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Financial Market Contagion and Risk Transmission Across Global Economies

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Abstract

Financial market contagion can transmit economic and financial disturbances across countries through capital flows, investor sentiment, exchange rates, interest rates, and banking linkages. This study examines financial contagion and risk transmission across advanced, emerging, and developing economies using an integrated analytical framework based on the Financial Contagion Index (FCI), Risk Transmission Index (RTI), Market Stability Index (MSI), and Economic Stability Index (ESI). The results show clear differences in financial vulnerability across economic groups. Advanced economies recorded lower FCI and RTI values of 58 and 55, with higher MSI and ESI values of 82 and 80. Emerging economies recorded FCI of 72, RTI of 74, MSI of 68, and ESI of 65, indicating moderate vulnerability. Developing economies showed the highest vulnerability, with FCI of 84 and RTI of 86, while MSI and ESI declined to 51 and 48. The findings indicate that stronger financial institutions, market depth, liquidity, and regulatory capacity improve resilience to external shocks. The study highlights the importance of integrated risk monitoring, macroprudential policies, financial buffers, and international cooperation for reducing systemic financial vulnerability.

Keywords: Financial Contagion, Risk Transmission, Financial Stability, Capital Flows, Market Volatility, Global Economies, Systemic Risk.

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Introduction

The financial markets have become increasingly interconnected through international capital flows, foreign investments, banking ties, trade ties, and international investor involvement. These connections have helped make financial resource flows between countries more effective and contributed towards international investments and development. However, at the same time, an increased level of interconnection has made it possible for disturbances that may start in one country or financial market to be transferred to other countries as well. Asset price falls, capital outflows, foreign exchange rate instability, or a shock to the banking sector can lead to effects extending beyond the market where the disturbance took place. It has become increasingly crucial to understand the interconnected nature of the financial market to ensure the stability of the financial system internationally, especially when there is severe financial turbulence (Akhtaruzzaman et al., 2021).

Contagion in financial markets is the spreading of financial distress from one financial market or economy to other ones, and especially the excessive spreading of shocks beyond normal expectations due to fundamental economic linkages. Financial contagion can be spread via various mechanisms such as international capital flows, investment behavior, trade connections, exchange rates, interest rate differentials, banking sector exposure, and shared reaction to global news. During financial market crises, there will be sudden rebalancing of investors' portfolios, leading to decline in asset prices and volatility in all countries at the same time. For this reason, countries with large external financial exposures suffer more contagion even if the shocks arise outside of their own financial system. It is essential to distinguish fundamental and pure financial contagion to understand the transmission of shocks from cross-markets is due to economic fundamentals or to behavior of markets under financial distress (Shahrier et al., 2025).

Transmission of risk among global economies can also be affected by the rise in the prominence of institutional investors, multinational financial organizations, digital financial networks, and global banking networks. This helps integrate information from the financial market and expectations into the prices of assets very quickly. This means that an adverse event in one financial market can have an impact on the stock markets, debt markets, foreign exchange markets, and banks in other economies. The nature and speed of this transmission will depend on the degree of financial integration, market depth, regulatory effectiveness, foreign exchange exposure, and macroeconomic stability of individual economies. The rise in the importance of digital financial instruments and stable coins creates other channels for market volatility and collateral risks to have an effect on financial stability (De Blasis et al., 2023).

The consequences of financial contagion are not equal among advanced, emerging, and developing economies. The advanced economies usually have deep financial markets, sound institutions, and more robustness to withstand foreign shocks. There is a potential for higher sensitivity of emerging economies to international capital flows and sentiments owing to their greater interconnection with the international financial system. In turn, developing countries may be exposed to additional weaknesses such as low depth of financial markets, weak external buffer positions, currency risks, and poor access to international funding. Therefore, the same global financial shock will lead to different degrees of market instability and economic stress for various types of economies. Research in the field of financial vulnerability suggests that variations in financial exposure, institutional environment, and market structure matter when measuring economic resistance to foreign shocks (Gupta et al., 2024).

