Global Pandemics

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Introduction

When the US sneezes, the rest of the world catches a cold?

Conventional wisdom was that the rest of the world was **decoupling** from US:

- The US crisis will not hit emerging countries like China, Brazil, Russia and India
- Europe did not joint ‘le capitalisme sauvage’

Introduction

But after a while the **European financial system collapsed**:

- Germany was forced to bail out Hypo Real Estate
- Ireland had to garantee its banks
- By October 2008 many European countries and Canada had to garantee not only bank deposit but also bank debts.

Also world **emerging countries** where hit by the crisis: by trade and currency channels, by financial flows etc..

It was **not only a contagion** many country had already stability problems.

Financing a Pandemic

Money markets are global institutions creating a **global network** of money transactions.

If one bank fails a link in this network is eliminated, debtor of this bank may have **liquidity problems** and, in general, banks may **fear** of providing loan to others.

For example in 1837 Bank of England refused to roll over debt to three main financial firms, these firms failed. These firms provided **short term credit** around the world thus their failure hit many financial firms around the world.

Financing a Pandemic

Global financial crisis usually followed the collapse of a **crucial financial corporation**: Jay Cookes in 1873, Austria biggest bank Credit-Anstalt during the Great Depression.

Financing a Pandemic

The global financial network was **strictly interdependent** on the eve of the 2007 crisis as never before:

- When Lehman brother collapsed the **short term loans** froze and their rates increased by over 400 basis points, crippling also global trade.
- Moreover, many **European banks** had bought mortgage backed securities and collateralized debt obligations.
- European banks have lent credit to **East European countries**, but because their loss, they decided to reduce exposure in these emerging countries

Financing a Pandemic

- Also **stock markets** spread the crisis, when the stock market value plunged in US, all around the world stock market prices rapidly declined.In 1875 von Rothshild after observing stock market plunging: ‘The whole world has become a city’

- Finally **international trade** diffused the crises.

Decease through Trade

United Kingdom before and now United States is at the center of international trade, in particular US has 700bn of **current account deficit**.

Thus, when US goes into recession the impact on trade is strong, for instance there was a huge drop of import from China and for all the **Asian value chain**.

The payment through **letter of credit** collapsed after Lehman Brother failure.

The **Great Synchronization**: export fell by 30% in Germany and China.

People and Commodity

Migrant people that usually send **money back home** because of the crisis have no more resources to save and transfer back home.

As in 1929 the price of **commodities** (food, minerals, and oil) fell hitting oil producers and developing countries.

Currency

When the crisis started the dollar fell down and this hit the **exporters** (China and Germany).

But when the crisis became deeper investor start buying **dollars as safe assets** this impact on those firms and households in emerging countries that borrowed at cheap interest rate from rich one:

- There are **no more funds** for poorer countries
- The **value of the debt** of poorer counties increased because the value of dollar appreciates.

Shared Excesses

When a country boom goes burst, **other countries** that have accumulated the same excess tend to collapse as well.

Not only US had an housing bubble but also Spain ,Australia, Dubai, Ireland, China, New Zealand,Iceland, Vietnam, Estonia

The American house price appreciated by **73%** between 1997 and 2005, in **Australia by 114%**, in **Spain by 145%**, in **Dubai by 226% between 2003 and 2007** alone.

Shared Excesses

The reason of real estate bubble are **similar**:

- Expansionary **monetary policy**.
- Excess of **saving** around the world.
- No regulation of mortgage and in general **financial sector**.

Thus, the burst in housing market in US was just the **catalyst** of a crisis that was emerging in many countries.

Shared Excesses in Europe

Not only house bubble but also the increase of **bank leverage** and the growth of level of risk:

Credit Swiss had leverage up to 33 to 1, ING 49 to 1, Deutsche Bank was 53 to 1, Barclays was 61 to 1. While Lehman Brothers was 31 to 1 and Bank of America 11 to 1.

Shared Excesses in Europe

European Bank has:

- Bought large quantities of subprime loans, ABS and CDO form US.
- Even European asset back securities and CDO where created even if not at US levels.
- High risk loans in emerging European countries.

Thus, BNP Paribas failed, the German Sachsen LB and IKB failed, the whole Iceland financial system.

In Europe as in US: housing bubble, high leverage, easy money policy and enthusiastic embrace of high risk financial innovation.

Not Everyone got Sick

India for instance:

- Conservative **monetary policy**.
- Restrictive rule on **financial market**.
- In general India did not embraced the mantra of **free market**.

Emerging Economies, existing problems

Developing countries depends on capital flows from developed ones.

Thus a crisis as the default of Peru in 1826 may affect developed countries, on the contrary a crisis in a developed country may reduce drastically the capital flow to developing one causing a crisis in poor countries (As US in 1837).

In the 90s Mexico Asian Tigers, Brazil Russia and Argentina, where it by this **sudden stop** of credit.

During the 2007 crisis **Easter European countries** where it by sudden stop of credit.

The Death of Decoupling

When the crisis started in US, other countries believed in **decoupling** (EU increased interest rates).

Moreover the answer of European countries was not that strong in terms of **fiscal stimulus**.

The US GDP decreased by 6%, while Japan by 13.6%.

The Death of Decoupling

The crisis was not just the effect of the failure of **Lehman Brothers**, the American economy was in contraction from 10 month and the other countries where already in recession.

The crisis does not infected most of the other countries by chance but because also the other countries had **similar problems**: bubbles, chea money, high leverage, deregulation of financial markets.

But central banks actuated **unorthodox** policies that where able to reduce the effects of the crises: the Great Recession did not become the Great Depression.