

The Great Recession: A Self-Fulfilling Global Panic¹

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February 10, 2013

¹Preliminary. Do not quote.

Abstract

While the 2008-2009 financial crisis originated in the United States, we witnessed steep declines in output, consumption and investment of similar magnitude around the globe. This synchronicity is surprising in the context of both existing theory and past business cycle experience. Theory implies that perfect co-movement can only happen when countries are perfectly integrated, in sharp contrast to the large observed home bias in goods and financial markets. We develop a two-country model that allows for self-fulfilling business cycle panics and is consistent with high international co-movements. We show that we only need limited integration of goods and financial markets for business cycle panics to be perfectly synchronized across countries. Moreover, a panic is more likely with tight credit, low interest rates, and unresponsive fiscal policy. Therefore we argue that the world was particularly vulnerable to such global panics in 2008.

1 Introduction

The 2008-2009 Great Recession clearly had its origins in the United States, where an historic drop in house prices had a deep impact on financial institutions and markets. It is remarkable then, as illustrated in Figure 1, that the steep decline in output, consumption and investment during the second half of 2008 and beginning of 2009 was about the same in the rest of the world as in the United States.¹ This is surprising both in the context of existing theory and historical experience. Transmission channels in existing models depend critically on trade and financial linkages and on the type of shocks. A recent literature has shown that it is possible to have one-to-one transmission of shocks if goods and financial markets are perfectly integrated and there are credit rather than technology shocks.² But in reality goods and financial markets are far from perfectly integrated and there is significant home bias in both goods and asset trade. As illustrated in van Wincoop (2013), a model with credit shocks that captures the observed financial home bias will have partial transmission at best. Consistent with this, Rose and Spiegel (2010) and Kamin and Pounder (2010) find that there is little relation between financial linkages that countries have with the U.S. and the decline in their GDP growth and asset prices during 2008-2009.

The close co-movement of business cycles illustrated in Figure 1 is also unusual from an historical perspective. Figure 2 shows that during the Great Depression the decline in output in the rest of the world was smaller than in the United States. Perri and Quadrini (2012) show that the co-movement during the 2008-2009 recession stands out significantly relative to previous recessions since 1965. This then leads to two questions that we aim to address in this paper. First, given the limited extent of goods and financial integration, how can we theoretically explain that the decline in business cycles was similar in the rest of the world as in the United States during the Great Recession? Second, what can explain the difference relative to previous recessions?

To answer these questions we develop a two-country, two-period New Keynesian

¹Even outside of Europe, which had by far the largest foreign exposure to U.S. asset backed securities, the business cycle decline was of similar magnitude.

²Examples are Devereux and Sutherland (2011), Kollmann, Enders and Muller (2010) and Perri and Quadrini (2012). It is well known that with technology shocks output tends to be negatively correlated across countries even in models with perfect goods and financial market integration.

model that explains the recession as resulting from a self-fulfilling panic as opposed to an exogenous shock to fundamentals. The self-fulfilling beliefs are a result of several inter-linkages between the present (period 1) and the future (period 2). The future affects the present as beliefs of lower and riskier second-period income lead to lower first period consumption and investment, which reduces output and firm profits. But the present also affects the future as lower profits lead to an expectation of lower future economic activity and greater sensitivity of firms to future shocks. This lowers expected future output and increases uncertainty about future output. Figure 3, which is based on survey data, shows that there was indeed a large drop in expected GDP growth and an increase in its perceived variance. Moreover, these changes in beliefs were of similar magnitude in the rest of the world as in the United States.³

A key result of the model is that a business cycle panic is necessarily synchronized across the two countries as long as they have some minimum level of trade and financial integration. The drop in output, consumption and investment will then be of equal magnitude in the two countries. When trade and financial linkages are very weak, it is possible to have a business cycle panic that is limited to just one country. But this is no longer possible when there is sufficient, although incomplete, economic integration. If the Foreign country does not panic, it then provides enough stability to preclude a Home country panic. A panic, if it happens, will then necessarily be global. The threshold level of economic integration does not need to be high. It is therefore possible to still have significant home bias in trade and asset holdings as seen in the data.

The model also provides an explanation for the difference relative to previous recessions. Limited co-movement of business cycles in open economy models is usually the result of partial transmission (through trade and financial linkages) of exogenous country-specific shocks. That may well be a good description for most business cycles. However, in our model the co-movement is not a result of transmission but rather of a coordinated panic. A combination of distinct factors, all featured in the model, made the 2008 period particularly vulnerable to such

³The data comes from Consensus Economics who survey about 250 "prominent financial and economic" forecasters. Each January, forecasters are asked to give probabilities for GDP growth rate intervals for the current year. We compute the average and the variance for each country, as explained in more details in Appendix A. For the non-US data line, we compute the simple average of averages and variances.

a global self-fulfilling panic. First, credit was tight. We show that when credit conditions are easier self-fulfilling panics are not feasible in equilibrium. Tight credit makes firms more susceptible to default when hit by a drop in demand that lowers profits. This is a critical element in our model of self-fulfilling beliefs. Second, interest rates were initially low. This reduced the expected stabilizing role of monetary policy, since it is easier to fall in a liquidity trap. Third, there were several constraints on fiscal policies, including high debt level and relatively new fiscal rules. Fourth, the world had experienced a significant increase in both trade and financial integration over the past two decades. The model then implies that panics are more likely to be common across countries.

The crisis in U.S. financial markets plays a role in our theory of a global recession, but only as a trigger event for the self-fulfilling shift in beliefs. This stands in contrast to models in which the linkage between financial markets and the real economy operates through a credit shock or a decline in wealth. While credit was tight, it is hard to argue that there was a large credit shock. Chari, Christiano and Kehoe (2008) document an increase in both consumer and industrial bank credit in the second half of 2008. Adrian, Colla and Shin (2011) find that a decline in bank credit to firms in 2009 was replaced by an equal increase in bond financing.⁴ Moreover, it is also hard to argue that a decline in wealth was responsible for the global recession. With the exception of some smaller European countries (Ireland and Spain) the sharp decline in housing wealth was a U.S. phenomenon rather than a global phenomenon.⁵

The paper is related to some other recent work on self-fulfilling business cycle panics.⁶ The most important difference is that these are closed economy models and therefore do not address the co-movement question. Farmer (2012a,b) analyzes models where self-fulfilling beliefs are associated with wealth. A belief of a lower value of financial wealth leads to lower consumption, which leads to lower firm profits, which justifies the drop in wealth. But as just pointed out, the decline in wealth was much smaller in the rest of the world than in the United States.

⁴Also consistent with the absence of a large credit shock, Kahle and Stulz (2011) use firm level data to show that there was no relationship between the drop in investment by firms and their bank dependence. Helbling, Huidrom, Kose and Otrok (2010) estimate a global VAR to find that a global credit shock accounts for only 10% of the global drop in GDP in 2008-2009.

⁵While stock markets declined significantly everywhere, they tend to be less important in most countries than in the United States.

⁶See Schmitt-Grohé (1997) for a review of earlier models.

Heathcote and Perri (2012) also have a model where the decline in wealth is critical to self-fulfilling beliefs, although through a different mechanism. In their model lower housing wealth makes it possible to have self-fulfilling beliefs of higher unemployment. If households find it less likely that they have a job tomorrow, and it is hard to borrow when their housing collateral is low, they will reduce consumption. This reduces output, which indeed leads to more unemployment. Both this paper and the Farmer papers rely on labor market rigidities rather than nominal rigidities to generate a link from demand to production.

Benhabib, Wang, and Wen (2012) develop a model where business cycles are affected by market sentiments when production decisions need to be made in advance of knowing demand and agents receive imperfect information about aggregate demand. It has in common with the Farmer papers that the business cycle then depends on a market sentiment variable that can take on a continuum of values, as opposed to models such as ours where there is either a panic or not.⁷

Finally, Perri and Quadrini (2012) introduce a mechanism leading to self-fulfilling credit shocks. If the resale value of firms is expected to be low, credit will be tight. But tight credit makes it difficult for constrained firms to purchase assets from defaulting firms, which indeed makes the resale value low. While they have a two-country model with perfect business cycle co-movement, this is a result of perfect financial and goods market integration.⁸

To present the basic mechanism, we analyze a benchmark model without investment, financial asset trade or uncertainty. In that context, it is possible to derive theoretically the conditions under which global panics occur. Our main result, stated in Proposition 2, is that full integration is not needed to necessarily have perfect business cycles co-movements. We show numerically that the extent of

⁷Also related is Bacchetta, Tille and van Wincoop (2012) who focus on the stock market rather than business cycles. Their model features self-fulfilling spikes in stock price risk and an associated sharp decline in stock prices. Bacchetta and van Wincoop (2012) extend this to an open economy framework.

⁸Dedola and Lombardo (2012) find that that perfect co-movement is possible even with portfolio home bias. But this relies on a setup that precludes arbitrage between risky and riskfree assets as only leveraged agents hold risky assets and face borrowing constraints. As shown in van Wincoop (2013), allowing for non-leveraged agents that can conduct such arbitrage, and calibrating the relative size of leveraged institutions in financial markets, transmission is limited. The 2008 crisis saw very large arbitrage between risky and low risk assets, with a large flight to quality that increased prices of low risk Treasuries.

integration required is relatively small. The intuition is relatively simple. Assume only one country panics. A given level of integration is sufficient either to drag the other country into a panic or for the other country to pull out the first country out of the panic. This occurs through various spillover channels, that we discuss in details. Outside of a panic, however, these spillover channels imply only limited co-movement. When we extend the model to include investment, financial asset trade or uncertainty, the results are similar but can only be derived numerically.

The remainder of the paper is organized as follows. Section 2 describes the benchmark model. Section 3 analyzes the equilibria and determines when business cycle panics are global. Section 4 shows that countries are more vulnerable to global panics with tight credit, low interest rates, or rigid fiscal policies. Section 5 considers various extensions and Section 6 concludes.

2 The Model

In this section we describe the benchmark model. There are two countries, Home and Foreign, and two periods, 1 and 2. The basic two-period New Keynesian structure is similar to closed economy models found in the literature, starting with Krugman (1988).⁹ Prices are pre-set, while wages are flexible. There is partial integration of goods markets through trade. Countries are in financial autarky, with financial assets (claims on firms, a bond, and money) only held domestically. Goods are only used for consumption, abstracting from investment. There are households, firms, a government and a central bank. There is no uncertainty, but in period 1 there may be different expectations in case of multiple equilibria.

In Section 5, we examine several extensions to this benchmark. In particular, we examine the role of investment, uncertainty and financial integration.

2.1 Households

Households make consumption and leisure decisions in both periods. Households in the Home country maximize

$$\frac{1}{1-\gamma}c_1^{1-\gamma} + \lambda_1 + \beta \left(\frac{1}{1-\gamma}c_2^{1-\gamma} + \lambda_2 \right) \quad (1)$$

⁹See Mankiw and Weinzierl (2011) or Fernandez-Villaverde et al. (2012) for recent contributions. Aghion et al. (2000) analyzed a small open economy.

where l_t is the fraction of time devoted to leisure in period t and c_t is the period t consumption index of Home and Foreign goods:

$$c_t = \left(\frac{c_{H,t}}{\psi} \right)^\psi \left(\frac{c_{F,t}}{1-\psi} \right)^{1-\psi} \quad (2)$$

where

$$c_{H,t} = \left(\int_0^{n_{H,t}} c_{H,t}(j)^{\frac{\mu-1}{\mu}} dj \right)^{\frac{\mu}{\mu-1}} \quad (3)$$

$$c_{F,t} = \left(\int_0^{n_{F,t}} c_{F,t}(j)^{\frac{\mu-1}{\mu}} dj \right)^{\frac{\mu}{\mu-1}} \quad (4)$$

Here $c_{H,t}$ is the consumption index of Home goods and $c_{F,t}$ the consumption index of Foreign goods. Consumption of respectively the Home and Foreign good j is $c_{H,t}(j)$ and $c_{F,t}(j)$. The number of Home and Foreign goods in period t is $n_{H,t}$ and $n_{F,t}$, which are equal to the number of Home and Foreign firms. The elasticity of substitution among goods of the same country is $\mu > 1$, while the elasticity of substitution between Home and Foreign goods is 1 (we examine non-unitary elasticities in Section 5). There is a preference home bias towards domestic goods as we assume $\psi > 0.5$. The specification is symmetric for the Foreign country, with the overall consumption index denoted as c_t^* and $c_{H,t}^*(j)$, $c_{F,t}^*(j)$ denoting the consumption of individual Home and Foreign goods consumption by Foreign households.

The parameter ψ captures the degree of goods market integration, with the limit of $\psi = 0.5$ reflecting perfect goods market integration. As we will see, $\psi = 0.5$ implies that in equilibrium $c_t = c_t^*$, so that financial markets are complete even though there is no asset trade.¹⁰ This is a feature that results specifically from the Cobb Douglas specification and is familiar from Cole and Obstfeld (1991). We can then think of $\psi = 0.5$ as perfect economic integration across the two countries.

In period 1 Home households earn labor income $W_1(1 - l_1)$, where W_1 is the nominal wage rate, earn a dividend Π_1^C and receive a transfer of $\bar{M}_1$ in money balances from the central bank. They use these resources to consume, pay a tax T_1 to the government, buy Home nominal bonds with interest rate i and hold

¹⁰Financial market completeness implies that the ratio of marginal utilities of consumption across the two countries is equal to the real exchange rate, which is 1 when $\psi = 0.5$.

money balances:

$$\int_0^{n_{H,1}} P_{H,1}(j) c_{H,1}(j) dj + \int_0^{n_{F,1}} S_1 P_{F,1}(j) c_{F,1}(j) dj + T_1 + B + M_1 = W_1(1 - l_1) + \Pi_1^C + \bar{M}_1 \quad (5)$$

where $P_{H,t}(j)$ and $P_{F,t}(j)$ are the price of respectively Home and Foreign good j in the Home and Foreign currency. S_t is the nominal exchange rate in period t (Home currency per unit of Foreign currency).

In period 2 Home households earn labor income $W_2(1 - l_2)$, earn a dividend Π_2^C , receive $(1 + i)B$ from bond holdings, carry over M_1 in money balances from period 1, and receive an additional money transfer of $\bar{M}_2 - \bar{M}_1$ from the central bank. These resources are then used to consume, pay a tax T_2 to the government and hold money balances M_2 :¹¹

$$\int_0^{n_{H,2}} P_{H,2}(j) c_{H,2}(j) dj + \int_0^{n_{F,2}} S_2 P_{F,2}(j) c_{F,2}(j) dj + T_2 + M_2 = W_2(1 - l_2) + \Pi_2^C + (1 + i)B + M_1 + (\bar{M}_2 - \bar{M}_1) \quad (6)$$

We assume a cash-in-advance constraint, with the buyer's currency being used for payment:

$$\int_0^{n_{H,t}} P_{H,t}(j) c_{H,t}(j) dj + \int_0^{n_{F,t}} S_t P_{F,t}(j) c_{F,t}(j) dj \leq M_t \quad (7)$$

The constraint will always bind in period 2. It will bind in period 1 when the nominal interest rate i is positive. When $i = 0$, the constraint will generally not bind in period 1.

Households choose consumption and leisure to maximize (1). The first-order

¹¹As usual in finite-time models, there is an implicit assumption on the final use of money, e.g., agents need to return the money stock to the central bank.

conditions are

$$c_1^{-\gamma} = \beta(1+i)\frac{P_1}{P_2}c_2^{-\gamma} \quad (8)$$

$$c_{H,t}(j) = \left(\frac{P_{H,t}(j)}{P_{H,t}}\right)^{-\mu} c_{H,t} \quad (9)$$

$$c_{F,t}(j) = \left(\frac{P_{F,t}(j)}{P_{F,t}}\right)^{-\mu} c_{F,t} \quad (10)$$

$$c_{H,t} = \psi \frac{P_t}{P_{H,t}} c_t \quad (11)$$

$$c_{F,t} = (1-\psi) \frac{P_t}{S_t P_{F,t}} c_t \quad (12)$$

$$\frac{W_t}{P_t} = \lambda c_t^\gamma \quad (13)$$

where

$$\begin{aligned} P_{H,t} &= \left(\int_0^{n_{H,t}} P_{H,t}(j)^{1-\mu} dj \right)^{\frac{1}{1-\mu}} \\ P_{F,t} &= \left(\int_0^{n_{F,t}} P_{F,t}(j)^{1-\mu} dj \right)^{\frac{1}{1-\mu}} \\ P_t &= P_{H,t}^\psi [S_t P_{F,t}]^{1-\psi} \end{aligned}$$

$P_{H,t}$ and $P_{F,t}$ are price indices of Home and Foreign goods that are denominated in respectively Home and Foreign currencies. P_t is the overall price index, denominated in the Home currency.