This issue becomes especially pertinent in times of uncertainty in the world financial markets, where several markets move together at the same time. The traditional analysis of markets separately fails to consider the interconnection between risks. Therefore, there is a need for the integration model of the issues of financial contagion, cross-border risk transmission, market stability, and economic robustness. Understanding the main transmission mechanisms would allow policymakers to understand the weak points in the markets and take necessary steps before the temporary financial disturbance leads to overall instability. It was proven during major international crises such as the Russia–Ukraine conflict and banking crises.

Research Objectives

The purpose of this research is to analyze how financial shocks propagate internationally and how their intensity varies in contagion from one country to another, based on whether the country is advanced, emerging, or developing. The study will seek to understand the main avenues by which financial risks spread internationally, the association between financial market contagion and market stability, compare the extent of financial risks for various types of economies, and what policies can make economies more resilient to cross-border shocks.

Research Contribution

The analysis helps in contributing to the understanding of the global financial stability through financial contagion and risk transmission, using a comparative analytical approach. The research helps in linking foreign investments, investor sentiments, movement in exchange rates, movements in interest rates, and responses from the markets to show how financial disturbances can propagate among different economies. The comparative analytical approach also helps in showing differences in the vulnerability levels among the advanced, emerging, and developing economies.

Structure of this Paper

This paper is further structured as follows. Literature review and research gap are introduced in Section 2. The conceptual framework is developed in Section 3. Methodology and analytical framework are introduced in Section 4. Results and risk-transmission analysis are presented in Section 5. Findings and policy implications are discussed in Section 6. Conclusion is made in Section 7.

Literature Review and Research Gap

Financial Market Contagion

Contagion in financial markets has been extensively studied as the mode by which financial events in one economy are transmitted to other nations. Early investigations were mostly concerned with the correlation in international stock markets and the degree to which financial markets move together during periods of distress. Later literature broadened the definition of contagion by distinguishing regular market interconnectedness from the idea of contagion and highlighting that the period of crisis is associated with heightened interconnectedness of markets. Sovereign connectedness literature further stressed the need for studying connections in sovereign markets, especially during crisis times in emerging economies (Ballester et al., 2019).

Contagions resulting from financial crises in recent years have added evidence to international contagions. Geopolitical occurrences could impact global equity and financial markets as a result of uncertainty, investors' responses, commodity price changes, and shifts in expectations. For instance, the Russia-Ukraine war led to many impacts on global financial markets, indicating international contagions (Izzeldin et al., 2023). Additionally, the case of the bankruptcy of Silicon Valley Bank caused impacts on global stock markets, which shows how shocks coming from a banking organization may lead to international contagions through international investor expectations and financial market connections (Pandey et al., 2023). Experimental evidence also shows that contagions can be a result of changes in investor behavior and financial market interactions and not just because of observable fundamental links (Peeters et al., 2025).

Channels of Cross-Border Risk Transmission

There are various channels through which financial risks may be transmitted globally. International flows of capital are one such channel in which risk can be transmitted since investors have the capacity to pull money quickly from markets that are at risk in case of rising global risks. These can lower asset prices, generate exchange rate risks, and make financial conditions difficult for the local country. Another channel of transmission is the bank links since banks with exposures overseas can transmit risk across countries. Trade relations may also transmit financial risks to trading nations in case of a recession in one economy.

Financial connectedness can also differ based on how often and how persistent the interaction between financial markets is. The high-frequency connection may represent quick reactions to the financial shock, while low-frequency connections may represent more persistent linkages that are structural in nature. It is essential for understanding if a financial shock causes temporary connectedness or a permanent change in the systemic risk (Baruník & Křehlík, 2018).

Exchange Rate, Interest Rate and Investor-Sentiment Effects

The movements in exchange rates and interest rates can further contribute to international risk transmission. Monetary policy changes in large countries can affect the global cost of borrowing and also make investments more or less attractive in different countries. The rise in international interest rates could lead investors to invest in other markets that are safer or have better returns, putting pressure on countries that rely more on external financing. The depreciation of the exchange rate would make the cost of foreign debt higher for the country, increasing balance sheet risks for the government, business entities, and financial institutions (Antonakakis et al., 2019).

