



Globalization & Recession

How and why the recent recession
became so widespread.

Is globalization to be blamed?



A primer

An **English** princess with an **Egyptian** boyfriend crashes in a **French** tunnel, driving a **German** car with a **Dutch** engine, driven by a **Belgian** who was high on **Scottish** whiskey, followed closely by **Italian** Papparazzi, on **Japanese** motorcycles, treated by an **American** doctor, using **Brazilian** medicines!

And this is sent to you by a **Canadian**, using Bill Gates' technology which he got from the **Japanese**.

And you are probably reading this on one of the IBM clones that use **Philippine**-made chips, and **Korean** made monitors, assembled by **Bangladeshi** workers in a **Singapore** plant, transported by lorries driven by **Indians**, hijacked by **Indonesians** and finally sold to you by a **Chinese**!

That's Globalization!!!

A little history to start with

- **Bimetallism: Before 1875**
 - **Classical Gold Standard: 1875-1914**
 - **Interwar Period: 1915-1944**
 - **Bretton Woods System: 1945-1972**
 - **The Flexible Exchange Rate Regime: 1973-Present**
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The state of international trading

In 2007, all the trading nations of the world

Exported: \$13.95 trillion

Imported: \$ 14.24 trillion

The biggest **exporter** was **Germany**: \$1.33 trillion

The biggest importer was the **US**: \$2.02 trillion

Canada exported: \$419 bn and imported \$389 bn.

China exported: \$1.218 trn and imported \$956 bn.

What do nations trade?

The biggest contributors:

Automotive

Energy products, including petroleum

Metals

Trades in services have become more common than ever.

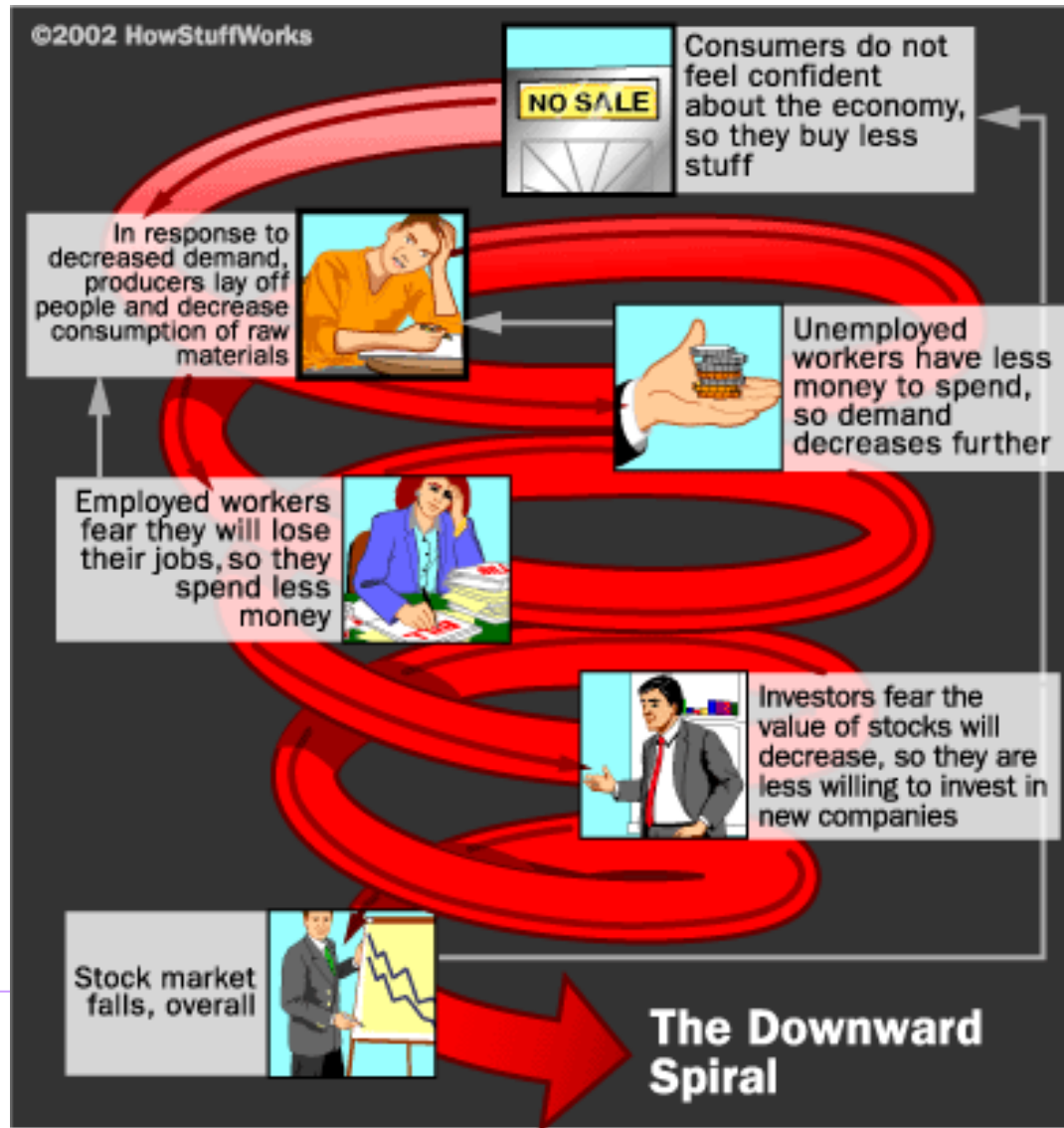
Outsourcing: A new trend in international trade.

