial crisis has seriously affected all segments of financial markets and highlighted the need to improve regulatory standards and increasing surveillance in all markets of the global market components, implementation of all financial entities to ensure greater transparency in their activities, investor protection and minimize risk investment.

To conclude, understanding the contagion's causes and its consequences is an important lesson.

KEYWORDS: financial contagion, financial crisis, investor behavior, financial globalization

JEL Classification: F21, G01, G11, G15,

INTRODUCTION

The extent and consequences of recent financial crisis contagion effect economists have drawn attention worldwide. The last decade has been marked by numerous financial crises, but the most serious is the U.S. housing sector, which debuted in June 2007 and affected the entire globe.

The crisis is spreading from one country to another leading to the phenomenon of contagion. Common feature of all financial crises is that an event specific to a country is rapidly transmitted through markets around the globe.

Global financial crisis has seriously affected all segments of financial markets and highlighted the need to improve regulatory standards and increasing surveillance in all markets of the global market components, implementation of all

* Pricopi Alexandra is Assistant Professor at the Romanian-American University

financial entities to ensure greater transparency in their activities, investor protection and minimize risk investment

Global financial crisis contagion effect of cumulative causality overlapped - the negative effects of external crisis being exacerbated by existing internal imbalances, especially in developing economies. Finally, the flock has taken effect - investors withdrawing speculative capital from emerging countries in a short period of time.

The degree of damage to world economies by the crisis depends on the vulnerabilities of each economy and their exposure to toxic assets.

1. CURRENT ECONOMIC AND FINANCIAL CRISIS

The current crisis in the U.S. mortgage market was just the trigger of the global financial crisis.

The crisis could have been anticipated in advance, its origins being related to the breaking of the dot.com bubble in late 2000. To save the Federal Reserve (Fed) federal funds rate decreased from 6.5% to 3.5% in few months. After the terrorist attacks of September 11, the Fed continued to drop interest rates to counter economic decline, so in 2003, the interest rates decreased to 1%. In this case there was an explosion of credit because it was very cheap currency, and this led to a boom in the housing market. Mortgage lenders decreased their standards very low and invented new ways to boost lending to generate commissions. Investment banks have invented new techniques to transfer credit risk to other investors.

In these conditions, the construction market exploded, Merrill Lynch estimated that half of U.S. GDP in the first quarter of 2005 came from this sector of the economy.

The growth of Real estate sector led of course to an explosion in prices, which favored the appearance of speculation. In 2005, almost half of the homes purchased were not working as permanent residences but as investments or holiday homes.

Creditors have invented tools that allowed anyone to turn to a mortgage. Thus came mortgages with variable rates, which in the first two years were below the average market interest rates, assuming that after two years when it began paying higher rates, the mortgage would be refinanced, taking advantage from price increases on real estate market.

Loans were made by brokers, temporarily stored in banks, then sold to investment banks which sold them to institutional investors in the form of guaranteed payment bonds.

Real economy was decisively influenced by the development of credit, so when the funding market collapsed it pulled after itself the entire real economy. Thus, the entire American economy went into crisis and the problems quickly contaminated all countries.

EFFECTS OF CURRENT CRISIS

The crisis led to a series of institutional responses which have resulted in a series of measures to increase control over the remaining areas outside the jurisdiction of central banks and supervisory committees of capital markets.

Romania entered the crisis with an unfavorable macroeconomic situation. Romania was heavily dependent on foreign capital inflows, both in the public sector, as well as the private sector.

But the crisis has caused a further and deeper crisis - the crisis of confidence. The global economy has installed a state of pessimism that reduced consumption of durable goods and investment firms.

There are several lessons to be out from the crisis. The first is that we must have in good times good policies. Only then we can have macroeconomic stability. Moderate growth will be accompanied by moderate recession.

2. FINANCIAL CONTAGION MECHANISM

The interest of economists for financial crisis contagion phenomenon gained widespread attention only in the second half of the '90s when effects of the crisis began to be more visible, spreading from one emerging country to another emerging country.

The phenomenon of propagation or spread of the crisis is known in literature as the contagion effect.