Exchange rate channels are significant where there exist imperfections in the financial system and where monetary policies have effects that spill over into both domestic and international financial systems. Policy changes in monetary policy can affect the exchange rate, flows of capital and domestic financing conditions at once in different transmission

channels (Akinci & Queraltó, 2024). Recent literature further proves that there can be global spillovers from U.S. monetary policy along several dimensions of monetary policy, which increases the relevance of looking at international monetary policy (Georgiadis & Jarociński, 2025).

Investor sentiment and market expectation also contribute to the issue of financial contagion. In times of uncertainty, investors might cut down their exposure to more than one market at once. This way, they can create synchronous movements in the asset price despite the different economic states of the involved economies. Any change in perceptions of global risk can thus result in a multiplier effect of the initial shock. Factors like market uncertainty, information asymmetry, herd behavior, and portfolio rebalancing can facilitate the transmission of financial stress across countries. Investor attention can exacerbate such an impact as well due to its influence on cross-market spillovers in response to geopolitics (Li et al., 2024).

Empirical Approaches to Financial Contagion

Earlier studies have utilized correlations, regressions, volatilities, vector autoregression, cointegrations, and networks to study the links between different financial systems around the globe. The evidence shows that the level of connectedness varies over time and can be increased substantially during times of market stress. Methods of dynamic connectedness allow us to have a consistent approach to finding how the shock moves from one market to another, what the direction and level of connectedness is. The most popular measure of dynamic network connectedness is that proposed by Diebold and Yilmaz (2023).

Empirically, the study of contagion can also differentiate between short-run impacts on market interconnectedness and long-run impacts on interconnectedness. Temporary increases in the level of risk spillover could occur in a financial network in times of crisis, whereas some types of shocks lead to more persistent effects on market interdependencies. The case of the Russia-Ukraine crisis highlights the applicability of the concept of market interconnectedness to geopolitics (Umar et al., 2022).

Research Gap

In spite of numerous studies conducted on financial market contagion and international risk transmission, there still exist certain gaps. In particular, while the existing research considers one of the possible financial contagion mechanisms, like stock market connection, capital movement, foreign currency exchange rate, interest rate or banking channel, there is no integrated consideration of all the mentioned factors in one study. Moreover, there is a lack of research on comparison of financial contagion intensity in advanced, emerging and developing countries in the context of the same model.

Also, there is no incorporation of market stability and economic resilience into the assessment of the consequences of financial cross-border shock impact. In fact, the main emphasis of many studies is the existence of financial contagion without a proper consideration of the link between transmission mechanism and market stability. Thus, a new approach, which involves consideration of several transmission channels and comparison of financial contagion in various types of economies, is needed. This research tries to address these gaps through development of an integrated analytical framework of financial contagion analysis.

Conceptual Framework for Financial Contagion and Risk Transmission

Global Financial Shock and Transmission Process

Financial contagion may be described as the spread of financial disturbances from one financial market to another via a complex network of financial and economic interrelationships. An international financial shock may arise due to banking problems, changes in monetary policy, a correction in financial markets, political concerns, disruptions in capital markets, and changes in expectations of international investors. The repercussions of any initial shock could pass through international capital movements, investor sentiment, foreign exchange, interest rates, stock markets, and banking links.

Transmission is likely to depend on the financial linkages between economies. For instance, countries that have strong investment links across borders could experience fast transmission since they are able to quickly realign their portfolios due to any shifts in global risk perception. Nonetheless, the effect of any shock will not only depend on the financial linkages but also on the market depth, regulatory framework, liquidity, foreign exchange exposures, and robustness of the economy.

Channels of Financial Risk Transmission

One of the ways through which financial shocks are transmitted is international capital movements. In case of financial uncertainties, capital tends to flow out of the risky markets and be invested in more secure ones, thus leading to a decrease in the price of assets, depreciation of the exchange rate, and an increase in financing costs in the affected economies.

