

International Financial Contagion is the subject of my research which I am currently conducting for my PhD at the Amsterdam School of Economics (UvA) and would like to share with the world! This subject needs an introduction:

The story starts in the nineties, a decade that was characterized particularly during the second half, by financial crises: The world experienced the Mexican Crisis (1994-95); the Asian Crisis (1997-98); and the Russian Crisis (1998). These crises were all characterized by the transmission of 'financial shocks' to other countries around the globe, which subsequently led to *global* financial crises in the form of simultaneous international stock market and currency crashes. The transmission went through economic similarities of countries; trade and financial linkages; and market psychology. As the speed and intensity of the transmission of financial shocks had been unequaled, the term 'contagion' in the world of finance and economics emerged as analogy to capture these events of viral spread across nations.

Contagion is definitely something of our time. Our current world that is increasingly becoming globalized is typified by an increase of linkages between countries, people, and economies resulting in a continuous increase of risk of international financial contagion. This was witnessed recently during the Credit Crisis (2007-08) where the US subprime mortgage sector *infected* the European economy through financial linkages (resulting from financial innovation), and even more recently by the European Sovereign Debt Crisis (2010-ongoing) where the difficulties faced by Greece triggered negative market sentiment which has attacked the credit ratings of many European countries like a domino effect.

Much research has been done already. However, that research has been mostly focused on the crises in the nineties in stock and currency markets. Hence knowledge of this phenomenon is very limited; we do not know how contagion would manifest in debt markets given the current state of financial innovation. The more recent crises have a different nature and have already shown how contagion in different markets and forms can still surprise governments and financial institutions. This presents research opportunities to gain more knowledge about this phenomenon; knowledge that will increase understanding of our changing financial world; knowledge that may help governments and financial institutions to form an adequate policy response for contagion.

I have already conducted a first part of research which has proven very useful for professional practice and society. Here I researched to what extent the US housing market is influencing the NL and UK housing markets via contagion. This was done by constructing an econometric model with the following variables to estimate their explanatory power on the NL and UK house prices:

- *Domestic variables*: Gross domestic product; interest rates; housing stock.
- *Global variable*: World credit development.
- *Contagion variable*: US house price (this is the variable under investigation)

To get an accurate estimation of the contagion effect of the US house price, domestic and global variables need to be controlled for (as shown above). I found that, besides domestic influences, the US house price is significantly influencing the house prices of the UK and NL through contagious channels with a lag of 1-2 years. These new insights have been appreciated by the business and brought essential added value for knowledge development, particularly since this research was not yet done previously.¹

The next steps taken are to extend this research to the sovereign debt market and investigating to what extent the European Debt Crisis (currently ongoing) can be explained by contagion. Since this debt market is different, the channels through which contagion occurs in this market are investigated thoroughly to create a strong theoretical base.

- Bond spread of Greece, Portugal, Ireland and Italy (versus Germany)
- Domestic and Global variables
- Contagion variable (to be constructed)

Besides estimating the explanatory power of contagion to this crisis, new theories will be developed on how to view contagion in this market and to advise on an adequate policy response.

¹ I was nominated for the IVBN Thesis award in 2009 for this research (Institutionele Beleggers in Vastgoed Nederland). This research gave new insights which institutional investors can take into account when investing in real estate: An example would be the fact that during crises stocks, bonds and real estate prices tend to show higher correlation (usually in a downward direction). Diversification becomes more problematic as in these situations it will be difficult to find assets that hedge against this downward movement. This consciousness will lead to better precautions in the case of crises.