Equation (8) is a standard intertemporal consumption Euler equation. (9)-(10) represent the optimal consumption allocation across goods within each country. (11)-(12) represent the optimal consumption allocation across the two countries. (13) represents the consumption-leisure trade-off. As usual, the inverse of γ measures the intertemporal rate of substitution. However, in equation (13) γ also measures the wage elasticity to consumption.

There is an analogous set of first-order conditions for Foreign households. Other than for Home and Foreign prices and price indices, all we need is add * superscripts to the variables and exchange ψ and $1-\psi$. The Foreign price index is $P_t^* = (P_{H,t}/S_t)^{1-\psi} P_{F,t}^\psi$.

2.2 The Government and the Central Bank

The government and central bank policies are analogous in the two countries. We therefore again only describe the Home country. The Home government only buys Home goods. The total government consumption index is analogous to the CES index for private Home consumption:

$$g_t = \left(\int_0^{n_{H,t}} g_t(j)^{\frac{\mu-1}{\mu}} dj \right)^{\frac{\mu}{\mu-1}} \quad (14)$$

In the benchmark case we will simply set $g_t = 0$. But we will also consider a positive constant level of government spending, where $g_t = \bar{g}$. And in Section 4 we will consider the role of countercyclical fiscal policy, where $g_t = \bar{g} - \Theta(c_1 - \bar{c})$, with $\bar{c}$ consumption in the non-panic equilibrium of the model and $\Theta \geq 0$.

Optimal allocation of government spending across the different goods implies

$$g_t(j) = \left(\frac{P_{H,t}(j)}{P_{H,t}} \right)^{-\mu} g_t \quad (15)$$

We have $\int_0^{n_{H,t}} P_{H,t}(j) g_t(j) dj = P_{H,t} g_t$. Since the timing of taxation across the two periods does not matter due to Ricardian equivalence, we simply impose the balanced budget condition

$$T_t = P_{H,t} g_t \quad (16)$$

The central bank's behavior is modeled as in other two-period models (e.g., Krugman, 1988, or Mankiw and Weinzierl, 2001). The central bank credibly sets second-period money supply to stabilize second-period prices. We assume that the central bank has a zero inflation target from period 1 to period 2 so that $P_2 = P_1$. Since the cash-in-advance constraint is binding in period 2, this target can be achieved setting $\bar{M}_2 = P_2 c_2$.

In the first period, the central bank sets the nominal interest rate i . For now we will assume that the central bank sets the interest rate such that $(1+i)\beta = 1$. This corresponds to the interest rate in the flexible price equilibrium of the model. We will see that the non-panic equilibrium of the model then corresponds to the flexible price equilibrium. In the panic equilibrium the central bank typically wants to lower the interest rate to stimulate demand.¹² However, it may hit the zero lower bound, which makes monetary policy ineffective no matter what the interest rate rule is. These issues will be discussed in Section 4.

¹²For example, we could assume an interest rate rule $1+i = 1/\beta + \zeta_1(P_2/P_1) + \zeta_2(y_1 - \bar{y})$ where $\bar{y}$ is full capacity output.

2.3 Firms

The number of firms operating in period 1 is based on prior decisions and therefore taken as given. We normalize it at 1 for both countries, so $n_{H,1} = n_{F,1} = 1$. At the end of period 1 firms decide whether to continue to operate in period 2. We denote the number of period-2 firms by $n_{H,2} = n$ and $n_{F,2} = n^*$. We do not allow new firms to enter.¹³

We focus our description mainly on Home firms. Results are analogous for Foreign firms. Output of Home firm j in period t is

$$y_t(j) = (AL_t(j))^\alpha \quad (17)$$

where $L_t(j)$ is labor input, A a constant labor productivity parameter and α is between 0 and 1.

Firms set prices at the start of each period. This Keynesian assumption only bites for period 1 as no unexpected shocks happen after firms set prices at the start of period 2. For period 1 a drop in consumption during a panic will lower demand for goods and therefore production. Labor demand is then set to satisfy the demand for goods. This Keynesian aspect is critical to the self-fulfilling business cycle panic in the model.

Since prices in period 1 are preset, and their level does not matter for what follows, we simply assume that all firms set the same price of P_{H1} , so that $P_{H1}(j) = P_{H1}$. Similarly, for the Foreign firms $P_{F1}(j) = P_{H1}$. In period 2 Home firm j sets its price $P_{H,2}(j)$ to maximize profits

$$\Pi_2(j) = P_{H,2}(j)y_2(j) - \frac{W_2}{A}y_2(j)^{1/\alpha} \quad (18)$$

subject to

$$y_2(j) = c_{H,2}(j) + g_2(j) + c_{H,2}^*(j) = \left(\frac{P_{H,2}(j)}{P_{H,2}} \right)^{-\mu} \left[\psi \frac{P_2}{P_{H,2}} c_2 + \bar{g} + (1 - \psi) \frac{S_2 P_2^*}{P_{H,2}} c_2^* \right] \quad (19)$$

The optimal price is a markup $\mu/(\mu - 1)$ over the marginal cost:

$$P_{H,2}(j) = \frac{\mu}{\mu - 1} \frac{W_2}{\alpha A} y_2(j)^{\frac{1-\alpha}{\alpha}} \quad (20)$$

¹³We could allow for entry under a fixed cost. If the fixed cost is large enough we revert to our current setup. Lower fixed costs that lead to limited entry, only partially replacing exiting firms, will only affect results quantitatively, not qualitatively.

Second-period profits are then

$$\Pi_2(j) = \kappa \frac{1}{A} W_2 y_2(j)^{1/\alpha} \quad (21)$$

where $\kappa = [\mu(1 - \alpha) + \alpha]/[(\mu - 1)\alpha]$. Since all firms face the same demand and the same wage, they set the same price. From the definition of the Home price index we have $P_{H,2} = P_{H,2}(j)n^{1/(1-\mu)}$.

Bankruptcy can occur at the end of period 1. The only difference across firms in period 1 is an ex-post fixed cost. A fraction $1 - \bar{n}$ of firms face an additional real cost z in period 1. This cost capture business costs other than wages.¹⁴ Total profits of Home firm j in period 1, $\tilde{\Pi}_1(j)$, are equal to

$$\tilde{\Pi}_1(j) = \Pi_1 - P_1 z(j) = P_{H,1} y_1 - W_1 L_1 - P_1 z(j) \quad (22)$$

where $z(j) = 0$ for a fraction $\bar{n}$ of firms and $z(j) = z$ for a fraction $1 - \bar{n}$ of firms. It is also useful to define Π_1 as period-1 profits before paying this cost. When firm j is unable to fully pay the fixed cost, it is declared bankrupt and cannot produce in period 2. We assume that $z(j)$ does not affect aggregate resources and is paid to an agency. In case of bankruptcy, the agency seizes Π_1 . The agency operates at no cost and transfers its income to households.

Since $\Pi_1 > 0$, the $\bar{n}$ firms for which $z(j)$ is zero always have positive profits in period 1 and therefore do not need to borrow to continue their operation into period 2. The other $1 - \bar{n}$ firms may need to borrow when their first-period profits are negative. But they face a maximum limit on their borrowing capacity. Let $D(j)$ be borrowing by firm j at the end of period 1. The firm then owes $(1+i)D(j)$ in period 2. It is assumed that this can be no larger than a fraction ϕ of second period profits:

$$(1+i)D(j) \leq \phi \Pi_2(j) \quad (23)$$

This standard borrowing constraint reflects that owners of the firm can seize at most a fraction ϕ of expected second period profits in case of non-payment. Second-period profits are positive and known at the end of period 1.

¹⁴We introduce firm heterogeneity through an additive term in profits because this simplifies the algebra. Results would not change fundamentally if instead we introduced shocks to firm productivity, which interacts multiplicatively with $W_1 L_1$. The binomial distribution of the cost is also assumed for convenience.

The $1 - \bar{n}$ firms facing the cost z are fragile in that they will go bankrupt if their debt limit is insufficient to cover negative profits in period 1. This is the case when

$$\Pi_1 + \phi \frac{\Pi_2}{1+i} < P_1 z \quad (24)$$

Another way to look at the bankruptcy condition is to define the real quantity of funds π available to pay for the fixed cost:

$$\pi \equiv \pi_1 + \phi \frac{\pi_2}{1+i} \quad (25)$$

where $\pi_1 = \Pi_1/P_1$ and $\pi_2 = \Pi_2/P_2$. From (24), the $1 - \bar{n}$ fragile firms will go bankrupt when

$$\pi < z \quad (26)$$

Therefore the number of firms in period 2 is either 1 or $\bar{n}$, depending on whether $\pi \geq z$ or $\pi < z$.

Let D denote aggregate borrowing by firms. The total dividends received by households include dividends from firms and from the service agency. Dividends received in periods 1 and 2 are

$$\Pi_1^C = \Pi_1 + D \quad (27)$$

$$\Pi_2^C = n\Pi_2 - (1+i)D \quad (28)$$

2.4 Market Clearing

For the Home country the market clearing conditions are

$$y_t(j) = c_{H,t}(j) + g_t(j) + c_{H,t}^*(j) \quad t = 1, 2 \quad (29)$$

$$n_{H,t}L_t = 1 - l_t \quad t = 1, 2 \quad (30)$$

$$M_t = \overline{M}_t \quad t = 1, 2 \quad (31)$$

$$B = D \quad (32)$$

These represent respectively the goods markets clearing conditions, the labor market clearing condition, the money market clearing condition and the bond market clearing condition. There is an analogous set of market clearing conditions for the Foreign country.

If we substitute into the household budget constraints (5)-(6) the bond, money and labor market clearing conditions, along with the dividend expressions (27)-(28) and assuming $g_t = 0$, we get

$$P_{H,t}c_{H,t} + S_t P_{F,t}c_{F,t} = \int_0^{n_{H,t}} P_{H,t}(j)y_t(j)dj \quad (33)$$

This says that national consumption is equal to GDP. The trade balance is therefore zero. Indeed, multiplying the goods market clearing condition (29) by $P_{H,t}(j)$ and aggregating and substituting into the right hand side of (33), gives the balanced trade condition

$$S_t P_{F,t}c_{F,t} = P_{H,t}c_{H,t}^* \quad (34)$$

Using the expressions for $c_{F,t}$ and $c_{H,t}^*$, this can also be written as

$$P_t c_t = S_t P_t^* c_t^* \quad (35)$$

The nominal value of consumption is equal across the two countries. This does not imply that real consumption is equal as the real exchange rate $S_t P_t^*/P_t$ is not necessarily equal to 1 when $\psi > 0.5$. Only when markets are perfectly integrated ($\psi = 0.5$) is the real exchange rate equal to 1 and $c_t = c_t^*$.

Together with the definitions of the price indices, (35) also gives an expression for relative prices that we will use below:

$$\frac{P_{H,t}}{P_t} = \left(\frac{c_t^*}{c_t} \right)^{\frac{1-\psi}{2\psi-1}} \quad (36)$$

The Foreign relative prices are the reciprocal: $P_{F,t}/P_t^* = P_t/P_{H,t}$.

2.5 Equilibrium

An equilibrium consists of values of $c_{H,t}(j)$, $c_{F,t}(j)$, l_t , M_t , B , $L_t(j)$, $P_{H,2}(j)$, $D(j)$, n , S_t , π_t and their Foreign equivalents, that satisfy the household optimality conditions (8)-(13), the cash-in-advance constraint (7), the budget constraints (5), (6) and (16), optimal government consumption allocation (15), optimal second period price setting (20), the borrowing constraint (23), the market clearing conditions (29)-(32), the bankruptcy condition (26) and all their Foreign counterparts.

The equilibrium can be reduced to a set of 6 equations in c_1 , c_1^* , π , π^* , n and n^* . For convenience we focus on the case where $g_t = 0$. Appendix B reports these

conditions for $g_t > 0$. We have

$$c_1 = \frac{1}{\theta} n^{(1-\delta)\zeta} (n^*)^{\delta\zeta} \quad (37)$$

$$c_1^* = \frac{1}{\theta} n^{\delta\zeta} (n^*)^{(1-\delta)\zeta} \quad (38)$$

$$\pi = c_1 - \frac{\lambda}{A} c_1^{\gamma+1/\alpha} \left(\frac{P_1}{P_{H,1}} \right)^{1/\alpha} + \frac{\phi\beta\kappa\lambda}{A} (c_1)^{\gamma+1/\alpha} \left(\frac{P_1}{P_{H,1}} \right)^{1/\alpha} n^{-\frac{\mu}{(\mu-1)\alpha}} \quad (39)$$

$$\pi^* = c_1^* - \frac{\lambda}{A} (c_1^*)^{\gamma+1/\alpha} \left(\frac{P_1^*}{P_{F,1}} \right)^{1/\alpha} + \frac{\phi\beta\kappa\lambda}{A} (c_1^*)^{\gamma+1/\alpha} \left(\frac{P_1^*}{P_{F,1}} \right)^{1/\alpha} n^{*-\frac{\mu}{(\mu-1)\alpha}} \quad (40)$$

$$n = \begin{cases} \bar{n} & \text{if } \pi < z \\ 1 & \text{if } \pi \geq z \end{cases} \quad (41)$$

$$n^* = \begin{cases} \bar{n} & \text{if } \pi^* < z \\ 1 & \text{if } \pi^* \geq z \end{cases} \quad (42)$$

where

$$\begin{aligned} \theta &= \left(\frac{\lambda\mu}{(\mu-1)\alpha A} \right)^{\alpha/(1-\alpha+\alpha\gamma)} \\ \zeta &= \frac{\alpha + \mu(1-\alpha)}{(\mu-1)(1-\alpha+\alpha\gamma)} \\ \delta &= (1-\psi)/[(1-\alpha+\alpha\gamma)(2\psi-1) + 2(1-\psi)] \end{aligned}$$

and the relative prices depend on c_1/c_1^* as shown in (36).

Appendix B provides algebraic details behind these equations. Equations (37)-(38) are derived by combining the Home and Foreign counterpart of the optimal second period price setting equation (20), the labor supply schedule $W_2/P_2 = \lambda c_2^\gamma$, $P_{H,2}(j)/P_{H,2} = n^{1/(\mu-1)}$ and the consumption Euler equations (and the assumed monetary policy). Equation (39) is the expression for available funds $\pi = \pi_1 + \phi\pi_2/(1+i)$, using $W_t/P_t = \lambda c_t^\gamma$, (35) and the fact $c_2 = c_1$ from the consumption Euler equations. Equation (40) is the Foreign counterpart for available funds. After substituting the expression (36) for the relative price, available funds depend on c_1 , c_1^* , n and n^* . Finally, (41)-(42) follow from the description of default in Section 2.3.

Before turning to the solution of the model, some brief comments are in order about the flexible price equilibrium, where first-period prices are perfectly flexible. We show in Appendix B that the equilibrium is then unique. This results from the absence of a Keynesian demand effect. First-period consumption is $c_1 = c_1^* = 1/\theta$,

while first-period profits are $\pi_1 = \pi_1^* = [\mu(1 - \alpha) + \alpha]/(\mu\theta)$. We will assume that in the flexible price equilibrium first period profits of all firms are positive:

Assumption 1 $z < [\mu(1 - \alpha) + \alpha]/(\mu\theta)$

The right hand side of the expression in Assumption 1 is equal to $\pi_1 = \pi_1^*$. We then also have $z < \pi$ since $\pi_2 > 0$, so that no firms go bankrupt ($n = n^* = 1$). Finally, we find that the equilibrium interest rates are given by $(1+i)\beta = (1+i^*)\beta = 1$. As mentioned above, this corresponds to the policy we assume in our benchmark model. The global non-panic equilibrium in the benchmark Keynesian model will then correspond exactly to the flexible price equilibrium.

3 Multiple Equilibria and Global Panics

The model can generate multiple equilibria with either $n = 1$ (no bankruptcies) or $n = \bar{n}$ (with bankruptcies). When both equilibria exist, we call the equilibrium with bankruptcies the *panic* equilibrium as it is simply generated by low expectations. There are potentially 4 equilibria, depending on the values of both n and n^* . We refer to equilibria where $n = n^*$ as symmetric equilibria. The case where $n = n^* = 1$ is a global non-panic equilibrium. If in addition there is an equilibrium where $n = n^* = \bar{n}$ we refer to it as a *global panic*. But there may also be asymmetric equilibria, where only one country panics and the other does not. There are potentially two asymmetric equilibria, with either $n = \bar{n}$ and $n^* = 1$ or $n = 1$ and $n^* = \bar{n}$.