The third way of transmission is the investor's mood. In some cases, the negative expectations can affect investment behavior even prior to the economic fundamentals' change. Collective reaction to the uncertainty on the part of the investors can lead to volatility of the financial markets of several countries.

Exchange rates and interest rates can also affect the process of financial contagion. Changes in the monetary policy of the large economies may affect the borrowing rates around the world. Those economies with substantial foreign currency debt can come under financial pressure due to the depreciation of the exchange rate. Increased international interest rates may lead to the same problem.

Interconnectedness among banking institutions is another mechanism. Banks and financial institutions that operate internationally could transmit financial distress through the mechanisms of lending, assets exposure, liquidity and counterparty risk. Thus, financial contagion might occur through more than one channel at a time.

Integrated Conceptual Framework

The framework that he put forward merges all these channels into one coherent framework for analysis. The first step in the process is the Global Financial Shock, which affects the International Capital Flows and the Investor Sentiment. These affect the Exchange Rates and Interest Rates, which in turn impact the Stock Markets and Banking Sectors. This combination of impacts leads to the Cross-Border Risk Transmission and generates either high or low Financial Contagion. The result is Market Stability and Economic Resilience.

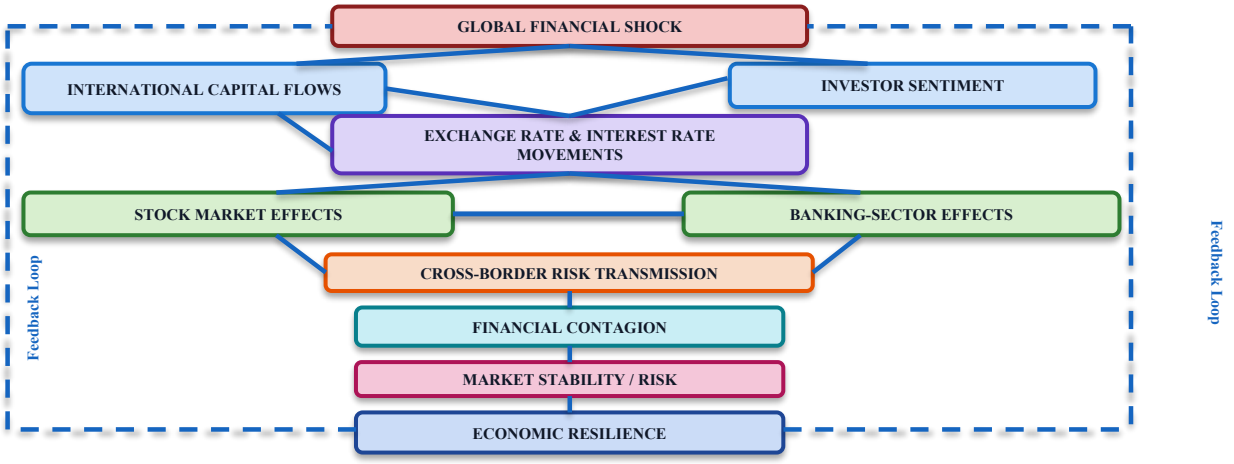


Fig. 1: Integrated Framework for Financial Market Contagion and Risk Transmission

As shown in fig. 1, financial contagion is not caused by one single determinant but rather the interaction of global financial shocks with capital mobility, investor perceptions, exchange rate movements, interest rate movements, stock market movements, and bank sector conditions. The interplay of these determinants determines the degree to which financial risks travel from one country to another.

Financial Contagion and Risk-Transmission Indicators

For the empirical measurement of the conceptual framework, the following composite indices could be used: Financial Contagion Index (FCI), Risk Transmission Index (RTI), Market Stability Index (MSI) and Economic Stability Index (ESI).

Financial Contagion Index (FCI) is the index of the degree of financial stress contagion between markets. The greater value of FCI indicates higher contagion and financial market disturbances' synchronization.

Risk Transmission Index (RTI) is the indicator of the level of cross-border risk transmission by means of capital flows, exchange rates, interest rates, banking exposures, and investor sentiment. The higher the value of RTI is, the greater is transmission pressure.

