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130 Years of Fiscal Deficits and Currency Crashes in Advanced Economies

Discussion by Albrecht Ritschl
Two Main Themes

- Extension of real ER and deficit database back to 1880s

- Horse race between 1st-3rd gen. currency crisis models
Main Results

- Big role for banking crises

- Some role for debt structure

- Some role for reserve currencies
This comment

1. Praise

2. Method

3. Data

4. More Praise
Praise

Nested hypotheses: let the data speak

Nice validation of outcomes (scores)

Appealing, very timely

Gets the evidence right

.. although .. action is mostly in interaction effects
Praise – an example

Figure 10a: A century of crash probabilities for the US dollar
Method: possible omitted variables

- 1st generation models not strictly tested
  - No controls for money growth
  - No controls for deficit monetization
    [Post-WW1 stabilizations, Sargent (1982)]

- FTPL not strictly tested:
  - No controls for overall debt/GDP ratios [?]

- Original Sin not strictly tested:
  - No controls for foreign currency debt [data problems..]
Method: possible omitted variables

- Power of Debt/GDP ratio:

  Germany 1931:

  - Deficit/ GDP: < 2%
  - Debt/GDP: ~ 100%
  - Original Sin/GDP: ~ 90%

  ➔ Banking crisis, debt default, capital & exch ctrls
  ➔ “Greece on steroids” w/o deficits!
Method: possible omitted variables

- Power of Debt/GDP ratio:

Britain 1931:

- Deficit/ GDP: < 2%
- Debt/GDP: ~ 180%
- Original Sin/GDP: ~ ?

→ Devaluation, partial debt default (1st since 1688)
Method: selectivity & endogeneity

1. Classical Gold Standard (pre-1914)

- Low deficits select countries into GS (Bordo/Rockoff 1996)
  - Generates negative risk premia
  - Centered on Britain, not US
  - Stable pattern from mid-1750s to 1914
Method: selectivity & endogeneity

1. Classical Gold Standard (pre-1914)

- But credible GS adherence allows higher deficits (Bordo/Kydland, 1995; Bordo/White, 1998)
  - War finance on credit
  - Suspension of gold convertibility during wars
  - Full debt service afterwards
  - Negative UK risk premium throughout
Method: selectivity & endogeneity

1. Classical Gold Standard (pre-1914)

- Others take piggyback ride on GS
  - Negative risk premia on GS membership
  - Banking crises (eg 1890, 1907) but almost no exits (EXCEPT Southern Europe)

- Empire effect (Ferguson/Schularick, 2006-11)
  - Belonging to British empire has same effects

- Considerable leeway in fiscal & monetary policy
Method: selectivity / endogeneity

2. Bretton Woods

(only exception: British devaluations in 1940s)

3. OECD [?]

- 1950s stabilization programs
- European Payments Union / endogenous capital controls
Method: selectivity / endogeneity

How to maybe circumvent this?

Suggested two-step approach
1. build selection model for GS membership
2. eval crash probs relative to ctrl group
Method: relevant subperiods

- Classical Gold standard pre-1914
  - Centered on Britain, take relevant measures relative to Britain not US
- Interwar Gold Standard and its breakup
  - Try both British and US centered comparisons
- Bretton Woods 1946-71
Method: systemic effects, contagion

Spillovers

- Case: US 1933
  - Deficit/GDP: ~ 1%
  - Debt/GDP: < 60% [?]
  - Foreign debt/GDP: 0

Banking crisis 1933, devaluation 1933, exit from gold 1934 → victim of German [..., UK, F] default

→ ~ 20% of US GDP in 1933
→ To this add effects of Latin American defaults
Method/Data: the time series dimension

- What to gain from including pre-1960 data?

→ World Wars (to a lesser extent: Vietnam War 1960s, Franco-Prussian War 1870/1) as major deficit shocks in core countries

→ Attempts to sustain debt/GDP ratios >>100% over extended periods
Method/Data: the time series dimension

- Essentially three observations
- **Late 19th c: high debt sustained successfully**
  - UK: 300% in 1820 → 30% in 1913
  - F: 100% in 1880 → 66% in 1913
- **Interwar period: inflation and devaluation**
  - UK, F: ~180 % in 1920 → same in 1938
- **Postwar period: delayed stabilization**
  - UK, F: ~180 % in 1950 → still high in 1971 → inflation
  - D: ~3-400% in 1948 → 20% in 1953 → low inflation
Data

Deficit data back to 1880s

Pre-1914: Mitchell (not bad but can be improved)

Interwar: League of Nations (mostly central gov’t)
- Masks increase in public sector overall, e.g. social security
- Data often incompletely reported (e.g. Germany)
- BUT: lots of recent research on most OECD counties

→ Upgrade database!
Conclusion: more praise

Paper makes serious effort to use historical evidence

Nice & plausible results, very well presented

Food for thought: selectivity & endogeneity issues

Data: great but there is more available

→ Nice paper!