Globalization and Financial Crisis

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What are we talking about?

RISK

HIGH LEVEL

- Event
  - Political
  - Contagion
- Counterparty
- Credit
- Interest Rate
- Liquidity
  - Specific
  - Systemic
- Operational
  - Failed processes
- Currency
- Sovereign

Brief Modern History
The "Public Crisis"

- 1970's – Oil Price Shock
- Gulf of Mexico oil deposit discovery
- Experts convince Mexico they can borrow based on $32 barrel spot price
- Mexico borrows from Developed Country Banks based on anticipated $32 future cash flow. Commercial Banks lend- at very high margin rates they cannot get from their corporate customers
- Many loans LIBOR based (floating rate – short term)(for long term project financing)
- World is awash in liquidity – **(Globalization of loan competition)**

Acceleration of Debt during 70's

- In 1970's the fifteen most heavily indebted nations (World Bank) had external debt of $17.9 billion
- In 1987 – debt was $402.2 billion or 47.5% of their GNP
- Mexico – 30.5% total external debt as a percent of GNP in 1980

Acceleration

- From 1970-1982 oil prices increased 260% in excess of U.S. Inflation
- Real Interest Rates increased in excess of 1961-1980 average – 41%
- These “petro-dollars” flowed from the oil consuming nations to the oil producing nations

Acceleration to Debt

- Oil producers awash in liquidity
- World has excess liquidity
- Looking for places to “invest”
- Developed Country Commercial Banks become facilitators

History cont'd

- Commercial Banks lend to Sovereign Nations for infrastructure, (hospitals, roads, deep water ports, schools etc.)
- 1979-1980 – Oil falls to below $20
- Cash receipts from oil not enough to sustain Mexican debt burden – Mexico defaults on commercial loans
- Developed country banks experience deep charge-offs – record losses

Effect on Commercial Banks

- Open discussion in Commercial Banking and Government Circles of a fear of an unraveling of the international financial system caused by the massive default of debtor countries
- Developed Country Banks (G-7's) overexposed (foreign loans in excess of capital)
- Raised the possibility of a widespread banking collapse reminiscent of the 1930's

Exposure as a Percentage of Capital
Major U.S. Banks, end of 1982

	Argentina	Brazil	Mexico	Venezuela	Chile	Total
Citibank	18.2	73.5	54.6	18.2	10.0	174.5
B of A	10.2	47.9	52.1	41.7	6.3	158.2
Chase	21.3	56.9	40.0	24.0	11.8	154.0
Morgan G	24.4	54.3	34.8	17.5	9.7	140.7
Manu/ Han	47.5	77.7	66.7	42.4	28.4	262.8
Chemical	14.9	52.0	60.0	28.0	14.8	169.7

Institute for International Economics 1984

Capital Risk

- At the end of 1982, nine major U.S. Banks had lent out over 287 percent of their capital to developing countries

History cont'd

- 1986/1987 -Commercial Banks lay off thousands
  - Investment Bankers not involved
  - Commercial Banks involved in Latin sovereign lending stocks depressed
  - Wall Street Analysts focus on any country risk being carried
- No more lending to sovereign countries
- Commercial Banks restructure their International Banking Units
- Development Banks

History cont'd

- Trade Financing becomes strategic focus
  - Financing of Trade
  - F/X Risk
  - Some Project Finance
- No more Sovereign Lending
  - Leave Sovereign Lending to Regional

Second Crisis
The "Private Crisis"

- 1990's – Globalizations dramatic increase. Foreign Direct investment by corporations at record high
- Rapid growth in Asia – (averages 10 – 14%)
- Asian Banks not as sophisticated in financial reporting – new cash flows allow them to lend to continue to fund growth

Third Crisis
The "Global Contagion"

- **Massive growth** in wealth worldwide due to expansion of globalized economy in 90's and turn of century
- **"Global savings glut"** – Ben Bernanke wrote before being appointed as Chairman of Federal Reserve
- Excess liquidity sought investments
- Many countries had **modernized their financial systems** in these ensuing years making it easier for individuals to access investment channels

Current First

- Resulting in **global mortgage growth**
- **80 percent of mortgages issued during this period - adjustable rate (Senator Chris Dodd 02/07/2007)**
- **Subprime mortgages in 1994 – 5% of originations, in 2006 – 20% Federal Reserve Bank**
- **Comparison – China requires 20% home down payment – by 2005 in U.S. median down payment – 2%**

Current
Second

- **More liquidity** has always meant more willingness to take **risk**
- Real estate
- Derivative markets
  - CDO's
  - SIV's
- Loans to companies that were highly levered
- Over priced equities – <u>caused by increased demand to invest in companies</u>

Current
Second

- Loose monetary policy in U.S. encouraged optimism
- EMU – new strength – new monetary power – rival to U.S. economy
- Breakup of Soviet Union – Eastern Europe – borrowing based on future growth/optimism
- Profits rather than prudence

Current Summary

- Markets failed (could BASEL II have helped?)
- Governments failed
- Could more regulation have saved us from ourselves?
- Remember – governments were happy to see growth – rising asset prices – rising real estate prices
- Would people have demanded governments to slow down this growth?