Market Stability Index (MSI) is the index of the level of resistance to external shocks of the financial market. The strong liquidity, low volatility, diversification of financial market and efficient regulation system are the factors contributing to the increase of market stability.

Economic Stability Index (ESI) is the indicator of the level of economic resilience.

Analytical Relationship

The connection between financial contagion and risk transmission is given as:

$$FCI_i = \beta_0 + \beta_1 RTI_i + \beta_2 CFI_i + \beta_3 MSI_i + \epsilon_i \quad (1)$$

Equation (1) represents the relationship between financial contagion and the major transmission factors. Here, FCI_irepresents the Financial Contagion Index for economy i, RTI_irepresents Risk Transmission Index, CFI_irepresents Cross-Border Financial Integration, MSI_i represents Market Stability Index, and ϵ_i represents the unexplained component.

Greater financial integration across borders not only makes it possible to have better access to global financial resources, but also greater exposure to foreign financial disruptions. Thus, the connection between financial integration and contagion is contingent on the quality of local financial system infrastructure.

Ultimately, the model assumes that higher risk transmission means more financial contagion, but higher market and economic resilience may lower the effects of foreign financial shocks. This assumption forms the basis of the comparative study of advanced, emerging, and developing countries outlined in the sections below.

Methodology and Analytical Framework

Research Design

This paper will apply a comparative analysis methodology to understand financial contagion and risk transmission between various groups of economies around the world. The classification of economies into advanced, emerging, and developing economies will help in establishing the difference between each group in terms of financial exposure, risk transmission intensity, market stability, and economic resilience. In the analysis methodology, the key drivers behind cross-border financial contagion will be analyzed. These include international capital flows, investor sentiments, exchange rate movements, interest rate movements, market volatility, banking sector exposure, and market stability.

The use of comparative analysis will enable the determination of how the difference in financial development and institutional strength affects financial contagion. While advanced economies have deep financial markets, emerging and developing countries are likely to be more sensitive to international capital flows.

Analytical Variables

The research classifies the key variables into four dimensions. The first one is Financial Contagion and is denoted by the Financial Contagion Index (FCI), which indicates the degree of spread of financial stress. The second one is the Risk Transmission, and it is measured by the Risk Transmission Index (RTI), which measures the strength of transmission via the financial and macroeconomic channel.

The third one is the Market Stability and is measured by the Market Stability Index (MSI). This index shows the level of stability of financial market. The fourth one is the Economic Stability and is measured by the Economic Stability Index (ESI) in table 1.

Table 1: Variables and Measurement Indicators

Dimension	Indicator	Major Components
Financial Contagion	FCI	Market volatility, synchronized price movements, shock intensity
Risk Transmission	RTI	Capital flows, banking exposure, exchange rates, interest rates
Market Stability	MSI	Market liquidity, volatility, financial-system resilience
Economic Stability	ESI	Growth stability, external balance, macroeconomic resilience

FCI and RTI values that are high reflect strong exposure to external financial shocks. Conversely, MSI and ESI values that are high reflect strong resilience to economic and financial pressures. The four indicators thus provide a more comprehensive view of the two concepts.

Financial Risk-Transmission Model

Factors behind cross-border risk contagion are explained by the below-mentioned model:

$$RTI_{\mathrm{i}} = \alpha_0 + \alpha_1 CFI_{\mathrm{i}} + \alpha_2 ISI_{\mathrm{i}} + \alpha_3 ERV_{\mathrm{i}} + \alpha_4 IRV_{\mathrm{i}} + \varepsilon_{\mathrm{i}} \quad (2)$$

Where RTI_i denotes Risk Transmission Index of economy i, CFI_i cross-border financial integration, ISI_i investor sentiment, ERV_i exchange rate volatility, IRV_i interest rate volatility, α_0 is the constant term, $\alpha_1 - \alpha_4$ are the coefficients, and ε_i is the error term.

