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The global financial crisis: Causes, threats and opportunities. Introduction and overview

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A B S T R A C T

This essay introduces the papers presented at a conference held in April 2009 on the global financial crisis. The issue begins with four articles that survey the key events and analyze important issues around the crisis from the context of four asset classes: the equity market, fixed income market, foreign exchange market, and emerging markets. The goal is to provide readers with a reference source for understanding what happened in each asset class, when and why it happened, and the consequences. The second group of papers provides in-depth analysis of specific aspects of the crisis. These studies include issues such as the FX carry trade, macro shocks and capital flows, Taylor rules in a low-inflation environment, and the credit boom that preceded the crisis.

1. Introduction

The financial crisis that began in 2007 has created the greatest financial dislocations since the Great Depression of the 1930s. A body of scholarly literature is now developing that addresses the causes of the crisis, the threats to economic well-being, and opportunities that may exist as a result of the crisis. In response to the need for an overview of the crisis in each asset class and serious analysis of important aspects of the crisis, we organized a conference held at Warwick University Business School on April 6, 2009. The conference was jointly sponsored by Warwick Business School and the *Journal of International Money & Finance*. In this brief introduction to the special issue devoted to the conference, we will provide an overview of the contributions of the contributed papers. The conference, and this

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issue, may be viewed as being organized in two sections. First, four papers survey the key events and provide related analysis in four different asset classes: equity, fixed income, foreign exchange, and emerging markets. Second, five papers provide in-depth analysis of specific aspects of the crisis. We believe that the assembled papers will be of great interest to policymakers, practitioners, and scholars.

2. What happened in each asset class?

The first four papers address the crisis from the perspective of the equity market, the fixed income market, the foreign exchange market and emerging markets. The goal is to provide a reference source for readers who want to understand *what* happened in each asset class, *when* it happened, and *why*, along with the likely consequences. The first paper, by Sohnke Bartram and Gordon Bodnar, addresses the crisis in the equity market.

The authors provide a comprehensive view of the value destruction that occurred during the crisis and compare this episode to earlier market crashes. They show that the crisis was truly global, so that the high correlations between markets resulted in no benefit from international diversification when it was most needed.

The second paper by Gerald Dwyer and Paula Tkac addresses the crisis from the fixed income perspective. A review of events shows how contagion from falling home prices leads up to the crisis and how subprime loans rippled through the markets peaking with the fall of Lehman Brothers. An important aspect of this paper is the description and analysis of government policy as it evolved through the crisis period.

The third paper by Michael Melvin and Mark Taylor deals with the crisis as experienced in the foreign exchange market. A crisis timeline is presented where the beginning of the crisis in the foreign exchange market is identified as August 2007.

Periods of peak volatility are related to the events that drove the market. The dramatic changes in exchange rates and costs of trading currencies are detailed and explained in the context of ongoing crisis developments. The last section of the paper proposes a financial stress index and then demonstrates how investors could condition their carry trades to minimize drawdowns from crisis events.

The final review-oriented paper by Michael Dooley and Michael Hutchison addresses emerging markets in the crisis. In addition to the *what* and *why* of emerging market events during the crisis, a particular focus of this paper is the process by which the U.S. subprime crisis was ultimately transmitted to emerging markets. The authors conduct an event study of the impact of U.S. shocks on emerging market CDS spreads and conclude that the "decoupling hypothesis" is supported through mid-2008, but then financial markets recoupled dramatically.

3. Asset pricing, transmission, and policy studies

Naohiko Baba and Frank Packer study deviations from covered interest rate parity (CIP) in the foreign exchange swaps market before and after the Lehman Brothers bankruptcy.

They find that as credit conditions deteriorated in the United States, deviations from CIP increased. This is consistent with a dollar funding shortage that appeared post-Lehman Brothers as financial institutions hoarded liquidity. Central bank liquidity provision actions aimed at addressing the dollar squeeze were successful at reducing deviations from CIP.

The relationship between FX carry trade returns and exchange rate volatility is studied by Richard Clarida, Josh Davis, and Niels Pedersen. They document a significant relationship between excess returns to the carry trade and both realized and implied volatility. By decomposing the data into volatility quartiles, the authors show that uncovered interest rate parity appears to hold better in high volatility quartiles. Finally, they relate currency risk premia to risk premia in the bond yield curve and find that the risk factors that drive bond yields are also reflected in carry trade currency pairs.

Many people were surprised by the strong appreciation of the U.S. dollar during the height of the crisis. Marcel Fratzscher addresses this issue by examining U.S. macroeconomic shocks and the role of global capital flows during the crisis. He finds that currencies of countries with large financial liabilities to U.S. entities depreciated more against the dollar than other countries. This is consistent with U.S. investors repatriating assets home during the crisis. An additional finding is that countries with smaller