Globalization and Financial Crisis

Michael A. Rinkus
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

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

Institute for International Economics 1984

Michael A. Rinkus
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%
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 – caused by increased demand to invest in companies
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

Michael A. Rinkus
Thank You

Comments/Questions