In this section we first focus on symmetric equilibria in which $n = n^*$. In that case first-period consumption, output and profits are also equal across the two countries. Then we look at equilibria when countries are in autarky, where $\psi = 1$. Finally, we consider all equilibria for any value of ψ between 0.5 and 1. We will show that when economies are in autarky ($\psi = 1$), asymmetric equilibria always exist. However, when countries are somewhat integrated, i.e. ψ is somewhat lower than 1, there are only symmetric equilibria and a panic is necessarily global.

3.1 Symmetric Equilibria

Considering symmetric equilibria allows us to clearly illustrate the mechanism behind a global panic. Moreover, considering global panics first is also of interest

as we will see that without a global panic equilibrium the model does not feature any type of panic equilibrium, including asymmetric panics.

The monetary policy rules $1 + i = 1 + i^* = 1/\beta$ imply that $c_1 = c_2$ and $c_1^* = c_2^*$ from the consumption Euler equations. Using this, it is immediate from the other equations that $n = n^*$ implies $c_1 = c_1^*$ and $\pi_1 = \pi_1^*$. From (37)-(42), the equilibria are characterized by (c_1, π, n) that satisfy

$$c_1 = \frac{n^\zeta}{\theta} \quad (43)$$

$$\pi = c_1 - \frac{\lambda}{A} c_1^{\gamma+1/\alpha} + \phi\beta \frac{\mu(1-\alpha) + \alpha}{\mu\theta} n^{\zeta-1} \quad (44)$$

$$n = \begin{cases} \bar{n} & \text{if } \pi < z \\ 1 & \text{if } \pi \geq z \end{cases} \quad (45)$$

Let $\pi(1)$ and $\pi(\bar{n})$ represent available funds without and with bankruptcies (from (44)) in the symmetric equilibrium. We will assume that parameters are such that available funds are higher without bankruptcies:

Assumption 2 $\pi(1) > \pi(\bar{n})$

This can be written in terms of a condition on the various parameters in the model.¹⁵ A sufficient, but not necessary, condition for this to hold is that $\zeta \geq 1$, which implies $\alpha\gamma(\mu - 1) \leq 1$.

Together with Assumption 1, which implies that $z < \pi(1)$, the equilibria follow directly from (43)-(45) and are summarized in the following proposition.

Proposition 1 *When Assumptions 1 and 2 hold, there are one or two symmetric equilibria. They are characterized by:*

1. $(n, c_1) = (1, 1/\theta)$ if $\pi(\bar{n}) \geq z$
2. $(n, c_1) = (1, 1/\theta)$ or $(n, c_1) = (\bar{n}, \bar{n}^\zeta/\theta)$ if $\pi(\bar{n}) < z < \pi(1)$

¹⁵The condition is $(\bar{n}^{-\zeta} - 1) + \frac{1}{\kappa} (\bar{n}^\kappa - 1) + \phi\beta (\bar{n}^{-\zeta} - \frac{1}{\bar{n}}) > 0$. The condition is not satisfied for a high γ as wages can decrease significantly to avoid the decline in profits in a panic. Similarly it does not hold when μ is high as substitutability among goods is high so that surviving firms see a large increase in demand in the crisis.

For the case where $\phi = 0$, so that $\pi = \pi_1$, Figure 4 illustrates the multiple equilibria in Proposition 1. The hump-shaped curve represents the first-period profits function (44). The vertical lines represent (43) for the two levels of n and the cut-off point is determined by the level of z . When $\zeta > 1$, both vertical lines cross the profit schedule when it is upward sloping. When z is in the intermediate range ($\pi(\bar{n}) < z < \pi(1)$), there are two equilibria, A and B. Equilibrium A is a good one, which we refer to as the non-panic equilibrium. First period consumption and profits are high and no firms go bankrupt ($n = 1$). Equilibrium B is the bad one, which we refer to as the panic equilibrium. First period consumption and profits are low and $1 - \bar{n}$ firms go bankrupt.

The presence of two equilibria is a result of the possibility of self-fulfilling business cycle panics. This occurs due to reinforcing linkages between periods 1 and 2. Low expected period-2 income leads to low period-1 consumption, which implies low firm profits. This in turn leads to bankruptcies and therefore a low number of firms in period 2. This implies low period-2 income, making the original belief self-fulfilling.

3.2 Autarky

When $\psi = 1$ the two economies are in autarky. They only consume their own goods, so that the relative prices $P_t/P_{H,t}$ and $P_t^*/P_{F,t}$ are equal to 1 in both periods. It then follows from (37)-(42) that for each country the equilibria correspond exactly to the symmetric equilibria described above. But in autarky the equilibrium in one country has no impact on the equilibrium of another country. When $\pi(\bar{n}) < z < \pi(1)$ there are then 4 possible outcomes. Either country may be in the panic equilibrium B or the non-panic equilibrium A, independent of the other country. Therefore it is possible for both countries to experience a panic together, but it is also possible for just one of the two countries to experience a panic (asymmetric equilibria).

There is no a priori reason why the two countries would panic simultaneously. There may be arguments outside of the model why a panic would be global. For example, if the trigger that sets off the panic is particularly frightening, the two countries may react together. But if this trigger event takes place in the Home country,¹⁶ it would seem odd that the Foreign country would react to it in the

¹⁶An example is the bankruptcy of Lehman Brothers or more generally events surrounding

absence of any integration between the two countries.

3.3 When Are Panics Global?

In this section we examine all equilibria for values of ψ between 0.5 and 1. We have already described the symmetric equilibria, where $(n, n^*) = (1, 1)$ or $(n, n^*) = (\bar{n}, \bar{n})$. We now need to consider asymmetric equilibria as well, where either $(n, n^*) = (\bar{n}, 1)$ or $(n, n^*) = (1, \bar{n})$. We are particularly interested in circumstances where only the two symmetric equilibria exist. When a panic occurs, it will then necessarily be global.

We will assume that symmetric multiple equilibria exist, i.e., $\pi(\bar{n}) < z < \pi(1)$ from Proposition 1. As discussed in Section 3.2, this implies that multiple equilibria also exist in individual countries in autarky. This means that asymmetric equilibria exist when $\psi = 1$ and $\pi(\bar{n}) < z < \pi(1)$. However, as we move away from autarky, i.e., as we lower ψ , the asymmetric equilibria will no longer exist, so that panics can only be global. This is stated in the following proposition.

Proposition 2 *Assume $\pi_1(\bar{n}) < z < \pi_1(1)$, so that there are multiple equilibria. There is a threshold $\psi(z) > 0.5$ such that only the symmetric equilibria exist when $\psi < \psi(z)$.*

Proof. See Appendix A. ■

Using equations (46) and (47), Figure 5 illustrates Proposition 2 by plotting all equilibrium Home consumption levels as a function of ψ . Symmetric equilibria give perfectly horizontal schedules as consumption is unaffected by the level of integration. This is not the case in the asymmetric equilibria, as Home consumption differs from Foreign consumption.

When ψ is below the threshold $\psi(z)$, only the two symmetric equilibria exist. In that case panics are necessarily global. In other words, when the level of trade is sufficiently high, or home bias sufficiently low, a panic will be perfectly coordinated across the two countries. However, the two countries do not need to be perfectly integrated. A panic will be necessarily global for all values of ψ larger than 0.5 and less than $\psi(z)$. A sufficient degree of integration, not perfect integration, is needed to guarantee that panics will be global. As we show in section 3.5, the cutoff for ψ

U.S. financial markets in the Fall of 2008.

will generally be far above 0.5, so that we do not need to be anywhere close to full integration to assure that panics will be perfectly coordinated across countries.

While the details of the proof are given in the Appendix, we will focus here on the main intuition behind the proof. To simplify notation, we set $\phi = 0$ and $\zeta = 1$. Equations (37) and (38) then imply

$$c_1 = \frac{1}{\theta} n^{(1-\delta)} (n^*)^\delta \quad (46)$$

$$c_1^* = \frac{1}{\theta} n^\delta (n^*)^{(1-\delta)} \quad (47)$$

We have $0 < \delta < 0.5$ when $0.5 < \psi < 1$. Limited integration implies that Home consumption is more closely associated with the number of Home than Foreign firms ($\delta < 0.5$). As integration increases (ψ falls), δ increases and therefore Home consumption will become more dependent on conditions in the Foreign country as captured by the number of Foreign firms n^* .

To help understand Proposition 2, it is useful to write profits π_1 and π_1^* as a function of ψ under the assumption that there is a panic in Home ($n = \bar{n}$) and no panic in Foreign ($n^* = 1$). Using the expressions (46) and (47) for Home and Foreign consumption, the expressions for profits as functions of ψ are given by:

$$\hat{\pi}_1(\psi) \equiv \pi_1(\bar{n}, 1) = \frac{1}{\theta\mu} \bar{n}^{(1-\delta)} (\mu - (\mu - 1)\alpha\bar{n}^\kappa) \quad (48)$$

$$\hat{\pi}_1^*(\psi) \equiv \pi_1^*(\bar{n}, 1) = \frac{\alpha + \mu(1 - \alpha)}{\theta\mu} \bar{n}^\delta \quad (49)$$

It is immediate that $\hat{\pi}(\psi)$ decreases with ψ since δ decreases with ψ and $\bar{n} < 1$. In contrast, $\hat{\pi}^*(\psi)$ increases with ψ . More integration (lower ψ) then lowers Home profits and raises Foreign profits. This is due to transmission as the strong Foreign economy raises Home consumption and profits while the weak Home economy drags down Foreign consumption and profits. We examine the specific transmission channels in more detail in the next subsection.

Figure 7 graphs these two profit schedules as a function of ψ . A panic limited to the Home country is an equilibrium when

$$\hat{\pi}_1(\psi) < z \leq \hat{\pi}_1^*(\psi) \quad (50)$$

In that case the fragile Home firms will indeed default ($n = \bar{n}$), while the fragile Foreign firms will not default ($n^* = 1$). This condition is clearly satisfied when

$\psi = 1$ since $\hat{\pi}_1(1) = \pi_1(\bar{n}) < z < \hat{\pi}_1^*(1) = \pi_1(1)$. But as the level of trade between the two countries increases, Home profits rise and Foreign profits fall.

At some point Home profits will be even higher than Foreign profits. This happens when $\psi < \bar{\psi}$, with

$$\bar{\psi} = 0.5 + 0.5 \frac{\Delta}{\Delta + (1 - \alpha + \alpha\gamma)(1 - \Delta)} \quad (51)$$

where $\Delta = \ln(1 + (1/\kappa)(1 - \bar{n}^\kappa)/\ln(1/\bar{n}))$ lies between 0 and 1. When $\psi < \bar{\psi}$, (50) cannot be satisfied: Home profits are higher than Foreign profits, so that it is not possible for Home firms to default and Foreign firms not to default. $\bar{\psi}$ is clearly larger than 0.5 and Section 3.5 will show that, for reasonable parameters, the difference is significant. Countries do not have to be very integrated to assure a coordinated panic and therefore perfect business cycle synchronization.

More generally the cutoff $\psi(z)$ below which a panic is always global is in the range $[\bar{\psi}, 1)$, depending on the value of z . This is illustrated in Figure 7. When $z = z_1$, the cutoff for ψ is ψ_1 . When $\psi < \psi_1$, Foreign profits are below z , so that fragile Foreign firms will default and $(n, n^*) = (\bar{n}, 1)$ cannot be an equilibrium. Similarly, when $z = z_3$, the cutoff for ψ is ψ_3 . When $\psi < \psi_3$, Home profits are above z , so that fragile Home firms will not default and $(n, n^*) = (\bar{n}, 1)$ cannot be an equilibrium. The lowest possible cutoff value for ψ occurs when $z = z_2$, in which case the cutoff is $\psi = \bar{\psi}$, where Home and Foreign profits are equal.

The general message is that only a limited amount of trade is sufficient to assure that a panic will be global in nature and therefore consumption and output move perfectly together across countries. A limited amount of trade is sufficient to either provide enough stability to the Home country, avoiding a panic altogether, or to drag the Foreign country down into a panic as well. The countries only need to be partially integrated to assure a common fate.

3.4 Understanding Spillovers

The previous discussion relied on reduced-form functions of profits. In order to understand better the transmission channels, Figure 8 illustrates the impact of international trade on Home and Foreign profits in the asymmetric equilibrium where only the Home country panics. There are four effects of trade on profits. In

order to better see these effects, it is useful to write Home profits as follows:

$$\pi_1 = \frac{P_{H,1}}{P_1}(c_{H,1} + c_{H,1}^*) - \frac{\lambda}{A}c_1^\gamma(c_{H,1} + c_{H,1}^*)^{1/\alpha} \quad (52)$$

where

$$c_{H,1} = \psi \frac{P_1}{P_{H,1}} c_1 \quad (53)$$

$$c_{H,1}^* = (1 - \psi) \frac{S_1 P_1^*}{P_{H,1}} c_1^* \quad (54)$$

with the expressions for c_1 and c_1^* as in (46)-(47). There is an analogous expression for Foreign profits.

Consider again the case where there is only a panic in the Home country, so that $(n, n^*) = (\bar{n}, 1)$. The first effect of trade is that the higher Foreign consumption demand leads to strong Home exports ($c_{H,1}^*$ is high), which raises Home profits. Similarly, weak Home consumption leads to low Foreign exports, which lowers Foreign profits. The other three effects all operate through the terms of trade. The relatively low supply of Home goods in period 2 ($n = \bar{n} < 1$) leads to an increase in the relative price of Home goods. This has three implications. First, it leads to a terms-of-trade improvement for the Home country that raises the real value of Home profits for a given quantity of sales. This shows up in (52) through a rise in $P_{H,1}/P_1$.¹⁷ The same effect lowers real Foreign profits. Second, the Home terms-of-trade improvement raises Home consumption and lowers Foreign consumption. This is implicit in the expressions for c_1 and c_1^* in (46)-(47). This also raises Home profits and lowers Foreign profits.

In all the effects discussed so far, trade raises Home profits and lowers Foreign profits, consistent with the profit schedules in Figure 7. The last effect goes the other way. The higher relative price of Home leads to an expenditure switch towards Foreign goods. This can be seen in (53)-(54) through a drop in $P_1/P_{H,1}$ and in $S_1 P_1^*/P_{H,1}$. This last effect is dominated though by the other three effects, leading overall to a positive impact of trade on Home profits and a negative impact on Foreign profits.

While these spillovers may be sufficient to assure a joint panic even with limited trade, by themselves they do not generate much business cycle co-movement. As

¹⁷Note from (36) that the period-1 terms of trade is the period-2 terms of trade as the consumption Euler equations imply that $c_1/c_1^* = c_2/c_2^*$.

illustrated in Figure 6, in asymmetric equilibria ($\psi > \psi(z)$) consumption in the country that does not experience a panic is only affected to a limited extent. If only the Home country panics ($n = \bar{n}$, $n^* = 1$), then in comparison to the global non-panic state we have

$$\frac{\Delta \ln c_1^*}{\Delta \ln c_1} = \frac{\delta}{1 - \delta} = \frac{1 - \psi}{(1 - \alpha + \alpha\gamma)(2\psi - 1) + (1 - \psi)} < 1 \quad (55)$$

Since $\psi > \psi(z)$ in this asymmetric equilibrium, the impact of the Home panic on Foreign consumption is only a fraction of that on Home consumption. This fraction may be quite small. We now turn to a numerical illustration to shed further light on this.

3.5 Numerical Illustration

While the model is obviously highly stylized, it is still useful to provide a numerical illustration for reasonable levels of parameters. We will set the elasticity μ equal to 3. Weinstein and Broda (2006) estimate this elasticity using 8-digit, 5-digit and 3-digit industry levels. In all cases they find that the median elasticity across industries is just below 3. We set $\alpha = 0.75$. This delivers a labor share of $\alpha(\mu - 1)/\mu = 0.5$, which is consistent with 2010 data for the U.S., Japan and the Euro zone on the ratio of employee compensation to GDP. We normalize private consumption in the non-panic state to be 1 by setting λ/A such that $\theta = 1$. We then set $\bar{g} = 0.3$, implying that government consumption as a fraction of GDP is $0.3/1.3=0.23$. This is consistent with recent data from industrialized countries for government spending (consumption plus investment) relative to GDP. For now we set $\phi = 0$, so that the borrowing constraint is very tight: firms cannot borrow at all. We will investigate the role of borrowing constraints further in the next section.

The only parameter left is γ . It is hard to calibrate as it plays three roles in the model: rate of risk aversion, inverse of intertemporal elasticity of substitution and real wage cyclical. The real wage is λc^γ . Based on estimates of risk-aversion and the intertemporal elasticity of substitution γ should be larger than 1. But this is inconsistent with evidence that the average real wage rate is not very cyclical. Moreover, given realistic choices for the other parameters the model implies counterintuitively that $\pi(1) < \pi(\bar{n})$ when γ is set at 1 or larger. The reason is that in the panic state the real wage is much lower, which raises firm profits. In order

to avoid this strong cyclical of the wage rate, we consider results both for the case where γ is well below 1 and the extension where nominal or real wages are rigid (preset at the start of each period). The extension is straightforward and described in Appendix D.

