Financial Crises, Credit Booms, and External Imbalances: 140 Years of Lessons

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Comments:

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Do external imbalances increase the risk of financial crises?

Approach:

- use 140 years of macro data to identify periods of global instability
- study patterns in macro data around periods of global instability; in particular, see if there is a link between (global) financial crises and external imbalances

Findings:

- only 5 periods of global instability in the 140 year span
- most crises happen to one country in isolation
- financial crisis recessions more closely linked to deflation and slow loan growth (relative to 'normal' recessions)
- external imbalances are not a strong predictor of global instability

Definitions

Systemic financial crisis = banking sector experiences bank runs, sharp increases in default rates accompanied by large losses of capital that result in public intervention, bankruptcy, or forced merger of financial institutions

Clustered financial crisis = "significant portion of countries simultaneously experienced crisis" (note: only 14 countries in sample)

When classified this way –

Most crises are isolated or in country-pairs

Long period of calm between 1945 and 1973 and only 5 crises

1890, 1907, 1921, 1930/31, 2007/8

Sample of countries

Jorda et al sample		Ranking of pcGDP as of 1870	Countries richer than Japan in 1870
US	1	Australia	Argentina
Canada	2	United Kingdom	Chile
Australia	3	New Zealand	Czechoslovakia
Denmark	4	Netherlands	Hungary
France	5	Belgium	Portugal
Germany	6	United States	Poland
Italy	7	Uruguay	Romania
Japan	8	Switzerland	Greece
Netherlands	9	Denmark	South Africa
Norway	10	France	Sri Lanka
Spain	11	Austria	Lebanon
Sweden	12	Germany	Syria
Switzerland	13	Ireland	Bulgaria
UK	14	Canada	Turkey
	15	Italy	West Bank and Gaza
	16	Norway	
	…		
	35	Japan	

Notes:

Sample is always subjective – but will affect measured frequency and location of crises

Subject to survivorship bias

Explains why no global crises picked up in post-73 period – no emerging Asian or Latin American countries in sample

(data from Maddison, p.c. GDP in 1990 Geary-Khamis international dollars)

What do we learn about the future by looking back?

Potentially a lot, if crises (like business cycles?) share common transmission mechanisms and conditions are similar.

Perhaps not much, if transmission mechanisms differ from crisis to crisis.

I'm not a historian, so won't reach back 140 years. But what were we saying about the role of international capital flows in the previous Asian financial crisis ?

- capital flows characterized as hot money – *current crisis blamed on large appetite of foreign investors for low-risk assets*
- concern about weaknesses in financial sector and bubble in asset markets triggered a capital outflow – *as the bubble burst capital flowed in*
- capital outflow resulted in exchange rate depreciation – *contrast with US dollar appreciation.*

To be fair, there are commonalities…

Weaknesses in financial sector play a critical role – distortions in financial intermediation; magnified by large capital inflow

- but fueling this problem does not require a *net* imbalance. Current account can be balanced and problem will arise if there are large *gross* capital flows.

Indeed, paper finds that credit growth, not external balances, are a robust precursor of crises.

- authors note that credit growth is correlated with widening external balances
- should check to see if credit growth is correlated with larger gross capital flows as well; probably correlated with expanding role of the financial sector more generally.

Important to know the difference – is this an *international* problem to be fixed by bringing savings and investment into balance, or a *domestic/micro* problem requiring better regulation of the financial sector.

Trade offs

Section 2.2 of the paper presents a model showing the problem facing the policymaker in correctly identifying crisis conditions and adopting policies to stave the crisis off.

- Bad to have overly "tight" policies that prevent "too many" crises
- Bad to be overly lax and allow "too many" crises to occur
  - Worry about false positives and false negatives.

The model isn't well integrated into the rest of the paper. I'd like to see (perhaps in another paper?) a deeper discussion of the trade-offs. Crises are bad, but choking off capital flows also comes at a cost.

<u>Bottom line:</u> should not discuss policies for regulating capital flows to prevent crises without discussing benefits of open capital markets. Capital inflows may have interacted with domestic financial conditions to create the crisis – but capital inflows are also helping us work our way out of the pit.