Lecture 8: Int'l Dimensions

How does a crisis morph from a local or regional crisis into a global crisis?

Distinction:

- common shocks
- cross border contagion

Note: countries may share common "domestic" macroeconomic fundamentals such as: burning bubbles
capital inflow bonanzas
increased private &/or public leveraging

Ex. financial institutions in other countries had large exposure to US subprime crisis ⇐ direct linkages cause CONTAGION

Ex. other countries experienced housing bubbles too
common fundamentals ~~as~~ experience common SHOCK
(e.g. Spain & Iceland)

Ex. other countries experienced "capital blow bonanza" too
so common SHOCK (e.g. Iceland, Ireland, Spain & UK)

SPILLOVER

Undocumented example (but interesting)

→ Austrian lender exposed to losses in Hungary curtails lending to both Hungary + other central + east European countries

Better example (or documented, at least)

→ when Russia ruble devalue'd in Aug 17 1998 Polish Zloty also dropped in value even though Poland had floating exchange rate + was trading primarily w/ EU

→ first week Aug 1998 : 3,42 PLN/USD

→ on Monday Aug 17, 1998 : 3,52 PLN/USD (+3%)

Aug 21, 1998 : 3,79 PLN/USD (+11%) from 1st rate

→ why on 11% depreciation in two weeks?

at the time, 70% of Polish trade was w/ EU

→ Asian economies export driven w/ large manufactured good component so they're more vulnerable to drop in world demand

"Second Great Contraction"

→ 1st global financial crisis since WW II

→ BCDI index (Banking, Currency, Debt + Inflation)

→ pulling out of a global financial crisis more difficult than pulling out of a regional crisis (e.g. Asia 1997-98) because slow growth & rest of world prevents foreign demand from compensating for the fall in domestic demand

BCDI index

→ takes a value between 0 and 5 (or 6)

→ it's the simple sum of the different types of crises that a country is experiencing

- external default
- ~~[illegible]~~ domestic sovereign default
- banking crisis
- currency crash
- inflation outburst (over 25%/year)

(- stock market crash (over 25% drop in real terms))

→ index does not capture defaults on household debt (such as US mortgage crisis), but those should be picked up by banking crisis indicator

⇒ index also fails to capture corporate defaults

- less of an issue in countries where corporations depend on banks
- but where capital markets are more developed, corporate defaults are another variety of crisis

⇒ Reinhart + Rogoff then develop a global index by weighting each individual country's index by share of world income

⇒ indexes show that crisis is ~~now~~ largest since WWII

⇒ prior to WWII, crises were frequent + severe

⇒ up until "Second Great Contraction" the post WWII crisis were mild by comparison w/ their pre-war counterparts

- oil shocks of mid-1970s
- crises associated w/ reducing inflation in early 1980s
- banking crises in Nordic countries + Japan in early 1990s
- bursting of dot-com bubble in early 2000s

⇒ "Second Great Contraction" severe in ~~scope~~ magnitude + global in scope

- ~~Stock Market Crashes almost universal~~

→ characterization of "Second Great Contraction" (p. 5)

- Stock market crashes almost universal
- bursting of asset price bubbles has caused banking crises + exposed high degrees of leverage
- currencies crashed against US dollar

→ looking at indices of equity prices (globally)

- the 2008 drop matches the scale + cross-country reach of the 1929 crash

→ large drop in merchandise exports

- the 9% drop in 2009 was the largest one-year drop since 1938
- though drops of slightly ~~[illegible]~~ smaller magnitude occurred in 1952 (Korean War) and 1982-83 (US recession + emerging market debt crisis)

~~→ more traded goods (as measured by indices of building activity) also~~

→

⇒ Why are global financial crises so much more dangerous than local ones?

- exports no longer form a cushion for growth because all countries contracting
- sudden stop in financing typically impacts a large part of world's public + private sectors

⇒ financial liberalization often precedes banking crises

- financial liberalization facilitates banks' access to external credit + more risky lending practices at home

⇒ currency crash can occur if country has a heavily managed exchange rate or has a peg

- if support banks, then money supply increases + expected inflation rises
- an increase in expected inflation would depreciate the currency
- to revalue the currency, a central bank must contract money supply... PS! can't do that!

- note depreciation of the currency worsens the problems of banks that have borrowed in foreign currency
- depreciation of currency also increases the odds that gov't will default on external + domestic debt if it borrowed in foreign currency

→ if in year preceding crisis, country had fixed exchange rate, then the peg may have lulled banks, corporations + citizens into false sense of security (so they would have borrowed more in foreign currency) which, of course, makes the depreciation far more brutal