

# [The immediate result of gfc in the](https://assignbuster.com/the-immediate-result-of-gfc-in-the/)

The immediate result of GFC in thecontext of trade linkage is that when the United States enter into therecession, countries which reliant on US as export market also get intotrouble.

In the pre-crisis era the US consider the consumer of last resort thisturn into the global trade in balance when the rest of word export theirproduct to the United States. The result was eminent when the US recessioncause less import of US consumer to the rest of the world.  India and China which is the largest emergingeconomies could pick up the slack that the US leave behind but the twocountries experiences their own domestic issue of excessive debt. During GFCemerging market term premium increases due to investors risk averseness to lendand on the demand side countries with already high amount of debt will unlikelyto increase borrowing as cost of doing so increases and prospect of improvedexport income also have slim chance to happen. In context of permanent incomehypothesis and the argument I laid it is difficult to find any country thatwill pick up the slack that US consumer left behind. Germany, the Nordic countryoil producing nation and Japan which possess high savings is potential candidatebut this country is running large surpluses before and during the GFC(Bernanke, 2005)Hernandez and Valdez (2001) in theirempirical studies show that trade links and neighborhood effects is robustcontagion channeled that financial variables such as government bond spread inexplaining the 1997 Asian Financial Crisis(AFC). The AFC first started in theThai central bank devaluating the baht and adopting the float exchange rate dueto heavy speculation from currency trader.

Years before the AFC, Thai and otherEast Asian economy is experiencing escalating amount of debt mainly denominatedin dollar. Fixed exchange rate and large current account deficit is a perfectrecipe for a currency speculation. As the Thai central bank fight currencyspeculator by supporting the baht to maintain its fixed rate with the dollarwhich resulted in the depletion of foreign exchange reserve which in turnresulted into the collapse of baht and allowing it to float against the dollar. Speculation continue, now the currency trader is targeting East Asian countrieswith large current account deficit that resulted into another series ofdevaluation in East Asian currencies. 2. 2Trade Balance and Current Account Aldasoro, Gatti and Faia (2016) intheir study using network model of the interbank market in which banks lend toeach other with illiquid assets concluded that contagion arises through the channelof liquidity hoarding, interlinkages and fire sales of asset. Also on theirstudy they show that there is tradeoff between decrease systemic risk and costof lower efficiency. In normal times banks and asset managers set aside optimalamount of liquidity either for regulatory requirement or for operationalperspective.

Holding extra amount of liquidity such as cash and other liquidassets is costly for banks and asset manager due to the forgone return it mightearn if this asset is put in high yield investment. In macro perspective duringthe GFC, the well-functioning MBS and derivatives market experience suddenevaporation of liquidity. The increasing default rate of the underlying MBS notonly contract credit and liquidly on the financial market but as well spillover to real economy by reduced output. This phenomenon of high correlation ofprice and return between asset classes even in the absence of fundamentals is hardto be explained by standard model of Capital Asset Pricing Model and RationalExpectation Hypothesis with strong assumption about the ideal world in whichall asset price must contain the fundamentals the risk of certain securities. Thebenefits of diverse portfolio diminishes specially to highly integratedfinancial markets under crisis, either through capital flows or financialinstitution linkages. Furthermore, during the crisis, asset prices breaks, securities price either contain little or no information about the truefundamental of the underlying assets due to increased information asymmetry introuble times and Hayek’s theory on price will not hold. During the onset of a crisis like theGFC, asset classes across risk premium became highly correlated and increasing volatilitiesmove across different segment of the financial market.

Furthermore in thecauses of GFC in 2008, MBS and CDOs as asset class is to small compare to otherdebt market, a plunge of price of this securitized debt due to the risingdefault rate of subprime mortgages suppose not to tip off the entire financialsystem of the US and Europe but what it creates is uncertainties in thefinancial system that led into runs from wholesale liquidity provider  mostly from asset managers in Europe, not onlyto MBS but as well to highly rated debt instrument as investors liquidatingposition moving into safe assets such as cash, gold and US Treasury. The runsin liquidly into the US market spur similar runs to banks in Europe with thecollapse and nationalization of the Northern Rock and RBS. As liquidity andcredit contracting in US and Europe, investor demand higher yield in mostsovereign debt of countries like Greece, Portugal and Italy that lead into the EuroDebt Crisis. Large bodies of literature discuss themechanism of contagion transmission specifically from the developed economiesinto EMEs.

Stiglitz (2010) in his paper discuss optimal policy design whencountry experience crisis contagion. The paper concluded that despite ofmainstream thoughts on the benefits of trade liberalization on stability, financial integration will result more instability during crisis. A powerfulanalogy from medicine that during onset of an infectious disease doctors shallcontain and quarantine the carrier not spread them across which worsen thesituation. Similar account by Fry-McKibben, Martin and Tang (2013) in theirpaper suggests that asset market interconnectedness can increase contagionrisks during long period of financial crisis they result also extend beyond thetraditional risk associated in asset volatilities and correlation. 2. 1Financial Linkages                 The section will provide different channelsof contagion and its impact into both the develop and emerging economy. 2.

Theoretical Framework  The Great Financial Crisis (GFC) of2008 made significant impact to both the developed and emerging economies. Theperiod after the crisis resulted in escalating unemployment and reduce output. The Fed in tandem with ECB, BOE and BOJ are in increasing monetary accommodationand other unconventional policy such as the introduction of quantitative easing, will do all tools available to combat the crisis. The rest of the emergingeconomies’ central bank on the other hand is on defensive side by devaluatingtheir currency in hope of reviving the failing export market share. Due tointerconnectedness of the world through trade and financial linkages the riskof contagion on emerging market economies (EMEs) is concern that is being watchedby policy makers of emerging countries.

In relation to that issue, large numberof literature was dedicated in studying contagion mechanism and transmission ofa crisis from one part to the rest of the world with goal of averting anyexternalities arises from future crises. In the Philippines, studies like Reyes, De Jesus and Sobrevinas (2010), Yap, Reyes and Cuenca (2009) and Guinigundo(2009) explore different transmission on how the GFC had impacted the country. Thisstudy mentioned focuses on impact of the GFC in welfare, in trade and financialmarket but don’t provide clear analysis on the nature of crisis transmissionfrom US to the Philippines. Hence, the aim of this paper is to provide analysison event that led to the GFC and what transmission mechanism does contagionpropagate in the Philippines and how peculiar is our experience to the rest ofthe emerging world. 1.

Introduction KeyWords: risk contagion, trade balance, financial interlinkage, risk transmissionand capital flows.  The recent GFC of 2008 in the US whichstart to move in other developed economies and lastly impact employment andgrowth of EMEs. In the era of globalization and financial interlinkages risk ofcontagion from one part of and to the rest of the world is a major concernamong both the fiscal and monetary policy makers. In time of crisis like theGFC, central banks in developed world with the leadership of the FED are inincreasing accommodating policy in supporting financial market with liquidityprovision while the EMEs are in competitive devaluation of currently to regainexport market share. Like any other EMEs the Philippines experience its own demiseof GFC many studies which focus on the impact of crisis on trade, in welfareand financial market fails to account both the contagion mechanism andtransmission of GFC in the Philippines. This paper aims to contributeliterature on understanding the peculiar experience of the Philippines inavoiding the dire consequence of the GFC which is different from other EMEs.