

A Global Financial Crisis?

Gerald P. Dwyer

- The so-called global financial crisis was not truly global because many countries did not have a financial crisis.
- Nevertheless, the effects of the crisis have extended far beyond the countries that experienced crises themselves.
- Evidence indicates that rapid credit growth and high leverage before the financial crisis in the United States and in some other countries left many countries vulnerable to adverse effects of the crisis.

Is the financial crisis that hit the United States and many other countries in 2007 and 2008 a “global financial crisis”? The term has become increasingly common, but it is misleading at best.

Many countries did not suffer a financial crisis. For instance, the United States’ major trading partner, Canada, did not have a financial crisis; none of its banks or major financial institutions failed. In addition to the United States, many countries in Europe experienced financial crises in 2007 and 2008, including the United Kingdom and Ireland, but several did not, including Italy, for example.

Debris from the financial crisis

While deeming a financial crisis “worldwide” is an exaggeration, the financial crisis of 2007 and 2008 has had effects across the globe. These effects are perhaps most tangible in halted construction projects, both in the United States and other countries.

The crisis resulted in a phenomenon that’s somewhat familiar to many in the United States—PVC farms (see the first photo). A recently coined term, “PVC farm” denotes a subdivision that has been partially completed, with PVC pipes emerging from the ground but no construction of dwellings begun.

The second photo shows a different effect of the financial crisis—a vacant lot on the Intracoastal Waterway in Palm Beach County, Florida. A hotel was knocked down to make way for new condominiums, but funding evaporated during the financial crisis, leaving quite valuable land sitting vacant.

Such scenes are not confined to the United States. In Barbados, for example, construction of upscale condominiums (see the photo) has been delayed because of a lack of sales and funding for completion. Also in Barbados, on the site where a hotel was knocked down, construction on another new resort with villas was halted in February



A “PVC farm” in suburban Atlanta



Dried-up construction funding leaves valuable land vacant along the Intracoastal Waterway

2009, with 700 hundred workers laid off (Dovkants 2009, Hudson 2010, "Protecting Barbadians" 2010).

This halted construction in Barbados is similar to halted construction in the United States, even though Barbados did not have a financial crisis. Nevertheless, Barbados has been affected by the crisis and ensuing difficulties elsewhere. First, the country's tourism has suffered because of the recession that followed the crisis in many countries. Second, worldwide funding for risky projects such as new resort communities has declined because of the financial crisis. Other countries around the globe also have been affected.



Stalled condo construction in Barbados

Effects of the crisis around the world

What factors determined which countries were affected by the financial crisis and how big the effects were? There are, of course, many suggested answers to this question. As opposed to speculating about the answer, some systematic empirical research has sought definitive answers. The Center for Financial Innovation and Stability recently cosponsored a conference to examine this research and related issues. The conference, "The Financial Crisis of 2008, Credit Markets and Effects on Developed and Emerging Economies," was held in São Paulo, Brazil. One of the papers presented at the conference, Berkman et al. (2009), directly examines the effect of the financial crisis across countries.

Gaston Gelos, one of Berkman's coauthors, presented their paper, in which they systematically explore the effects of the crisis on output across emerging and developing countries. They examine a wide range of factors that might account for lower output growth after the crisis of 2007 and 2008. They find that a few factors explain much of the observed decrease in output growth, measured by real gross domestic product (GDP) growth.

For the forty-three emerging economies the authors examine, higher leverage and credit growth before the financial crisis are the most important factors associated with subsequent decreases in GDP. Both higher leverage and credit growth left people exposed to the dramatic pullback in the credit supply. Much of the evidence is associated with Central and Eastern European countries as well as Central Asian countries, but the results are suggestive about a general explanation.

The evidence for these emerging economies also indicates that a flexible exchange rate, instead of a fixed or managed exchange rate, is associated with a smaller decline on a country's output. A flexible exchange rate can provide a buffer from adverse developments elsewhere. A decrease in the demand for a country's goods or services, as in Barbados, can decrease the value of local currency relative to other countries' currencies and lessen the foreign decline in demand for a country's goods and services.¹

Gelos and his coauthors also analyze data for these emerging countries plus low-income developing economies. They find that the global decline in trade is an important factor for explaining these countries' decreases in GDP. Countries producing manufactured products were affected more than

¹ Barbados has a fixed exchange rate relative to the U.S. dollar, a policy that is relatively common in the Caribbean. The comment above is not meant to suggest that Barbados would be better off with a flexible exchange rate. Barbados is a relatively small country, with about 285,000 people in 2010.

others. A flexible exchange rate helped reduce the effect of the crisis for these countries, as it did for the emerging countries alone.

Conclusion

The “global financial crisis” did not really occur globally. But the financial crisis centered in the United States and Europe has had effects worldwide. Some effects of the crisis in the United States—halted construction projects and declines in GDP—are mirrored in parts of the world that have not experienced a financial crisis.

The effects of the crisis have extended far beyond the countries with crises themselves. This spread is due partly to countries’ vulnerability to the decreases in the global supply of credit since the crisis and partly due to their vulnerability to the global decline in the demand for goods and services.

Gerald Dwyer is the director of the Center for Financial Innovation and Stability at the Atlanta Fed. He thanks R.W. Hafer for helpful comments on an earlier draft.

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