The Great Recession: A Self-Fulfilling Global Panic

Philippe Bacchetta
University of Lausanne
Swiss Finance Institute
Centre for Economic Policy Research
Hong Kong Institute for Monetary Research

and

Eric van Wincoop
University of Virginia
National Bureau of Economic Research
Hong Kong Institute for Monetary Research

June 2013

Summary

While the 2008-2009 financial crisis originated in the United States, we witnessed a steep decline in output, consumption and investment that was of similar magnitude in the rest of the world as in the United States. This is surprising, both from a historical and theoretical perspective. Historically we have never seen such close business cycle co-movement before. Both the Great Depression and post WWII recessions witnessed far weaker co-movement of business cycles across countries. It is surprising in terms of theory as well because standard models imply only limited transmission of shocks when countries are imperfectly integrated.

This leads to two questions that we address in the paper. First, given the observed strong home bias in goods and financial markets, what can account for the remarkable global business cycle synchronicity during this period? Second, what can explain the difference relative to previous recessions, where we witnessed far weaker co-movement? To address these questions, we develop a two-country model that allows for self-fulfilling business cycle panics. We argue that the financial market turmoil in 2008 impacted the real economy through a self-fulfilling expectation shock as opposed to a global decline in credit or wealth.

We show that a business cycle panic will necessarily be synchronized across countries as long as there is a minimum level of economic integration. When countries are sufficiently integrated, it is not possible for one country to have self-fulfilling negative beliefs about the future while the other country has favorable beliefs about the future. Limited interconnectedness implies that their fate will be common. A panic, if it occurs, will be global. We also show that several factors generated particular vulnerability to such a global panic in 2008: tight credit, the zero lower bound, unresponsive fiscal policy and increased economic integration. This sets the Great Recession apart from previous recessions.