A first general approach would be that contagion is the mechanism by which shocks are transmitted between different countries, creating a domino effect globally. According to this definition, contagion can occur both in times of growth and in times of crisis. The phenomenon refers mainly to periods of financial instability and crisis. And strict approach to contagion is contagion occurs when the correlation between two or more countries in times of crisis increases significantly compared with the periods of "silence". Based on this definition we can say that a method of measuring contagion is by comparing the correlation (covariance) between the two capital markets in a period of relative stability and then a time of crisis.

Another approach deriving from the strict definition of contagion effect is given by Kaminsky and Reinhart (2003): the effect of contagion is that situation where information about the existence of a crisis in another country, increases the likelihood of a crisis locally. Some authors like Mody and Taylor (2003) have further narrowed Gertsman strict approach to the contagion effect: "contagion is the situation where the magnitude and extent of transmission of shocks internationally exceeds ex ante expectations of market operators".

"FLOCK" BEHAVIOUR OF INVESTORS

The key to understanding how shock are being transmitted between countries, is in fact understanding the behavioral changes of investors in crisis situations to those of stability. Starting from this idea, when the foundations of a country or common shocks of many countries can not fully explain the occurrence

of contagion, its propagation causes were attributed to the herd behavior of investors, which is either rational or irrational.

Investors with relative information follow investors well informed, leading to a market move in cooperation.

The next question is put by experts: it is rational for investors to follow irrational behavior?

Contagion effect takes into account the investor and consumer emotional response to radical changes on international markets, with a pronounced psychological and behavioral dimensions. Imperfections in international financial markets can generate bubbles, irrational behavior of market actors, speculative attacks, stock market crash and other such phenomena. These imperfections can lead to major imbalances in the balance of payments or the basic macroeconomic indicators (inflation, exchange rate, interest, unemployment) in countries that initially seemed economically stable.

3. GLOBALIZATION - ENGINE OF CONTAGION

Years 1989-2008 are those in which globalization has become a defining aspect of social, political and economic world.

As a tool for rapid dissemination of economic, capital movements came to identify with globalization as a phenomenon, so that today we can speak, identifying fully with one another, by financial globalization. Globalization of interconnected financial markets, geographical and temporal, transactions are made in real time to all azimuths.

Globalization has increased the role of capital markets which trade bonds, banks themselves have become an engine of this development, including through direct administration of hedge funds. Banks would have to be interested in protecting the market transparency of what we call trust - trust. Without the latter, the financial markets is contaminated, it freezes.

Anthony Gidees - *“globalization can be defined as the intensification of worldwide social relations which link in such places as distant events that are taking place through the eyes of others similar, spent many miles away and vice versa „*

CONCLUSIONS

One of the fundamental questions that arises from economic and financial approaches that try to answer is the degree of normality and crisis prediction.

And other tough questions should be directed to fiscal and monetary regulators about how to better regulate the financial sector access, how to improve market surveillance by the central bank or qualified agencies and how to introduce and maintain supervisory standards to improve risk management standards for the financial services sector.

Interdependence of economies and global financial systems have led to the propagation chain crisis due to market globalization of financial services. Fall of

developed markets had a strong impact on emerging markets, which have experienced unprecedented lack of liquidity.

BIBLIOGRAPHY

Anghelache, Gabriela, "The capital market in the context of EU integration"; Theoretical and Applied Economics, no. 9 / 2007, ISSN 1841-8678 ISSN pp.22, 26, September 2007

Hetes - Gavra Roxana, "Financial globalization in the contemporary economy", Bastion House, Timisoara, 2009

George Soros, "New paradigm of financial markets. The credit crisis of 2008 and its implications", Letter Publishing International, Bucharest 2008

"Does International Financial Contagion Really Exist?", international Finance 6:2, pp. 179 – 199

"What is International Financial Contagion?", International Finance 6:2, pp. 157 – 178

"International Financial Contagion: What do we Know?", Cambridge Endowment for Research in Finance.

Banca Centrală Europeană, Buletin lunar, 2008-2009

Banca Națională a României, Raport asupra stabilității financiare, București, 2008-2009

Comisia Națională a Valorilor Mobiliare, Raport anual, București, 2006-2008

Fondul Monetar International, Global Financial Stability Report, 2008

www.cristianpaun.finantare.ro