Current Summary

- If governments would have tried – would people have said – “get out of my business”, “stop limiting my ability to grow”.

OECD PREDICTS RECOVERY SOONER THAN EXPECTED

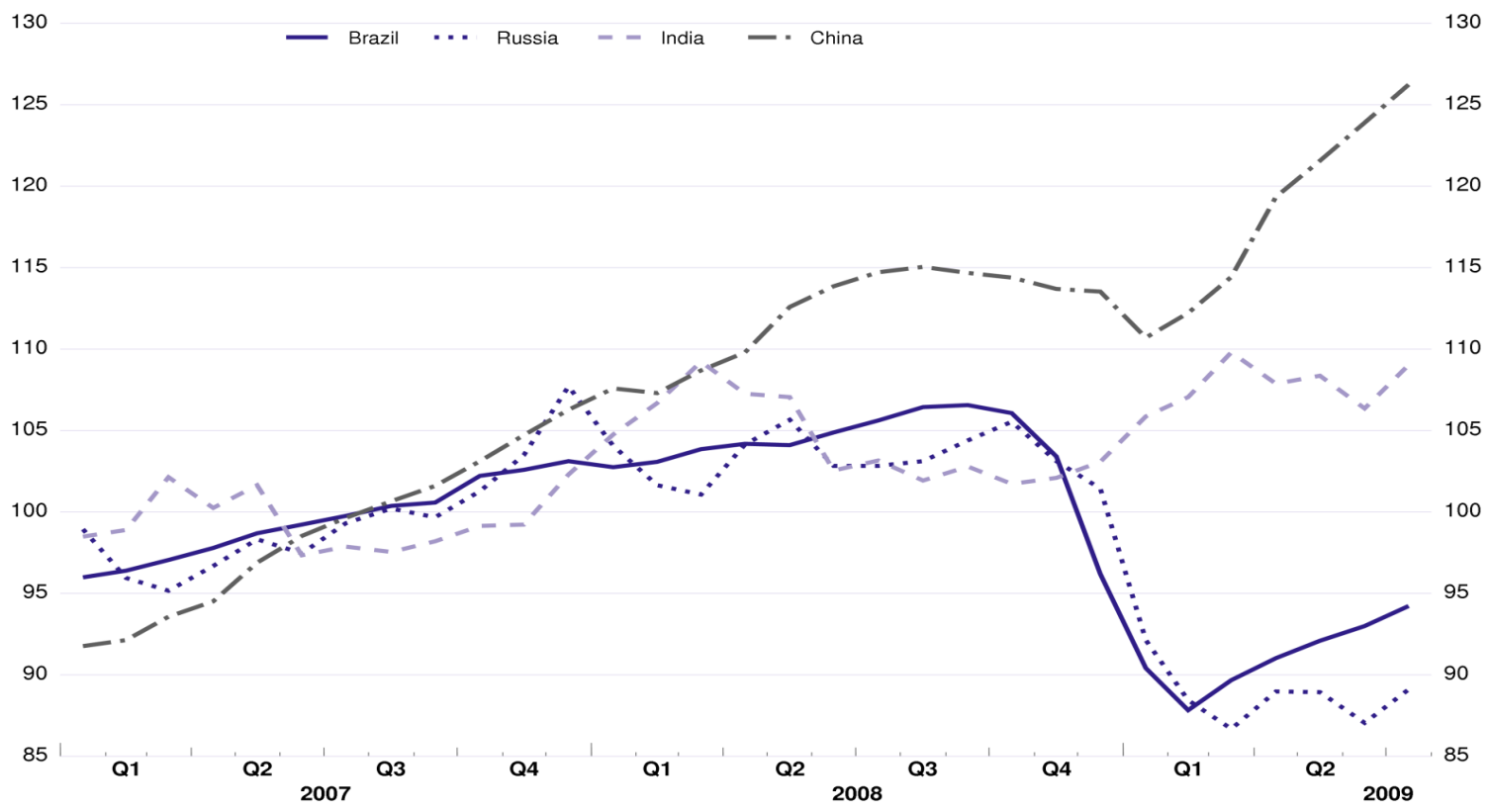
- Overall financial conditions have improved and corporate bond spreads have narrowed
- Signs that housing is stabilizing in the U.S. and the U.K., the two markets most adversely impacted

OECD

- International trade flows have stopped falling and is beginning to increase
- The recovery in large emerging markets, especially China, was gaining momentum

A recovery is underway in the BRICs

Industrial production, index, 2007 = 100, three-month averages



U.S. Dept. of Commerce

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Thank You

Comments/Questions