When we set $\gamma = 0.2$, so that the real wage rate is not very cyclical, we find $\bar{\psi} = 0.9$, independent of the level of $\bar{n}$. The actual cutoff $\psi(z)$ then lies somewhere between 0.9 and 1. Only limited trade is then sufficient to guarantee a global panic. When 10% of private consumption goods are imported a panic is necessarily global and therefore business cycles will be perfectly synchronized during the panic. $\bar{\psi}$ will be only slightly lower, at 0.88, when we set γ infinitesimally close to 0, so that the real wage rate is not cyclical at all.

As discussed further in Appendix D, under both nominal and real wage rigidity wages are set at the start of each period under the assumption that there will be no panic.¹⁸ Results will be very similar when setting the probability of a panic at a small positive number. This does not affect period 2 as there are no further unexpected shocks during period 2. When the real wage is negotiated at the start of period 1, it will then be set at its equilibrium non-panic level. When instead the nominal wage rate is agreed to in advance, it is set at the non-panic real wage rate times the price index P_1 . The latter is affected by a panic only when the panic is asymmetric. We now set γ at 3, which is a standard value when measuring risk aversion or the inverse of the intertemporal elasticity of substitution.

Under real wage rigidity we find that $\bar{\psi}$ is 0.89. Note that this is not the same model as under flexible real wages with γ very small since the second period equilibrium does depend on γ . Nonetheless the result is virtually identical and it again does not depend on $\bar{n}$. Under nominal wage rigidity $\bar{\psi}$ is a bit lower at 0.77, so that $\psi(z)$ is in the range of 0.77 to 1. But it is still the case that limited trade is needed to guarantee perfect synchronization of panics across countries. It is sufficient that 23% of private consumption goods are imported. This number may be even less depending on the precise value of z .¹⁹

¹⁸Even though firms preset their prices, there is a difference between nominal and real wage rigidity due to the exchange rate impact on the price level.

¹⁹The slightly lower cutoff under nominal wage rigidity can be explained as follows. We have seen that when a panic is limited to the Home country, Home profits rise and Foreign profits decline as we lower ψ , until they are equal at $\psi = \bar{\psi}$. But the decrease in the relative price of Foreign goods will lower the Home price index and more so the higher the level of trade (the lower ψ). When the nominal wage rate is fixed, this by itself raises the real wage rate and lowers Home

We can finally consider the extent of business cycle transmission when a panic is limited to one country. This is the expression (55) for $\Delta \ln c_1^* / \Delta \ln c_1$. Take the example of real wage rigidity where $\bar{\psi} = 0.89$. The expression for transmission is not affected by the wage rigidity. Assume that $\psi(z) = \bar{\psi}$ and that $\psi = 0.9 > \bar{\psi}$. We are then in the region where asymmetric panics are possible. Using the values for α and γ above (respectively 0.75 and 3), the expression is 0.05. This means that when there is a panic in the Home country, the percentage drop in Foreign consumption is only 5 percent of a drop in Home consumption. Transmission is limited because of trade home bias. But only slightly more trade integration (ψ equal to 0.89 or less) guarantees that panics are synchronized across countries, allowing us to explain the perfect business cycle co-movement while retaining the observed home bias.

4 Vulnerabilities

We can now consider factors that make countries vulnerable to self-fulfilling panics. We will focus on symmetric equilibria. If symmetric panics do not exist, no type of panic, including asymmetric ones, exist in the model. We consider a version of the model that is general enough to focus on the role of credit, monetary policy and fiscal policy. These are captured by respectively ϕ , i and g_t . At the same time we will simplify by setting $\zeta = \alpha = 1$. This leads to a cleaner set of equilibrium equations, but is not critical to the results. As shown in Appendix B, the schedules that determine the symmetric equilibrium are then

$$c_1 = [\beta(1+i)]^{-1/\gamma} \frac{n}{\theta} \quad (56)$$

$$\pi = c_1 + g_1 - \frac{\lambda}{A} c_1^\gamma (c_1 + g_1) + \frac{\phi}{(1+i)\mu\theta} \left(1 + \frac{g_1\theta}{n}\right) \quad (57)$$

$$n = \begin{cases} \bar{n} & \text{if } \pi < z \\ 1 & \text{if } \pi \geq z \end{cases} \quad (58)$$

We consider different versions of this set of equilibrium equations, dependent on the vulnerability of interest. We can think of $\phi = 0$, $g_t = 0$ and $(1+i)\beta = 1$ as a benchmark that we deviate from one parameter at a time.

profits as we lower ψ . It will remain the case, as a result of the other channels that we discussed, that Home and Foreign profits are equal for a value $\bar{\psi}$ larger than 0.5, but this counterweighting force reduces somewhat the value of $\bar{\psi}$.

4.1 Credit

In order to consider the role of credit we focus on the impact of the parameter ϕ , while setting $\beta(1+i) = 1$ and $g_t = 0$. Equilibrium is then characterized by two schedules:

$$c_1 = \frac{n}{\theta} \quad \text{with } n = \bar{n} \text{ if } \pi < z \text{ and } n = 1 \text{ if } \pi \geq z \quad (59)$$

$$\pi = c_1 - \frac{\lambda}{A} c_1^{1+\gamma} + \frac{\phi\beta}{\mu\theta} \quad (60)$$

These schedules are shown in Figure 8 for two values of ϕ . The vertical lines represent the consumption schedule while the humped shaped line reflects the available fund schedule. A higher ϕ raises the available fund schedule. Figure 8 shows that when ϕ is low, so that credit is tight, there may be two equilibria, so that self-fulfilling panics are possible. At the same time, when credit is loose, so that ϕ is high, only the non-panic equilibrium exists. The more firms are able to borrow, the less fragile they are. They are then better able to withstand a drop in demand that lowers first period profits. This in turn can make a self-fulfilling panic impossible. While it remains the case that conditions in period 2 affect consumption in period 1, the linkage in the other direction is broken. Even with low consumption in period 1, leading to low profits, firms can avoid bankruptcy by borrowing when credit is loose (ϕ is high).

4.2 Monetary Policy

So far we have assumed that monetary policy is a zero inflation policy and $(1+i)\beta = 1$, so that the non-panic equilibrium corresponds to the flexible price equilibrium. But it is sensible for the central bank to lower the interest rate when faced with a panic that reduces output and consumption. We will now assume that $\phi = 0$ and $g_t = 0$, but we no longer restrict monetary policy to be $(1+i)\beta = 1$. The symmetric equilibrium is then determined by

$$c_1 = [\beta(1+i)]^{-1/\gamma} \frac{n}{\theta} \quad \text{with } n = \bar{n} \text{ if } \pi < z \text{ and } n = 1 \text{ if } \pi \geq z \quad (61)$$

$$\pi = c_1 - \frac{\lambda}{A} c_1^{1+\gamma} \quad (62)$$

The interest rate only enters the consumption schedule. Lowering the interest rate shifts the consumption schedule to the right.

Now consider the following policy. In the absence of a panic the central bank keeps $(1+i)\beta = 1$, so that we achieve the flexible price equilibrium. But when a panic occurs the central bank lowers the interest rate. The chart on the left hand side of Figure 9 considers the case where the central bank lowers the interest rate all the way to zero during a panic. When β is only slightly below 1, so that the non-panic interest rate is already close to zero, this involves only a small rightward shift of the left vertical line of the consumption schedule. We see that in that case the central bank cannot avoid a panic. There is a panic equilibrium at B' that is quite close to the panic equilibrium B under the passive policy $(1+i)\beta = 1$. The reason for this is that the central bank does not have much room to maneuver when the interest rate is already close to 0.

When instead β is well below 1, so that we are far from the zero lower bound without a panic, the interest rate will drop much more when it is lowered all the way to zero during a panic. This leads to a much larger rightward shift of the left vertical line of the consumption schedule. When the central bank follows this policy, it is clear from Figure 9 that a panic can be avoided altogether. A large drop in the interest rate leads to a significant rise in first period consumption, which dampens the decline in firm profits and thus avoids defaults.

The chart on the right hand side of Figure 9 illustrates this point as well. We can think of (61) as a downward sloping IS curve in the space of (i, c_1) . A panic lowers n , which shifts the IS curve to the left. When policy is passive, so that $i = 1 - 1/\beta$, the panic leads to a significant drop in first period consumption. We shift from point A to point B, corresponding to the same points in the chart on the left. But if β is only slightly below zero, so that without a panic we were already close to the zero lower bound, lowering the interest rate all the way to zero during a panic is not of much help. It will then only slightly stimulate consumption to point B' . Profits will then remain very weak and we are unable to escape bankruptcies and therefore the panic.

There is one other policy option that theoretically exists that does allow the central bank to avoid a panic even when close to the zero lower bound. Instead of a zero inflation policy it could adopt a high inflation policy during a panic. The consumption schedule is then

$$c_1 = [\beta(1+i)\frac{P_1}{P_2}]^{-1/\gamma} \frac{n}{\theta} \quad \text{with } n = \bar{n} \text{ if } \pi < z \text{ and } n = 1 \text{ if } \pi \geq z \quad (63)$$

High inflation expectations will then lead to a large rightward shift of the left

vertical line of the consumption schedule in the left chart of Figure 9. The panic equilibrium will then no longer exist. This policy has been widely discussed but suffers from a serious credibility problem as ex-post the central bank has little incentive to generate the promised inflation.

4.3 Fiscal Policy

Figure 10 illustrates the role of fiscal policy. In this case we set $\phi = 0$ and $(1+i)\beta = 1$, so that the two schedules become

$$c_1 = \frac{n}{\theta} \quad \text{with } n = \bar{n} \text{ if } \pi < z \text{ and } n = 1 \text{ if } \pi \geq z \quad (64)$$

$$\pi = c_1 + g_1 - \frac{\lambda}{A} c_1^\gamma (c_1 + g_1) \quad (65)$$

First consider the case where fiscal policy takes the form $g_1 = \bar{g}$, which is illustrated in the left chart of Figure 10. A higher level of $\bar{g}$ then shifts upward the available funds schedule.²⁰ The chart illustrates that when government consumption is sufficiently high, the panic equilibrium is ruled out. Only the non-panic equilibrium without bankruptcies exists. With a very high level of government consumption, it is impossible to have a self-fulfilling business cycle panic because government spending is not affected by expectations. Even if private consumption were to decline substantially, period 1 profits would remain relatively strong because of the stable government spending. This precludes the fragile firms from going bankrupt, thus avoiding a self-fulfilling panic.

The chart on the right hand side considers the role of countercyclical fiscal policy. The broken humped shaped schedule assumes that fiscal policy takes the form $g_t = \bar{g} - \Theta(c_1 - 1/\theta)$. In that case government consumption is the same as under the $g_t = \bar{g}$ policy in the absence of a panic. But when a panic occurs, which lowers first period consumption, government spending will now be higher. When fiscal policy is sufficiently countercyclical, as measured by the parameter Θ , the chart shows that the panic equilibrium no longer exists. When the drop in private consumption during a panic is sufficiently offset by an increase in government consumption, firm profits remain relatively strong and bankruptcies are avoided.

²⁰The derivative of π with respect to $\bar{g}$ is $1 - (\lambda/A)c_1^\gamma$. When $c_1 = 1/\theta$, as in the non-panic equilibrium, this derivative is $1/\mu$, which is positive. Only for first period consumption values well above that can the derivative be negative, but those are not of interest to us as first period consumption can be no larger than $1/\theta$.

4.4 Vulnerabilities during the 2008 Crisis

There are three ways in which the world economy was particularly vulnerable to a self-fulfilling panic in 2008. First, credit was known to be tight due to large losses experienced by banks and other financial institutions since early 2007, leading to deleveraging in the financial system. Second, interest rates around the world were quite close to the zero lower bound even prior to the Fall of 2008, leaving central banks little room to maneuver. Third, the Great Recession took place against the backdrop of high levels of government debt, which limited the ability of fiscal authorities to respond with strong countercyclical policies.²¹ Moreover, several countries had adopted fiscal rules, also limiting the flexibility of fiscal policy. These three factors were combined with increased global economic integration in recent decades and made the world particularly vulnerable to a globally synchronized rather than a local panic.

5 Extensions

In this section we consider four extensions to the benchmark model. While these extensions make the model more realistic, they do not alter the main results derived in the benchmark case. The first extension introduces international risk sharing, which leads to further integration across the two countries. The second extension allows for a non-unitary elasticity of substitution between Home and Foreign goods. The third extension adds investment and is able to explain the synchronized drop in investment during the Great Recession. The last extension adds uncertainty about z , which allows us to also explain the sharp increase in uncertainty about future output during the Great Recession, documented in Figure 3.

5.1 Financial Integration

In the model so far the two countries trade goods but are in financial autarky. We have seen that a limited degree of goods market integration is sufficient to

²¹Even before fiscal debt around the globe rose significantly as a result of the recession itself, gross public debt as a percent of GDP stood close to 80% among advanced economies (see for example the World Economic Outlook, International Monetary Fund, October 2012). With the exception of the end of World War II, this is the highest level in over a century.

guarantee that a business cycle panic is global. We now add to this financial integration. We only consider the extreme case of full risk sharing.²²

There is room for risk sharing as business cycle panics are shocks that may be limited to one country. Under complete markets the ratio of marginal utilities of consumption is equal to the real exchange rate:

$$\frac{c_t^{-\gamma}}{(c_t^*)^{-\gamma}} = \frac{P_t}{S_t P_t^*} \quad (66)$$

This replaces the condition $P_t c_t = S_t P_t^* c_t^*$ under financial autarky. As long as γ is different from 1 these two conditions will differ.²³ The expression (36) for relative prices no longer holds and is replaced by (66). This is the only change to the model. The new expressions for consumption and profits are shown in Appendix E.

We find numerically that risk sharing tends to further increase the cutoff level of ψ below which a panic is necessarily global. With financial integration, less trade integration is needed to assure a global panic. For example, in the numerical exercise in Section 3.5 we found that $\bar{\psi}$ was 0.89 under real wage rigidities and 0.77 under nominal wage rigidities.²⁴ With risk sharing these numbers increase to respectively 0.95 and 0.84.

To understand the role of risk sharing, consider again the case where only the Home country panics, so that $(n, n^*) = (\bar{n}, 1)$. Under risk sharing, and assuming that $\gamma > 1$, there will be a net transfer to the Home country when it is hit by a panic. This leads to an increase in relative demand for Home goods, which further raises the relative price of Home goods. The Home terms-of-trade improvement will then be even larger than without risk sharing. The favorable impact of this terms-of-trade improvement on Home profits was discussed in Section 3.4 and illustrated in Figure 6. This implies that as ψ decreases below one, Home profits increase and Foreign profits decrease more faster than before. Therefore, the two

²²Intermediate cases with partial financial integration can be accomplished in many ways and this is not necessarily captured well through one parameter in a way that is analogous to ψ for goods market integration.

²³We assume that only households share risk. Firms do not have access to risksharing because of standard principal agents problems that also lead to borrowing constraints.

²⁴As explained, without wage rigidities we needed to set γ close to zero to avoid excessive wage cyclicity, which is particularly unrealistic in the present context of risksharing where γ plays a role as the rate of relative risk-aversion. With wage rigidities we set $\gamma = 3$.

schedules meet each other at a higher level of $\bar{\psi}$. Risk sharing therefore limits the decline in Home profits when the Home country panics, which makes it less likely that Home firms will default. On the other hand, the transfer from Foreign makes it more likely that Foreign firms default when Home panics. A panic limited to only one country is therefore less likely in equilibrium.²⁵

5.2 Elasticity of Substitution

Throughout the paper so far we have assumed a unitary elasticity of substitution between Home and Foreign goods. We now relax this assumption by adopting a CES specification with an elasticity of substitution of ν between Home and Foreign goods:

$$c_t = \left[\psi^{1/\nu} c_{H,t}^{\frac{\nu-1}{\nu}} + (1-\psi)^{1/\nu} c_{F,t}^{\frac{\nu-1}{\nu}} \right]^{\frac{\nu}{\nu-1}} \quad (67)$$

The specification for c_t^* is analogous, with the weights ψ and $1-\psi$ switched.