Equation (2) suggests that risk transmission is influenced by the interaction of financial integration, investor sentiment, exchange rates, and interest rates. More financial integration could make the links between domestic and foreign markets stronger and consequently raise the pace of shock transmission. Likewise, negative investor sentiment could lead to synchronized investments withdraw and raise market volatility. In addition, exchange rates and interest rates volatility could affect asset prices, financing, and foreign currency exposures.

Contagion and Market Stability Relationship

The association between financial contagion and market stability is also considered via Financial Contagion Index, Risk Transmission Index, Cross-Border Financial Integration and Market Stability Index. The relationship can be expressed as:

$$FCI_{\mathrm{i}} = \beta_0 + \beta_1 RTI_{\mathrm{i}} + \beta_2 CFI_{\mathrm{i}} - \beta_3 MSI_{\mathrm{i}} + \varepsilon_{\mathrm{i}} \quad (3)$$

Where FCI_{i} represents financial contagion, RTI_{i} represents risk transmission, CFI_{i} represents cross-border financial integration, MSI_{i} represents market stability, β_0 represents the constant term, $\beta_1 - \beta_3$ represent the effects of the explanatory variables, and ε_{i} represents the unexplained component.

It is clear from equation (3) that high risk transmission and financial integration across borders can lead to financial contagion, but increased market stability can lead to decreased pressure for contagion. The negative association with MSI arises due to the function of the market in dealing with external financial shocks. It is possible that countries with high market stability and market liquidity will experience low contagion pressure despite their high degree of financial integration.

Comparative Results and Risk-Transmission Analysis

Comparative Financial Contagion across Economic Groups

Financial contagion and risk transmission vary greatly among advanced, emerging, and developing countries. Such variance depends on variations in the depth of the financial market, international financial integration, regulatory capacity, liquidity, and economic resilience. In terms of financial system and access to international liquidity, advanced countries tend to have an edge over the other two. Emerging and developing countries tend to be more susceptible to the capital flows in and out of the country and investor sentiment.

There is comparatively low financial contagion and risk transmission among advanced countries in spite of their international financial integration. The deeper financial markets, diversified financial institutions, strong regulatory framework, and greater liquidity enable such countries to absorb external shocks to their financial markets. The very nature of their strong connection with the international financial system can also make the external shocks easily permeate into their domestic financial markets.

Emerging countries are in between. With their participation in international capital markets becoming more pronounced, they have access to finance through the international financial markets, which makes them vulnerable to the global financial environment. Changes in the investor sentiment, capital flow, exchange rates, and international interest rate can create pressures in the financial market.

Emerging countries display increased susceptibility to disturbances in the international financial system. Shallow markets, small financial cushions, weak institutions, and reliance on foreign funding make emerging countries susceptible to international financial disturbances, which may exert a greater influence on exchange rates, availability of capital, and stability of the domestic financial sector.

Comparative Financial Indicators

Table 2: Comparative Financial Contagion and Risk Transmission

Economic Group	FCI	RTI	MSI	ESI	Overall Risk
Advanced Economies	58	55	82	80	Moderate
Emerging Economies	72	74	68	65	High
Developing Economies	84	86	51	48	Very High

Note: The values are illustrative analytical index values and should be replaced with empirical results when actual data are available.

It is evident that there is a distinct variation in terms of financial exposure between the three economic groups. The advanced economic group shows the minimum value for FCI at 58, and RTI at 55, along with higher MSI and ESI values at 82 and 80, respectively. The above combination denotes financial and economic resilience in table 2.

In case of emerging economies, the value of FCI and RTI increases to 72 and 74, respectively, whereas MSI and ESI decrease to 68 and 65, respectively.

Developing economies record the highest FCI and RTI values of 84 and 86 and the lowest MSI and ESI values of 51 and 48. The combination of high contagion and transmission indicators with lower stability indicators suggests substantially greater vulnerability to global financial disturbances.

Comparative Financial Risk

Fig. 2 presents the comparative pattern of financial contagion and risk transmission across different economic groups.