The Global Capital Trade

- International Bond Market is very big and has an estimated size of nearly **\$47 trillion**. The size of the US bond market is the largest in the world. The US bond market's outstanding debt is more than **\$25 trillion**.
- The International Bond Market has grown double in size since the year 2000.

International capital flows: The total value of the world's financial assets—including equities, private and government debt securities, and bank deposits—grew faster in 2006 than the historical average rate, climbing by 17 percent to reach **\$167 trillion**. Spurred largely by equities, this growth in financial assets also outpaced growth in global GDP. Meanwhile, cross-border capital flows climbed to a record \$8.2 trillion.

Now, what is recession?



It all started in the U.S.

- In US, a boom in the housing sector was driving the economy to a new level. A combination of **low interest rates and large inflows of foreign funds** helped to create easy credit conditions where it became quite easy for people to take home loans. As more and more people took home loans, the demands for property increased and fueled the home prices further. As there was enough money to lend to potential borrowers, the loan agencies started to **widen their loan disbursement reach and relaxed the loan conditions**.
 - As a result, many people with low income & bad credit history or those who come under the NINJA (No Income, No Job, No Assets) category were given housing loans in disregard to all principles of financial prudence. These types of loans were known as **sub-prime loans** as those were are not part of prime loan market (as the repaying capacity of the borrowers was doubtful).
 - Since the demands for homes were at an all time high, many homeowners used the increased property value to refinance their homes with lower interest rates and take out **second mortgages** against the added value (of home) to use the funds for consumer spending. The lending companies also lured the borrowers with attractive loan conditions where for an initial period the interest rates were low (known as **adjustable rate mortgage (ARM)**).
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The Bubble Bursts.....

- Overbuilding of houses during the boom period finally led to a surplus inventory of homes, causing **home prices to decline** beginning from the summer of 2006. Once housing prices started depreciating in many parts of the U.S., refinancing became more difficult. Home owners, who were expecting to get a refinance on the basis of increased home prices, found themselves unable to re-finance and began to **default** on loans as their loans reset to higher interest rates and payment amounts.
 - In the US, an estimated 8.8 million homeowners - nearly **10.8% of total homeowners** - had zero or negative equity as of March 2008, meaning their homes are worth less than their mortgage. This provided an incentive to **"walk away"** from the home than to pay the mortgage.
 - Foreclosures (i.e. the legal proceedings initiated by a creditor to repossess the property for loan that is in default) accelerated in the United States in late 2006. During 2007, nearly **1.3 million** U.S. housing properties were subject to foreclosure activity.
 - Further, a record nearly **four million unsold existing homes** were for sale including nearly 2.9 million that were vacant. This excess supply of home inventory placed significant **downward pressure on prices**. As prices declined, more homeowners were at risk of default and foreclosure.
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Now, here is the complication.....

- Sub-prime loans were excellent investment options as long as the housing market was booming. Major (American and European) investment banks and institutions heavily bought these loans (known as **Mortgage Backed Securities, MBS**) to diversify their investment portfolios. Most of these loans were brought as parts of CDOs (**Collateralized Debt Obligations**). CDOs are just like mutual funds with two significant differences. First unlike mutual funds, in CDOs all investors do not assume the risk equally and each participatory group has different risk profiles. Secondly, in contrast to mutual funds which normally buy shares and bonds, CDOs usually buy securities that are backed by loans
 - Owing to heavy buying of Mortgage Backed Securities (MBS) of subprime loans by major American and European Banks, the problem, which was to remain within the confines of US **propagated into the world's financial markets**.
 - The problem got worsened as the Mortgage Backed Securities (MBS), which by that time had become parts of CDOs of giant investment banks of US & Europe, lost their value. Falling prices of CDOs dented banks' investment portfolios and these losses destroyed banks' capital. The complexity of these instruments and their wide spread to major International banks created a situation where no one was too sure either about how big these losses were or which banks had been hit the hardest.
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The downfall

- The effects of these losses were huge. Global banks and brokerages have had to write off an estimated **\$512 billion** in subprime losses so far, with the largest hits taken by Citigroup (\$55.1 billion) and Merrill Lynch (\$52.2 billion). A little over half of these losses, or \$260 billion, have been suffered by US-based firms, **\$227 billion by European firms and a relatively modest \$24 billion by Asian ones.**
 - From this point, a chain reaction of panic started. Since banks and other financial institutes are like backbone for other major industries and provide them with investment capital and loans, a loss in the net capital of banks meant a serious detriment in their capacity to disburse loans for various businesses and industries. This presented a serious **cash crunch situation** for companies who needed cash for performing their business activities. Now it became extremely difficult for them to raise money from banks.
 - A sense of disbelief and extreme precaution is prevailing in the banking sectors. The global investment community has become extremely risk-averse. They are pulling out of assets that are even remotely considered risky and buying things traditionally considered safe-gold, government bonds and bank deposits. Inter-bank markets across the world have frozen over. The meltdown in stock markets across the world is a victim of this contagion.
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Recession and S&P500 Jan '07 – Dec '09