The equations (37)-(42) that describe the equilibrium of the model remain unchanged. The only change is the expression (36) for relative prices. It is derived from the balance trade condition $S_t P_{F,t} c_{F,t} = P_{H,t} c_{H,t}^*$. With a unitary elasticity this implies $P_t c_t = S_t P_t^* c_t^*$. With an elasticity ν this generalizes to

$$\left(\frac{S_t P_{F,t}}{P_{H,t}} \right)^{\nu-1} \left(\frac{S_t P_t^*}{P_t} \right)^{\nu} = \frac{c_t}{c_t^*} \quad (68)$$

The left hand side is a function of the relative price $S_t P_{F,t}/P_{H,t}$, so this gives an implicit solution of the relative price as a function of c_t/c_t^* .²⁶

We find numerically that the cutoff $\psi(z)$ rises when we lower ν below 1 and falls when we raise ν above 1. There is evidence that ν is in fact lower than 1. For example, Hooper, Johnson and Marquez (2000) estimate import price elasticities to be well below 1 for the G-7 countries. Using the parameter assumptions from Section 2.5 we find that lowering ν from 1 to 0.7 raises $\bar{\psi}$ from 0.91 to 0.95 for

²⁵One can also understand the intuition in terms of weakening the self-fulfilling linkages in Figure 5. First, a drop in expected second period income has less effect on consumption demand because of a net transfer to Home agents. Second, the larger real appreciation leads to a more favorable terms of trade effect, which raises Home profits. Finally, the same terms of trade improvement raises real income in period 2 for a given number of firms.

²⁶It is well known that for sufficiently low elasticities of substitution (in our case below 0.5), this balanced trade condition has more than one solution for the relative price. This is an entirely separate form of multiplicity, discussed for example by Bodenstein (2010).

the flexible wage case, from 0.9 to 0.95 for the rigid real wage case and from 0.77 to 0.89 for the case of rigid nominal wages. These results imply that with trade elasticities less than 1 even less trade is needed to guarantee that panics will be global in nature.

The intuition behind this finding can be understood by returning to Figure 7. When only the Home country panics, the only negative impact of trade on Home profits operates through the expenditure switching effect as a higher relative price of Home goods leads to a substitution from Home to Foreign goods. But this effect is weakened when the price elasticity is less than 1. The result is that Home profits rises even more when trade increases (ψ falls) and Foreign profits drops more. The stability generated by the Foreign country now makes it even more difficult to have a panic limited to the Home country.

5.3 Investment

As shown in Figure 1, investment also declined sharply during the Great Recession. And the decline was again of similar magnitude in the rest of the world as in the United States. To capture this, we now consider a simple extension that allows for investment.

We assume that firms that do not go bankrupt need to invest in period 1 to operate in period 2. To simplify, we assume a given level of required investment per firm of $\bar{k}$. This investment is measured as the same index of Home and Foreign goods as for consumption. Investment demand for individual goods therefore takes the same form as for consumption, with c_1 replaced by I_1 and c_1^* by I_1^* . Aggregate investment is $I_1 = n\bar{k}$ and $I_1^* = n^*\bar{k}$.

The equilibrium conditions (70)-(77) listed in Appendix B remain the same, except that c_1 and c_1^* in the profits expressions need to be replaced by $c_1 + I_1$ and $c_1^* + I_1^*$ (with the exception of wages, which only depend on consumption as in (13)). The only other change is to the expression for the relative price in period 1. It is derived from the balanced trade condition. Without investment we showed that it can be written as $P_1 c_1 = S_1 P_1^* c_1^*$. With investment it becomes $P_1(c_1 + I_1) = S_1 P_1^*(c_1^* + I_1^*)$. Correspondingly, in the expression (36) for the period 1 relative price we again need to replace c_1 and c_1^* with $c_1 + I_1$ and $c_1^* + I_1^*$.

The change in the expression for the relative price makes it more difficult to derive analytical results, but the numerical results are consistent with Propositions

1 and 2. If we set $\bar{k}$ such that the ratio of investment to GDP is 0.15 without a panic (the average for the U.S. since 1990), and set the other parameters the same as in Section 3.5, the values of $\bar{\psi}$ remain virtually the same. Therefore it is again the case that limited integration is sufficient to assure that a panic is global. The only difference is that now during a global panic there is also a synchronized drop in investment in both countries. The percentage drop in investment is $1 - \bar{n}$.

5.4 Uncertainty

A simple way to introduce uncertainty is to assume that the level of the fixed cost z is not known in advance. Let us assume that z can take two values z_L or z_H , with $z_H > z_L > 0$. The probability of either value is 0.5 and the draw is uncorrelated across countries. As we will see, this generates business cycle uncertainty only when there is a panic, consistent with evidence of a significant spike in GDP uncertainty during the Great Recession, documented in Figure 3.

Of the equilibrium conditions (70)-(77) listed in Appendix B, only the consumption Euler equations will change. Previously period 2 consumption was known in period 1, while now it may be uncertain. Assuming $\phi = 0$, the Home fragile firms default when $\pi_1 < z$. This depends on the level of z . We assume that the fixed cost is paid at the end of period 1 and is unknown when consumption decisions are made. Let p_D be the probability of default. We have $p_D = 0$ when $\pi_1 \geq z_H$, $p_D = 1$ when $\pi_1 < z_L$ and $p_D = 0.5$ when $z_L \leq \pi_1 < z_H$. In the latter case, default will depend on whether the draw of z is z_L or z_H . This implies that a global panic, i.e., lower consumption, is not necessarily associated with bankruptcies. They only occur when $z = z_H$. The probability of default p_D^* in the Foreign country depends similarly on π_1^* . Since z and z^* are not correlated, there might be a global panic without perfect co-movement after the panic.

Let $c_2(n, n^*)$ and $c_2^*(n, n^*)$ be second-period consumption in both countries as a function of the number of firms. This takes the form, $c_2 = \frac{1}{\theta} n^{(1-\delta)\zeta} (n^*)^{\delta\zeta}$ when $g_2 = 0$ but more generally is derived from (70)-(71) in Appendix B. There are now 4 possible outcomes, dependent on whether or not there is default in the Home country and Foreign country. This leads to the following consumption Euler equation for the Home country (assuming $(1+i)\beta = 1$):

$$\begin{aligned} c_1^{-\gamma} = & p_D p_D^* c_2(\bar{n}, \bar{n})^{-\gamma} + (1 - p_D)(1 - p_D^*) c_2(1, 1)^{-\gamma} + \\ & p_D(1 - p_D^*) c_2(\bar{n}, 1)^{-\gamma} + (1 - p_D)p_D^* c_2(1, \bar{n})^{-\gamma} \end{aligned} \quad (69)$$

The consumption Euler equation for the Foreign country is analogous.

We can numerically verify the equilibria by considering all 9 possible values of the pair (p_D, p_D^*) . Given a set of values for these default probabilities, we can compute first-period consumption from the consumption Euler equations. This gives us expressions for first-period profits in both countries, which maps into values of p_D and p_D^* as described above. When the latter are consistent with their assumed values, there is an equilibrium.

To provide an illustration of the type of equilibria that this can generate, consider again the parameter values in Section 3.5. Let $z_L = 0.5$ and $z_H = 0.58$. In the case of rigid real wages we find that for $\psi < 0.92$ there are two equilibria. In one equilibrium there is no panic in either country. Consumption and profits are high and the probability of default is zero. In the second equilibrium there is a panic. Consumption and profits are weak. The probability of default is 0.5 as there will not be default when $z = z_L$. The panic is synchronized across the two countries. When $\psi > 0.92$ these same two equilibria still exist. In addition there are now mixed equilibria where only one country panics, with a 0.5 probability of default, and the other does not.

The basic difference relative to the previous equilibria is that in a panic equilibrium there is now a positive probability of default rather than certain default. The main result of the paper still holds in that a limited extent of trade integration ($\psi < 0.92$) is sufficient to guarantee that panics are global. The same equilibria also apply to nominal wage rigidities, with the cutoff for ψ being 0.83, as well as flexible wages.²⁷

The intuition behind the impact of uncertainty is as follows. Without a panic, consumption and profits are strong. No firms defaults, whether $z = z_L$ or $z = z_H$. The exogenous uncertainty about z therefore does not generate output uncertainty. In a panic, however, consumption and profits are weak. In that case the value of z does matter. When $z = z_L$ defaults can still be avoided even though profits are weak. But when $z = z_H$ the fragile firms will default. Therefore the uncertainty about z translates into output and consumption uncertainty only during a panic.

The endogenous uncertainty also contributes to the self-fulfilling mechanism itself. Without uncertainty we saw that the self-fulfilling beliefs operate through the expected level of second period income. Lower expected income leads to lower

²⁷In the case of flexible wages we need to set different values for z_L and z_H . For example, if we set them at 0.4 and 0.54 the equilibria remain the same, with the cutoff for ψ being 0.92.

consumption, which causes lower profits that generates bankruptcies that are consistent with the belief of lower expected future income. With uncertainty the second moment plays a role as well. Higher income uncertainty leads to lower consumption as a result of precautionary saving. This in turn lowers profits, which makes the fragile firms sensitive to fixed cost shocks. This generates uncertainty about defaults, making the belief of income uncertainty self-fulfilling.

6 Conclusion

The paper is motivated by evidence of close business cycle co-movement during the Great Recession. Even though the housing and financial shock originated in the United States, business cycles in the rest of the world were impacted to a similar extent. Given limited trade and financial integration across countries this is surprising as standard models with exogenous shocks and limited integration generate only partial transmission. It is also surprising given the much lower co-movement of business cycles during prior recessions.

We have developed a model with self-fulfilling business cycle panics that is consistent with a high international co-movement. We find that limited economic integration is sufficient to assure that a panic, when it occurs, is necessarily perfectly synchronized across countries. In a panic, consumption, investment, and output collapse similarly across countries and perceived uncertainty increases.

However, such global business cycle panics should not be considered a normal outcome. We have argued that several factors made the 2008 episode particularly vulnerable to such a global panic: tight credit, a low interest rate, and rigid fiscal policy combined with increased economic integration across countries. The combination of these conditions separates the 2008 episode from previous recessions.

Appendix

A. GDP Forecast Expectation and Variance

This Appendix describes in some more details how the numbers in Figure 3 are computed. The data has been purchased from Consensus Economics. In their January newsletter of “Consensus Forecast” and “Asia Pacific Consensus Forecasts” they publish one-year-ahead GDP forecast probabilities since 1999 for the countries listed in the Figure. More specifically, for every country and year, the range of potential forecasts is appropriately divided into seven classes. These classes may change from year to year. Each forecast is located in a given class, and we know the percentage of forecasts falling in each class. We compute the expectation and variance of the forecasts by considering the midpoint of a class as the realization of the random variable and the relative number (in percentage) of forecasts falling in a class as the associated probability.

One issue is that the classes at both ends of the range are not bounded on one side (e.g., a class could be defined as “< -1%”). In order to handle that issue, we considered two scenarios. In the first scenario, we assumed that the extreme classes had the same width as the others, whereas in the second scenario, we considered that the extreme classes had twice the width of the other classes. The difference between the two scenarios is small and Figure 3 shows the first scenario.

B. Model Equilibrium

When summarizing the model equilibrium equations in Section 2.5 we assumed that $g_t = 0$. More generally, without making this restrictive assumption, the

system of equations that describes the equilibrium becomes

$$\frac{\mu}{\mu-1} \frac{\lambda}{\alpha A} c_2^\gamma \frac{P_2}{P_{H,2}} \left(\frac{P_2}{P_{H,2}} c_2 + g_2 \right)^{\frac{1-\alpha}{\alpha}} = n^\kappa \quad (70)$$

$$\frac{\mu}{\mu-1} \frac{\lambda}{\alpha A} (c_2^*)^\gamma \frac{P_2^*}{P_{F,2}} \left(\frac{P_2^*}{P_{F,2}} c_2^* + g_2^* \right)^{\frac{1-\alpha}{\alpha}} = (n^*)^\kappa \quad (71)$$

$$c_1^{-\gamma} = \beta(1+i)c_2^{-\gamma} \quad (72)$$

$$[c_1^*]^{-\gamma} = \beta(1+i^*)[c_2^*]^{-\gamma} \quad (73)$$

$$\begin{aligned} \pi = c_1 + \frac{P_{H,1}}{P_1} g_1 - \frac{\lambda}{A} c_1^\gamma \left(\frac{P_1}{P_{H,1}} c_1 + g_1 \right)^{1/\alpha} \\ + \frac{\phi}{1+i} \frac{\kappa \lambda}{A} c_2^\gamma n^{-\frac{\mu}{(\mu-1)\alpha}} \left[\frac{P_2}{P_{H,2}} c_2 + \bar{g} \right]^{1/\alpha} \end{aligned} \quad (74)$$

$$\begin{aligned} \pi^* = c_1^* + \frac{P_{F,1}}{P_1^*} g_1^* - \frac{\lambda}{A} (c_1^*)^\gamma \left(\frac{P_1^*}{P_{F,1}} c_1^* + g_1^* \right)^{1/\alpha} \\ + \frac{\phi}{1+i^*} \frac{\kappa \lambda}{A} (c_2^*)^\gamma (n^*)^{-\frac{\mu}{(\mu-1)\alpha}} \left[\frac{P_2^*}{P_{F,2}} c_2^* + \bar{g} \right]^{1/\alpha} \end{aligned} \quad (75)$$

$$n = \begin{cases} \bar{n} & \text{if } \pi < z \\ 1 & \text{if } \pi \geq z \end{cases} \quad (76)$$

$$n^* = \begin{cases} \bar{n} & \text{if } \pi^* < z \\ 1 & \text{if } \pi^* \geq z \end{cases} \quad (77)$$

With relative prices as in (36), these are 8 equations in c_1 , c_1^* , c_2 , c_2^* , n , n^* , π and π^* . They are derived as follows. (70) follows by substituting the labor supply schedule $W_2/P_2 = \lambda c_2^\gamma$ and $P_{H,2}(j)/P_{H,2} = n^{1/(\mu-1)}$ into the optimal price setting equation (20). It also uses the expression (19) for $y_2(j)$ that enters into the optimal price setting equation (20), after substituting (35) into the expression for $y_2(j)$. (71) is the Foreign counterpart of (70). (72) follows from the intertemporal consumption Euler equation (8) after substituting the zero inflation monetary policy ($P_2 = P_1$). (73) is the Foreign counterpart.

(74) is an expression for available funds $\pi = \pi_1 + \phi\pi_2/(1+i)$. It is derived as follows. First, we derive π_1 , which is on the first line of the right hand side of (74). It is equal to

$$\pi_1 = \frac{P_{H,1}}{P_1} y_1(j) - \frac{W_1}{P_1} \frac{1}{A} y_1(j)^{1/\alpha} \quad (78)$$

Using that $P_{H,1}(j) = P_{H,1}$, we have from (29) that $y_1(j) = c_{H,1} + c_{H,1}^* + g_1$. Substituting $c_{H,1} = \psi(P_1/P_{H,1})c_1$ and $c_{H,1}^* = (1-\psi)(S_1 P_1^*/P_{H,1})c_1^*$, and also using

$P_1 c_1 = S_1 P_1^* c_1^*$ from (35), we have $y_1(j) = (P_1/P_{H,1})c_1 + g_1$. When we substitute this into (78), together with $W_1/P_1 = \lambda c_1^\gamma$, we get the line on the right hand side of (74). The second line is $\phi\pi_2/(1+i)$. We derive an expression for π_2 as follows. From (21) it is equal to $\pi_2(j) = \kappa \frac{1}{A} (W_2/P_2) y_2(j)^{1/\alpha}$. We substitute $W_2/P_2 = \lambda c_2^\gamma$ and the expression (19) for $y_2(j)$. In the expression for $y_2(j)$ we also substitute (35) and $P_{H,2}(j)/P_{H,2} = n^{1/(\mu-1)}$. This then delivers the second line on the right hand side of (74). (75) is the Foreign counterpart. Finally, (76) follows from the bankruptcy condition (26) and (77) is its Foreign counterpart.

The paper considers two special cases of this system of equations. In sections 2.5 and 3.1-3.4 we assume $g_t = 0$ and in the vulnerability section 4 we assume $\zeta = \alpha = 1$. We will now show that $g_t = 0$ allows us to summarize the equilibrium in the form of the 6 equations (37)-(42) and that $\zeta = \alpha = 1$ implies the symmetric equilibrium given by (56)-(58) in the vulnerability section.