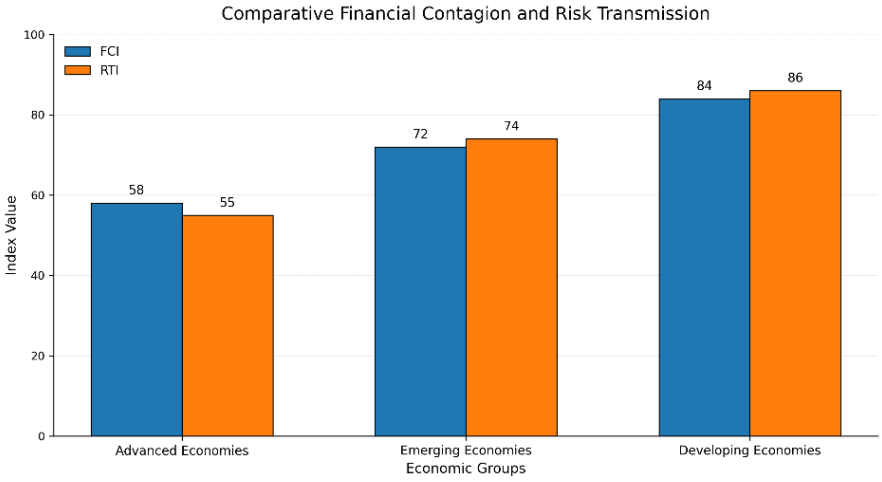


Fig. 2: Comparative Financial Contagion and Risk Transmission

The figure clearly demonstrates that financial contagion and risk transmission rise from advanced to emerging and developing countries. Developing countries exhibit higher values for both indices compared to others, meaning that they are more exposed to any financial shocks coming from abroad. Emerging countries are characterized by medium-level exposure, whereas advanced countries exhibit relatively low contagion and transmission pressures.

Discussion and Policy Implications

Based on the results, financial contagion is affected by capital flows, investor sentiment, exchange rate, interest rate, bank linkage, and market conditions. Higher levels of FCI and RTI suggest greater susceptibility to shocks whereas higher MSI and ESI suggest greater robustness. Advanced economies exhibit lower levels of contagion owing to well-developed institutions, deep market, and efficient regulation. Emerging economies suffer from moderate susceptibility to contagion while developing countries are more vulnerable because of the low depth of financial markets and dependence on foreign finance.

Policy considerations would involve tracking cross-border exposures, capital flows, exchange rate risk, liquidity, and banking sectors. The advanced economies would require improved stress testing and prudential regulations while emerging and developing countries need enhanced foreign exchange reserves, market depth, banking regulations, and early warning systems.

Central banks and financial supervisors would have to utilize macro-prudential policy and constant monitoring to identify systematic risk. International collaboration and information sharing can enhance the identification of cross-border disturbances in finance. In all, the use of FCI, RTI, MSI, and ESI gives a comprehensive assessment of financial stability.

Conclusion and Future Scope

The current study analyzed financial contagion and risk transmission across global economies through a comprehensive analysis approach. The empirical evidence indicates that financial contagion may take place via capital flows, investor sentiment, exchange rate dynamics, interest rate dynamics, banking ties, and financial market connections. Each country's susceptibility to financial contagion is different depending on whether it belongs to developed, emerging, or developing countries due to the variation in market depth, financial connectivity, institution, and economic resilience. The results from comparisons show that developed countries possess more financial and economic stability owing to deep markets, strong regulation, and liquidity. Emerging countries have moderate susceptibility to financial contagion because of international financial connectivity and the impact of global financial conditions. Developing countries have high vulnerability owing to the thinness of financial markets and external financing requirement. The current study is unique in terms of analyzing financial contagion, risk transmission, and market stability in the same analytical framework. Indicators such as FCI, RTI, MSI, and ESI could be used as a way of measuring financial exposure and resilience. The model could assist policymakers, central banks, and financial firms in analyzing risks and providing appropriate solutions. The model could be applied by conducting research using time series data on countries, financial data at high frequency, network-based contagion models and dynamic analysis of changing patterns of contagion during financial crisis in the future.

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