Setting $g_t = 0$ and taking (70)-(71) to the power $\alpha/(1 - \alpha + \alpha\gamma)$, these two equations can be written as

$$\theta \left(\frac{P_2}{P_{H,2}} \right)^{\frac{1}{1-\alpha+\alpha\gamma}} c_2 = n^\zeta \quad (79)$$

$$\theta \left(\frac{P_2^*}{P_{F,2}} \right)^{\frac{1}{1-\alpha+\alpha\gamma}} c_2^* = n^{*\zeta} \quad (80)$$

with θ and ζ defined in Section 2.5. Substituting the expressions for relative prices from (36), this gives two equations in c_2 and c_2^* that can be solved as a function of n and n^* . Using that $c_1 = [\beta(1+i)]^{-1/\gamma} c_2$ and $c_1^* = [\beta(1+i^*)]^{-1/\gamma} c_2^*$ from the consumption Euler equations (72)-(73), we then have

$$c_1 = \frac{[\beta(1+i)]^{-1/\gamma}}{\theta} n^{(1-\delta)\zeta} (n^*)^{\delta\zeta} \quad (81)$$

$$c_1^* = \frac{[\beta(1+i^*)]^{-1/\gamma}}{\theta} n^{\delta\zeta} (n^*)^{(1-\delta)\zeta} \quad (82)$$

This corresponds to the equilibrium equations (37)-(38) in Section 2.5 for the case where monetary policy is $(1+i)\beta = (1+i^*)\beta = 1$. (39)-(40) follow directly from (74)-(75) after again setting $(1+i)\beta = (1+i^*)\beta = 1$. This monetary policy also implies $c_2 = c_1$ and $c_2^* = c_1^*$. We therefore replace second period with first-period consumption on the second lines of (74)-(75). We also use that the second period relative prices are equal to the first period relative prices. This follows from

(36), together with $c_2 = c_1$ and $c_2^* = c_1^*$. Finally, (41)-(42) correspond exactly to (76)-(77).

In the vulnerability section 4 we only consider symmetric equilibria, under the assumption that $\alpha = \zeta = 1$. All relative prices are then equal to 1. It then follows immediately from (70) that $c_2 = n/\theta$. Together with the consumption Euler equation (72) this gives (56). (57) follows from (74) after substituting $c_2 = n/\theta$, setting $\alpha = \zeta = 1$ and setting all relative prices equal to 1.

Finally, a couple of brief comments are in order about the flexible price equilibrium for the case where $g_t = 0$, discussed at the end of Section 2.5. In that case there are two additional variables to solve for, the nominal interest rates i and i^* . There are also two additional equations, which are the period-1 analogues of (70)-(71), which follow from optimal price setting in period 1. Solving these equations for period 1, using the expression (36) for the relative price and the fact that the number of firms is 1 in period 1, gives $c_1 = c_1^* = 1/\theta$. This in turn implies that $\pi_1 = \pi_1^* = [\mu(1-\alpha) + \alpha]/(\mu\theta)$. Under Assumption 1, it follows that $\pi_1 > z$, so that also $\pi > z$ as $\pi_2 > 0$. Therefore no firms go bankrupt and $n = 1$. Similarly we also have $n^* = 1$. Solving for (70)-(71) with $g_2 = 0$ we then also have $c_2 = c_2^* = 1/\theta$. First and second period consumption are therefore equal and it follows from the consumption Euler equations (72)-(73) that $(1+i)\beta = (1+i^*)\beta = 1$.

C. Proof of Proposition 2

We already know that both symmetric equilibria exist when $\pi(\bar{n}) < z < \pi(1)$. We therefore focus on the existence of asymmetric equilibria. We will only consider the asymmetric equilibrium $(n, n^*) = (\bar{n}, 1)$ as the other asymmetric equilibrium, $(n, n^*) = (1, \bar{n})$, exists if and only if the first one exists.

From (37)-(38), setting $n = \bar{n}$ and $n^* = 1$ gives $c_1 = (1/\theta)n^{(1-\delta)\zeta}$ and $c_1^* = (1/\theta)n^{\delta\zeta}$. Substituting these values for c_1 and c_1^* into (39)-(40) gives

$$\begin{aligned}\hat{\pi}(\psi) &= \frac{1}{\theta}\bar{n}^{(1-\delta)\zeta} \left(1 - \frac{(\mu-1)\alpha}{\mu}\bar{n}^\kappa \right) + \phi\beta \frac{\mu(1-\alpha) + \alpha}{\mu\theta} \bar{n}^{\zeta(1-\delta)-1} \\ \hat{\pi}^*(\psi) &= \frac{1}{\theta}\bar{n}^{\delta\zeta} \frac{\alpha + \mu(1-\alpha)}{\mu} + \phi\beta \frac{\mu(1-\alpha) + \alpha}{\mu\theta} \bar{n}^{\zeta\delta}\end{aligned}$$

where $\hat{\pi}(\psi)$ and $\hat{\pi}^*(\psi)$ are the values of π and π^* when $(n, n^*) = (\bar{n}, 1)$ and $\delta = (1-\psi)/[(1-\alpha+\alpha\gamma)(2\psi-1)+2(1-\psi)]$. We will consider values of ψ between 0.5 and 1. The asymmetric equilibrium $(n, n^*) = (\bar{n}, 1)$ exists when $\hat{\pi}(\psi) < z \leq \hat{\pi}^*(\psi)$. This is clearly the case for $\psi = 1$ as $\hat{\pi}(1) = \pi(\bar{n})$ and $\hat{\pi}^*(1) = \pi(1)$.

Using the negative relationship between ψ and δ , it follows immediately from the expressions for $\hat{\pi}$ and $\hat{\pi}^*$ above that the derivative of $\hat{\pi}$ with respect to ψ is negative and the derivative of $\hat{\pi}^*$ with respect to ψ is positive for ψ between 0.5 and 1. We will also show that there is a value $\bar{\psi} > 0.5$ for which $\hat{\pi}(\bar{\psi}) = \hat{\pi}^*(\bar{\psi})$. These two results together imply the proposition. As we lower ψ below 1, $\hat{\pi}$ rises and $\hat{\pi}^*$ falls, until we reach a level $\psi(z) > 0.5$ so that either $\hat{\pi}(\psi(z)) = z$ or $\hat{\pi}^*(\psi(z)) = z$. If this were not the case, then $\hat{\pi}(\psi) < \hat{\pi}^*(\psi)$ for all ψ between 0.5 and 1, which is inconsistent with the finding that they are equal for $\psi = \bar{\psi} > 0.5$. For values of ψ above $\psi(z)$ we have $\hat{\pi} < z$ and $\hat{\pi}^* > z$, so that $(n, n^*) = (\bar{n}, 1)$ is an equilibrium. For values of ψ below $\psi(z)$ we either have $\hat{\pi} > z$ or $\hat{\pi}^* < z$, so that $(n, n^*) = (\bar{n}, 1)$ is not an equilibrium.

We finally need to show that there is a value $\bar{\psi} > 0.5$ for which $\hat{\pi}(\bar{\psi}) = \hat{\pi}^*(\bar{\psi})$. Let the corresponding value of δ be $\bar{\delta}$. Equating the expressions above for $\hat{\pi}$ and $\hat{\pi}^*$ gives

$$\bar{n}^{(1-2\bar{\delta})}\zeta = \frac{(\alpha + \mu(1 - \alpha))(1 + \phi\beta)}{\mu - (\mu - 1)\alpha\bar{n}^\kappa + \frac{\phi\beta(\mu(1-\alpha)+\alpha)}{\bar{n}}} \quad (83)$$

It follows from $\bar{n} < 1$ that the term on the right hand side is less than 1. Therefore it must be the case that $\bar{\delta} < 0.5$, from which it follows that $\bar{\psi} > 0.5$. It follows that there is a value $\psi = \bar{\psi} > 0.5$ for which $\hat{\pi}(\psi) = \hat{\pi}^*(\psi)$, which completes the proof of Proposition 2.

D. Introducing Wage Rigidities

In order to introduce wage rigidities we first introduce labor heterogeneity. Labor L_t in the production function is now a CES index of labor supply by all households:

$$L_t = \left(\int_0^1 L_t(j)^{\frac{\omega-1}{\omega}} dj \right)^{\frac{\omega}{\omega-1}} \quad (84)$$

where $L_t(j)$ is labor by agent j . Given L_t , this specification leads to the following demand for individual labor:

$$L_t(j) = \left(\frac{W_t(j)}{W_t} \right)^{-\omega} L_t \quad (85)$$

where $W_t(j)$ is the wage rate for labor supplied by agent j and

$$W_t = \left(\int_0^1 W_t(j)^{1-\omega} dj \right)^{\frac{1}{1-\omega}} \quad (86)$$

Aggregate labor demand in period t in the Home country is $n_{H,t}L_t$. Demand for labor supplied by agent j is then

$$1 - l_t(j) = \left(\frac{W_t(j)}{W_t} \right)^{-\omega} n_{H,t}L_t \quad (87)$$

We can now maximize agent j utility with respect to $W_t(j)$. All households choose the same optimal $W_t(j)$, which will then be equal to W_t . We will replace the λl_t in the utility function with $\tilde{\lambda} l_t$. Dropping the j , maximization of utility with respect to the individual wage rate gives

$$\frac{W_t}{P_t} = \lambda c_t^\gamma \quad (88)$$

where $\lambda = \tilde{\lambda}\omega/(\omega - 1)$. With the redefined λ this is the same as (13). Nothing else in the model changes.

When wages are rigid, they are set at the start of each period. This makes no difference for period 2 as there are no shocks during period 2. For period 1 the only shock is a self-fulfilling panic. We assume that the probability of a panic is infinitesimal. Then the right hand side of (88) needs to include the expectation of c_1^γ at the start of period 1 giving infinitesimal weight to a panic occurrence. The expectation is therefore based on $c_1 = 1/\theta$, its value in the absence of a panic. When the real wage is set at the start of period t , it will then be set at λ/θ^γ . If instead the nominal wage is set, it will be equal to $\bar{P}\lambda/\theta^\gamma$, where $\bar{P}$ is the price index in the non-panic state. In period 1 this is equal to P_{H1} , the price set at the start of period 1 by all firms. The real wage will then be $(P_{H,1}/P_1)(\lambda/\theta^\gamma)$, where $P_{H,1}/P_1$ depends on c_1^*/c_1 as in (36).

E. Perfect Risk Sharing

Under perfect risk sharing we have (66). From the definition of the price indices we find the analogue of (36):

$$\frac{P_t}{P_{H,t}} = \left(\frac{c_t}{c_t^*} \right)^{\gamma \frac{1-\psi}{2\psi-1}} \quad (89)$$

Taking the ratio of (70) and (71), assuming $g_t = 0$, and using (89) gives

$$\frac{c_2}{c_2^*} = \left(\frac{n}{n^*} \right)^{(1-2\tilde{\delta})\zeta} \quad (90)$$

where

$$\tilde{\delta} = \frac{\gamma(1 - \psi)}{(1 - \alpha + \alpha\gamma)(2\psi - 1) + 2\gamma(1 - \psi)} \quad (91)$$

This implies

$$\frac{P_2}{P_{H,2}} = \left(\frac{n}{n^*}\right)^{(1-\alpha+\alpha\gamma)\zeta\tilde{\delta}} \quad (92)$$

Substituting this back into (70)-(71), using that second-period consumption equals first-period consumption from the consumption Euler equation, gives

$$c_1 = \frac{1}{\theta} n^{(1-\tilde{\delta})\zeta} (n^*)^{\tilde{\delta}\zeta} \quad (93)$$

$$c_1^* = \frac{1}{\theta} n^{\tilde{\delta}\zeta} (n^*)^{(1-\tilde{\delta})\zeta} \quad (94)$$

Note that $\tilde{\delta} > \delta$ when $\psi < 1$ and $\gamma > 1$, so that Home consumption is less affected by the number of Home firms.

We now turn to profits. Define $C = \frac{P_{H,1}}{P_1}(c_{H,1} + c_{H,1}^*)$. Home profits are

$$\pi_1 = C - \frac{\lambda}{A} c_1^\gamma C^{1/\alpha} \left(\frac{P_1}{P_{H,1}}\right)^{1/\alpha} \quad (95)$$

Using that the first and second period relative price are the same, and using (92), this becomes

$$\pi_1 = C - \frac{\lambda}{A} c_1^\gamma C^{1/\alpha} \left(\frac{n}{n^*}\right)^{\kappa\tilde{\delta}} \quad (96)$$

Using (53)-(54) and (66) we can rewrite C as $C = c_1 X$, where

$$X = \psi + (1 - \psi) \left(\frac{c_1}{c_1^*}\right)^{\gamma-1} \quad (97)$$

Together with (90) this is equal to

$$X = \psi + (1 - \psi) \left(\frac{n}{n^*}\right)^{(\gamma-1)(1-2\tilde{\delta})\zeta} \quad (98)$$

So we have

$$\pi_1 = c_1 \left(X - \frac{\lambda}{A} c_1^{\gamma-1+1/\alpha} X^{1/\alpha} n^{\kappa\tilde{\delta}} (n^*)^{-\kappa\tilde{\delta}} \right) \quad (99)$$

Substituting the expression for c_1 this becomes

$$\pi_1 = \frac{1}{\theta} n^{(1-\tilde{\delta})\zeta} (n^*)^{\tilde{\delta}\zeta} \left(X - \frac{(\mu-1)\alpha}{\mu} n^\kappa X^{1/\alpha} \right) \quad (100)$$

We get a similar expression for Foreign profits.

Now consider the case where the Home country panics and the Foreign country does not, so that $n = \bar{n}$ and $n^* = 1$. We then have

$$\pi_1 = \frac{1}{\theta} \bar{n}^{(1-\tilde{\delta})\zeta} \left(X - \frac{(\mu-1)\alpha}{\mu} \bar{n}^\kappa X^{1/\alpha} \right) \quad (101)$$

$$\pi_1^* = \frac{1}{\theta} \bar{n}^{\tilde{\delta}\zeta} \left(X^* - \frac{(\mu-1)\alpha}{\mu} (X^*)^{1/\alpha} \right) \quad (102)$$

where

$$X = \psi + (1-\psi) \bar{n}^{(\gamma-1)(1-2\tilde{\delta})\zeta} \quad (103)$$

$$X^* = \psi + (1-\psi) \bar{n}^{-(\gamma-1)(1-2\tilde{\delta})\zeta} \quad (104)$$

For $\gamma > 1$ and $\psi < 1$, there are two differences relative to the solution without risk sharing. First, $\tilde{\delta} > \delta$. Second, without risk sharing $X = X^* = 1$, while with risk sharing we have $X < 1$ and $X^* > 1$. These have opposite effects on first period profits.

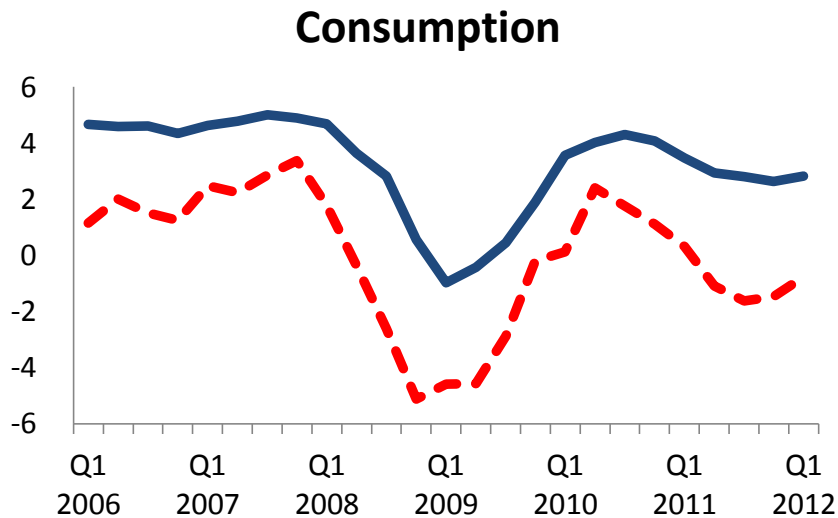
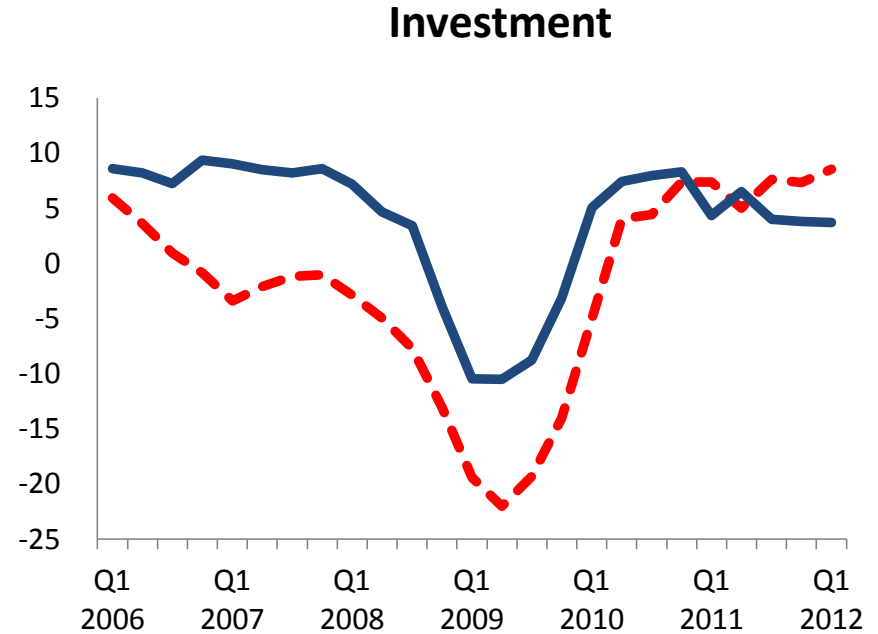
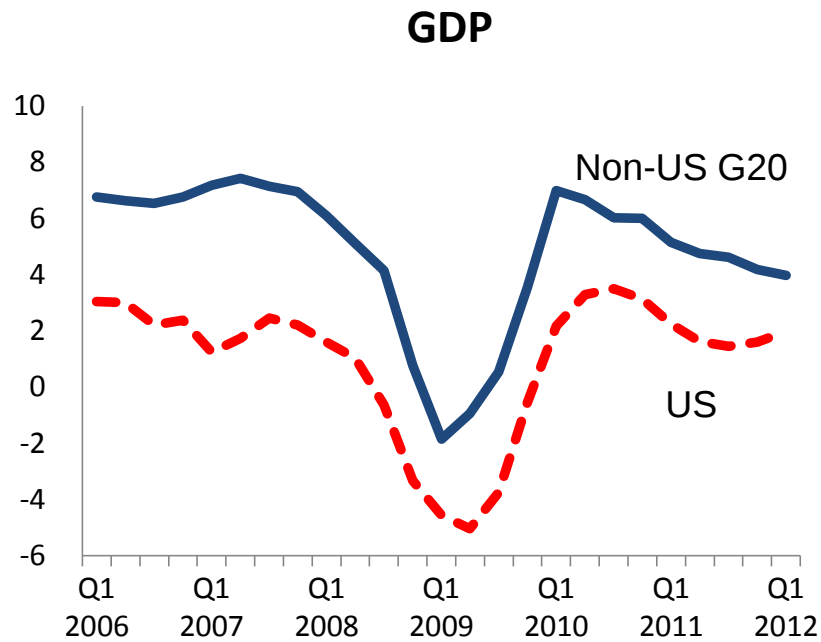
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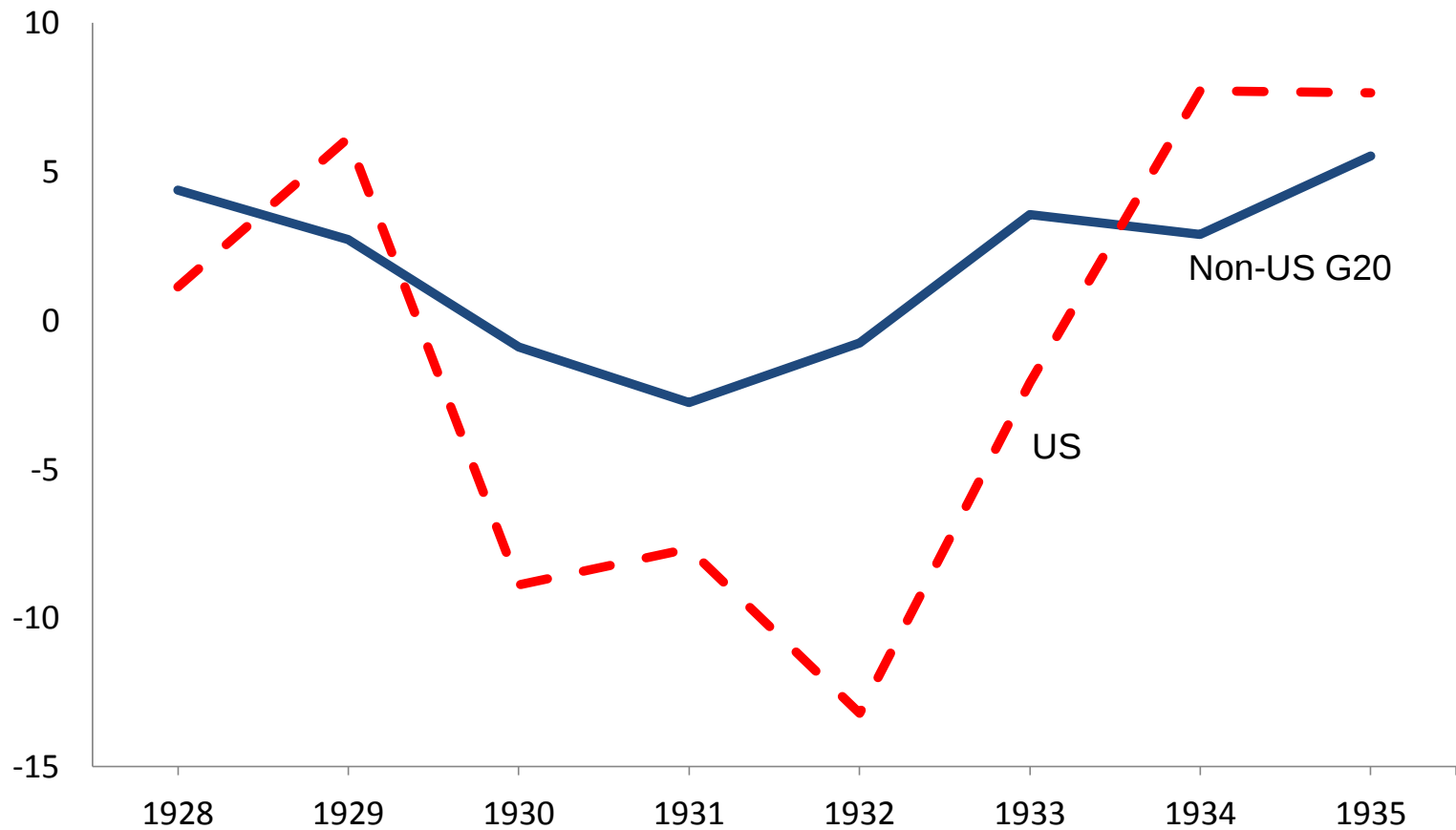
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Figure 1 Global Growth (Percent; Annual; Real)*



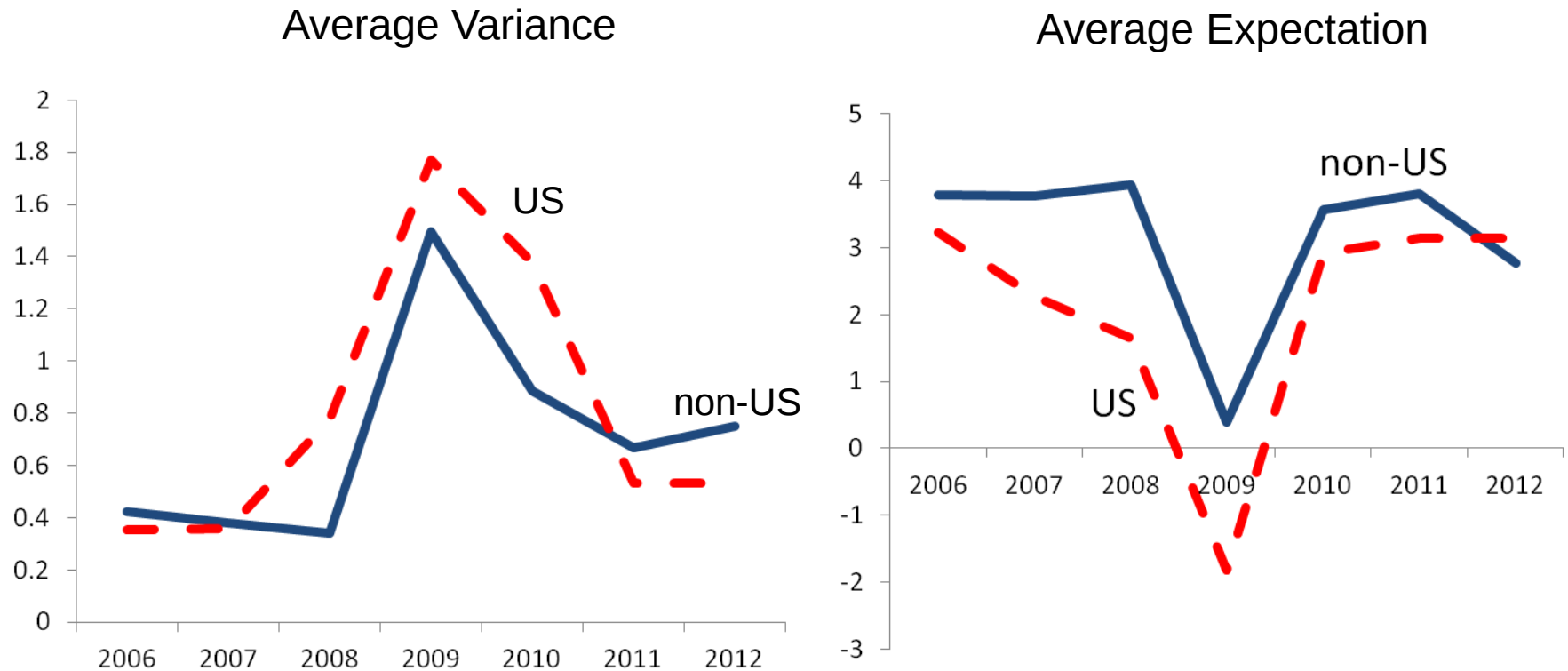
* Source: Datastream. Growth over past 4 quarters. Broken line is the U.S.; solid line is the non-U.S. G20 minus Saudi Arabia. Consumption and investment also do not include China.

Figure 2 Real GDP Growth During the Great Depression



*Source: Angus Maddison. Broken line is the U.S.; solid line is the non-U.S. G20 minus Saudi Arabia minus South Africa.

Figure 3 One-year ahead GDP Growth Forecasts: Average Expectation and Variance*



*Data from Consensus Forecasts. Non-US: Australia, China, Hong Kong, India, Indonesia, Malaysia, New Zealand, Singapore, South Africa, Taiwan, Thailand, Japan, Germany, France, U.K., Italy, Canada

Figure 4 Symmetric Equilibria*

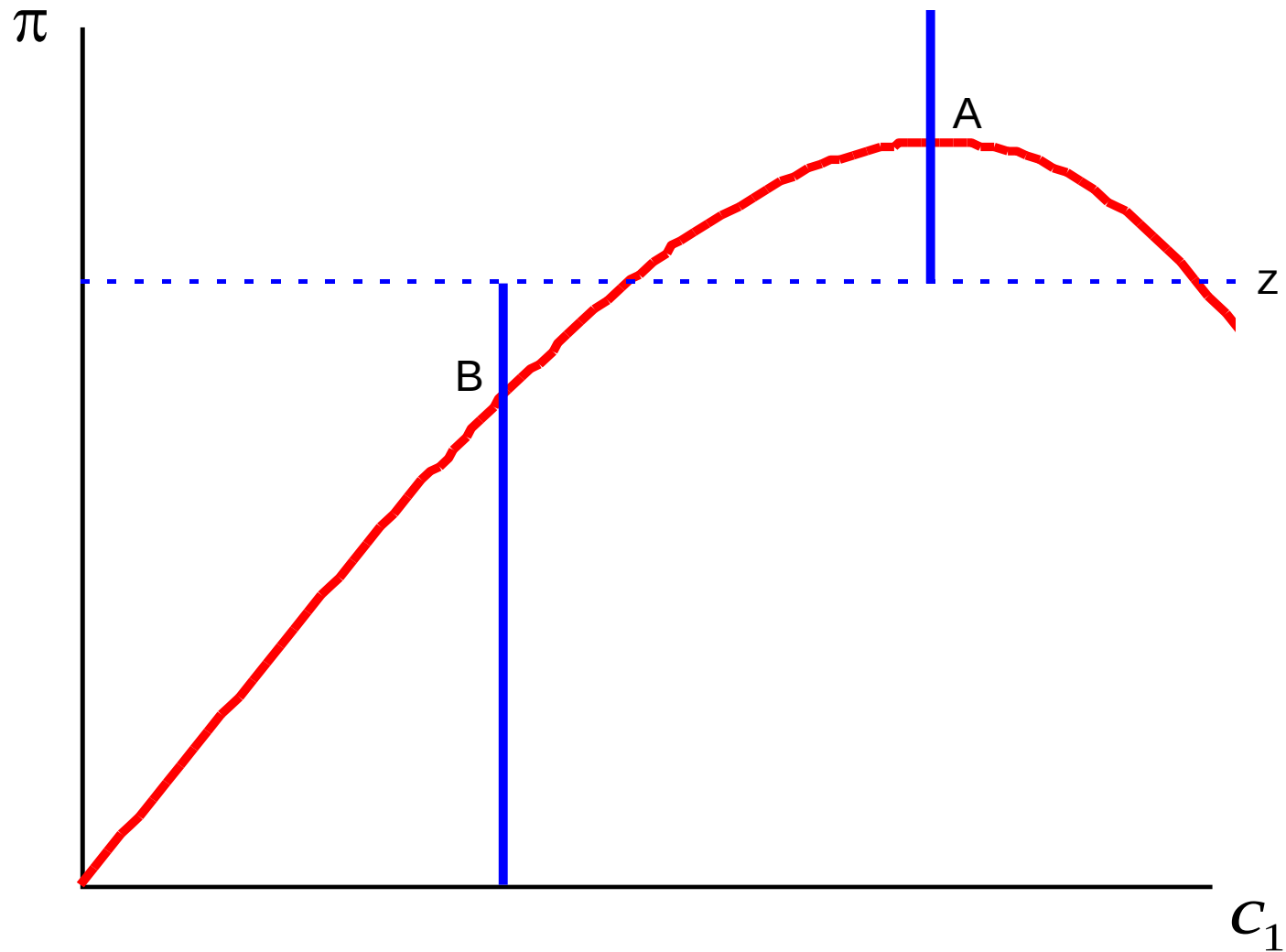


Figure 5 All Equilibria: Role of Trade Integration

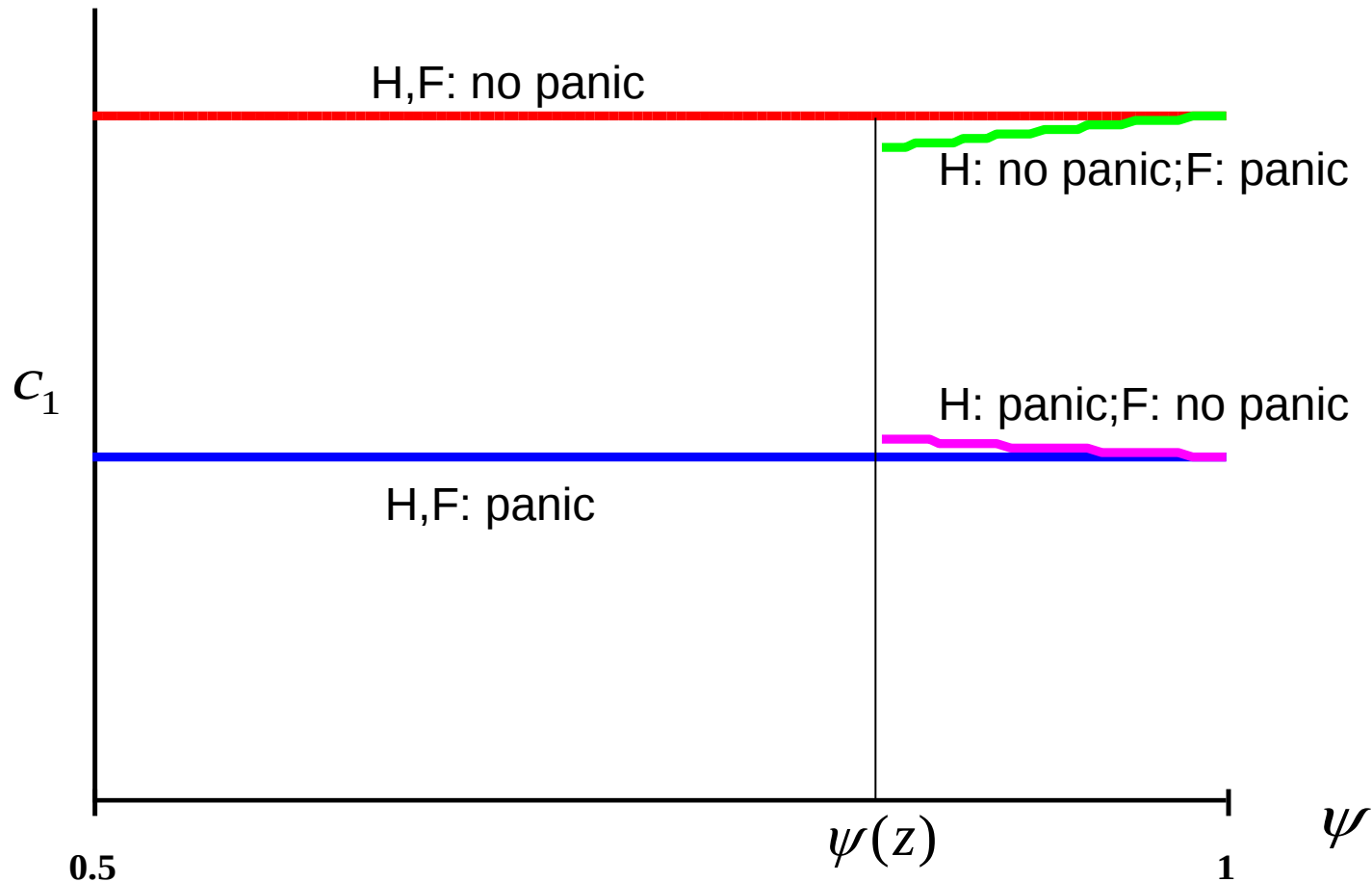
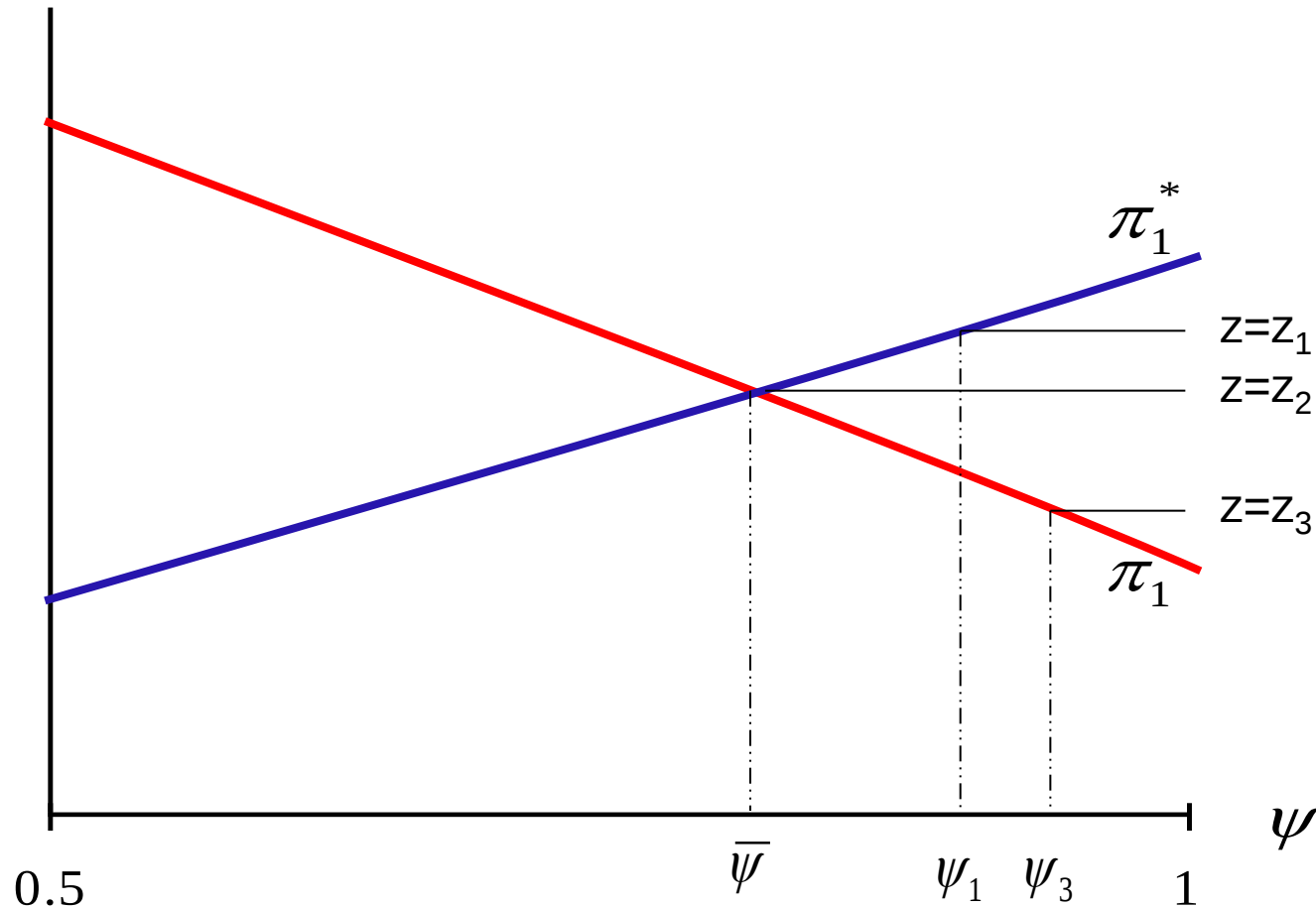


Figure 6 On Existence of Asymmetric Equilibria*



* The profit schedules are drawn under the assumption that there is a panic in Home and no panic in Foreign. When $z=z_i$ a mixed equilibrium exists as long as $\psi > \psi_i$ for $i=1$ and $i=3$. When $z=z_2$ a mixed equilibrium exists as long as $\psi > \bar{\psi}$.

Figure 7 Effect of Trade on Profits in Asymmetric Equilibrium ($n < 1$ and $n^* = 1$)

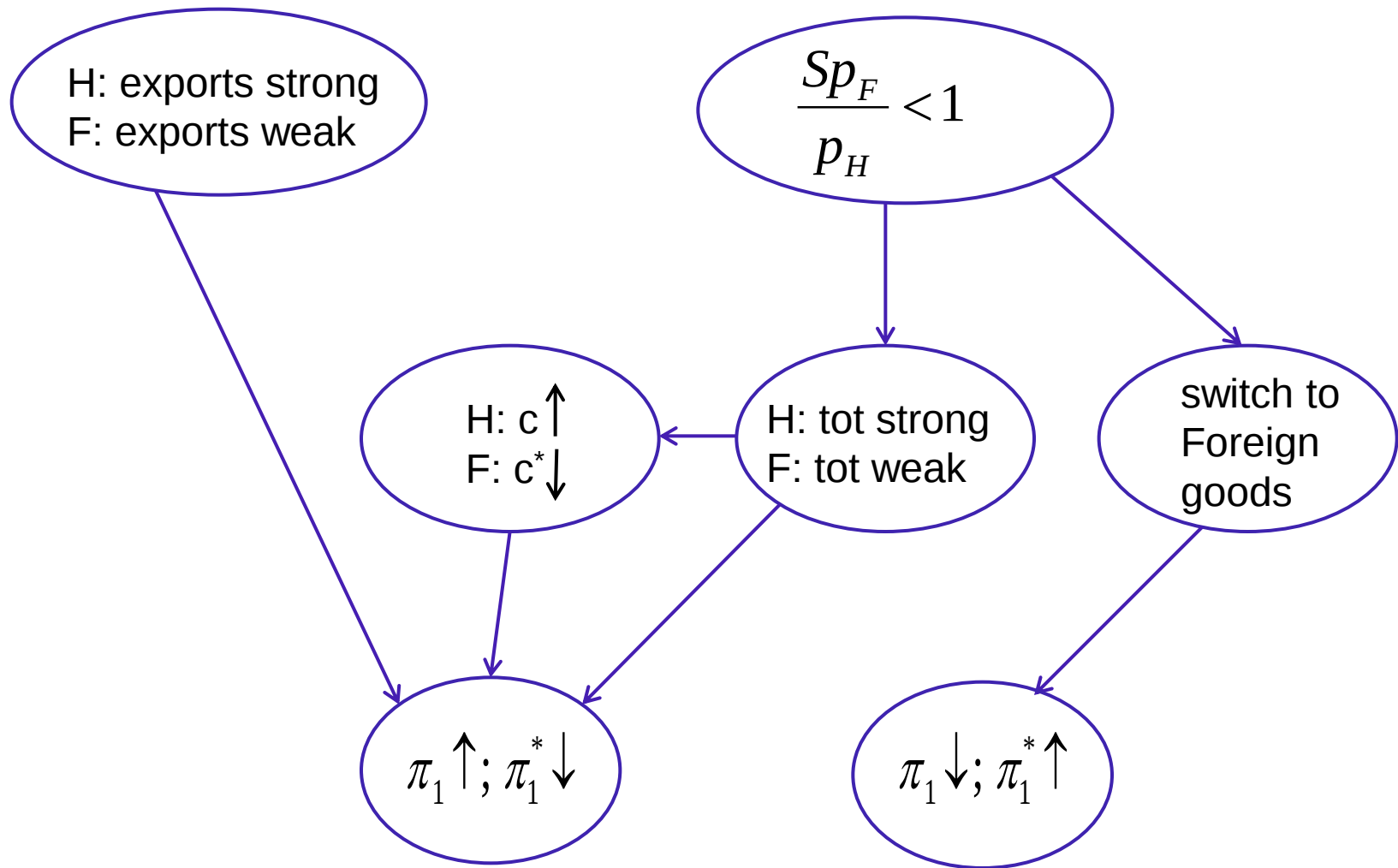


Figure 8 Panic Vulnerability: Role of Credit

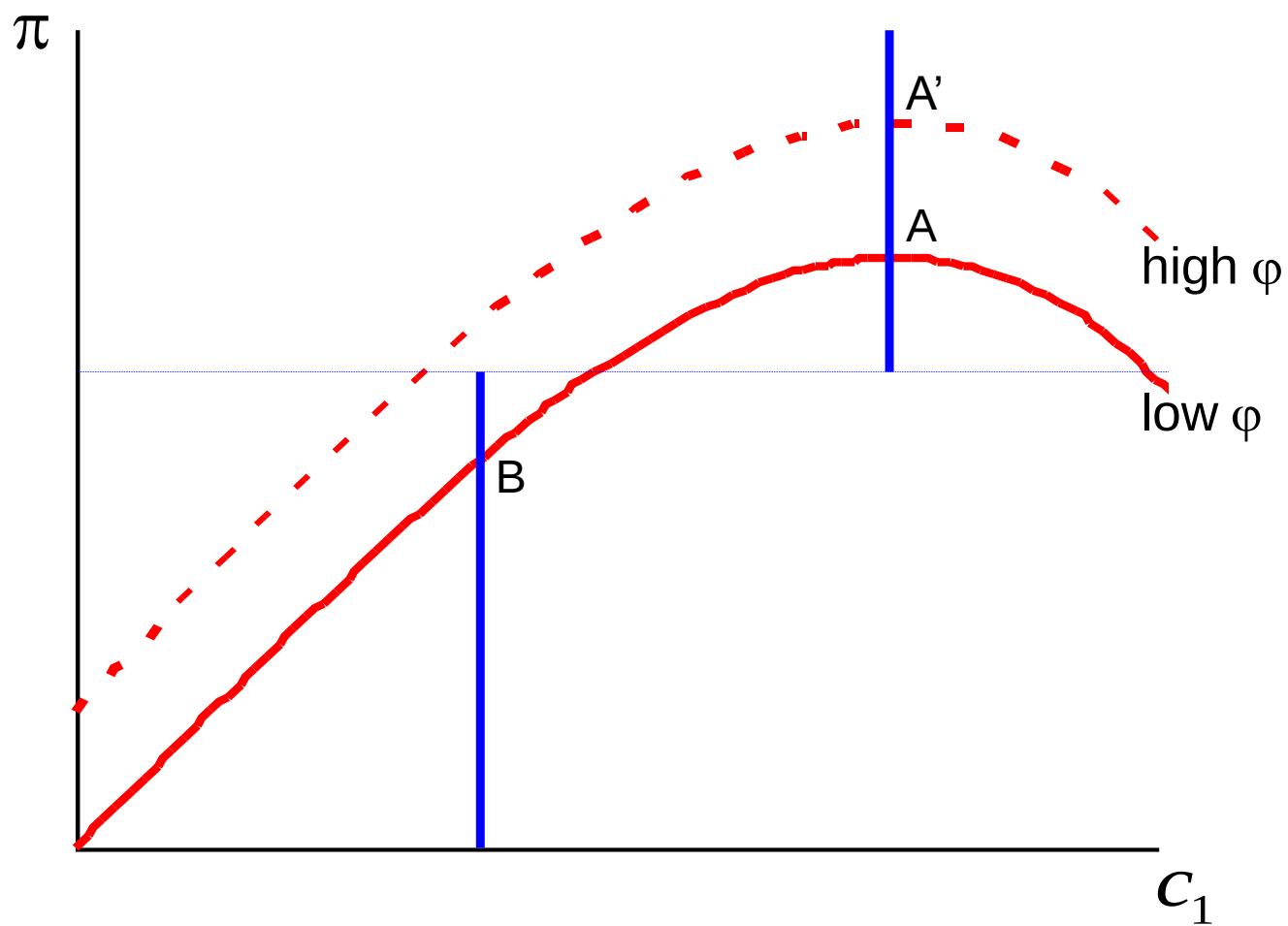


Figure 9 Panic Vulnerability: Role of Monetary Policy

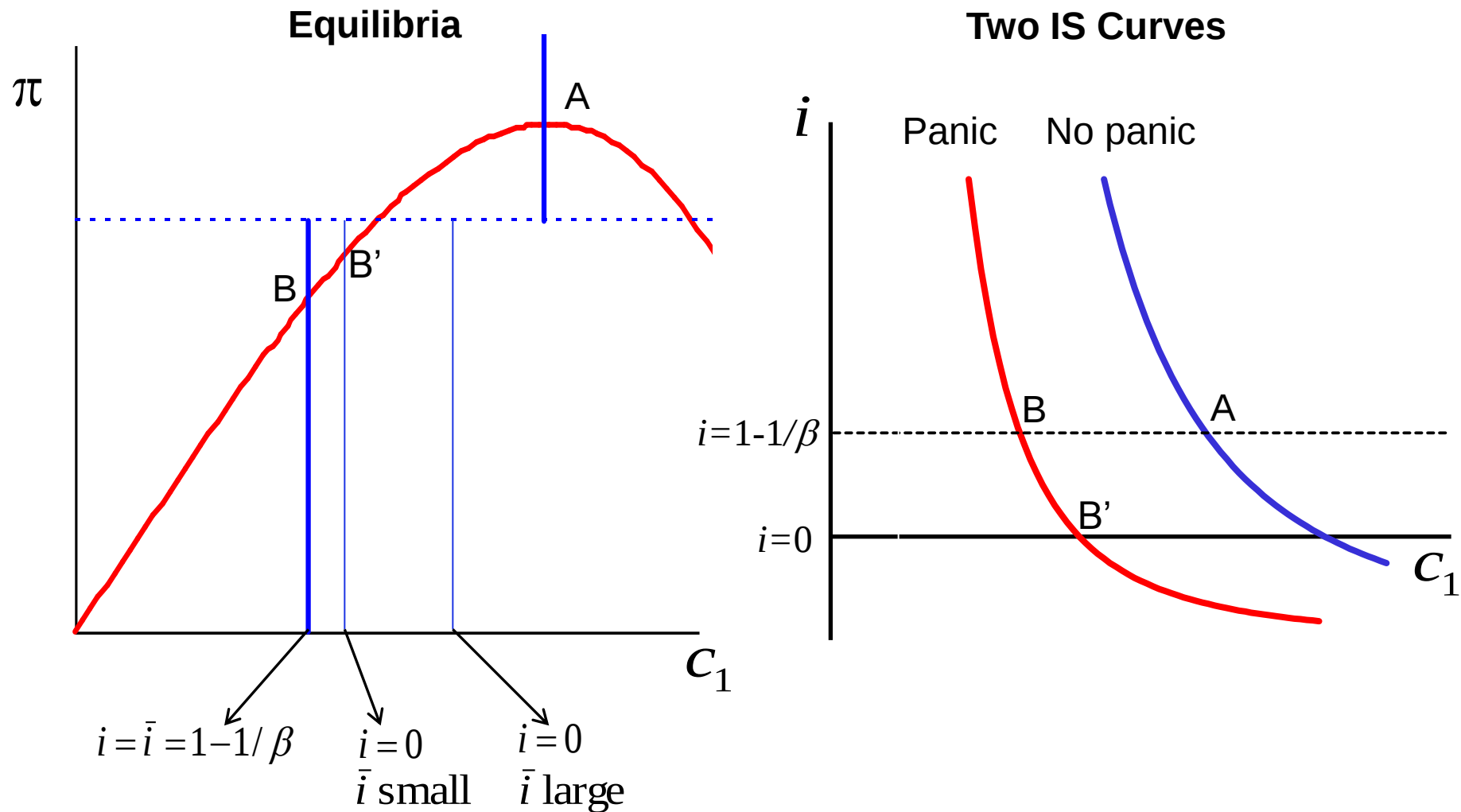


Figure 10 Panic Vulnerability: Role of Fiscal Policy*

