The European Crisis in the Context of the History of Previous Financial Crises

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Overview

• the macroeconomic context of the gold standard
• microeconomic financial sector linkages
• the domestic and international political economy of exchange rate regimes
Systemic Requirements and Benefits

- *monetary orthodoxy*: in the gold standard, the constraint is the convertibility of claims into a metallic equivalent; in the modern monetary union, it is imposed by a central bank with a price stability target.

- *fiscal orthodoxy*: both regimes depend on the avoidance of fiscal deficits that would place the monetary objective in danger.
Public Debt as a Share of GDP

Public Debt as a Share of GDP in Gold Standard

IMF Historical Database
Benefits of Gold Standard

• ease of a common monetary standard
• access to capital markets (overcoming “original sin” that made financially immature economies unable to borrow abroad except in foreign-denominated currency)
• reduction of borrowing costs
The Contingent Rule

• Bordo and Kydland 1995: In some unusual circumstances, above all the event of a major war, the commitment to gold convertibility would be temporarily suspended, but with an expectation of an eventual return to convertibility without a change in the exchange rate on the restoration of “normalcy”
Turning Point: 1890 (Argentina)

• Argentina importing 18.7% of its GDP between 1870 and 1889
• Australia, 9.7%
• Canada 7.2%

(Flandreau and Zumer 2004)
Consequences and Determinants of Flows

• Expansion of banking system
• State backing
• International Guarantees
• Absence of popular discontent
Trilemmas

1. The macroeconomic classic: fixed exchange rates, capital flows, autonomous monetary policy
2. The financial sector: fixed exchange rates, capital flows, financial stability
3. The international relations setting: fixed exchange rates, capital flows, national policy independence
4. The political economy: fixed exchange rates, capital flows, democratization
Interwar Reactions

1. Asymmetric adjustment
2. Financial intermediation weaker
3. Diplomacy strained
4. Domestic protest potential greater
EMU

• weaker countries: a credibility enhancing mechanism that would lower borrowing costs
• Stronger countries (creditors): depoliticizing of the adjustment process
General Government Net Borrowing/Lending 2000s (% of GDP)

Source: IMF
1. Banking glut (Shin) and then collapse

Spain: Total Bank Credit to Domestic Borrowers

Source: Bank of Spain
2. Problem of government backstop

Greek Bank claims (assets/loans) on foreign/domestic MFIs

- Other countries
- UK
- Bulgaria, Romania, Poland
- Cyprus
- Luxembourg
- Core: Germany, Austria, Belgium, Netherlands
- France
- PIIS
- Domestic
3. International Confidence

Jean-Claude Juncker: “We’re telling financial markets: Look out, we’re not abandoning Greece.”
4. Cross-border capital flows

• Weakness of chains
Net Change in Greek Bank Liabilities to Other Banks
March 2008 - March 2010

Source: Bank of Greece
Net Change in Greek Bank Assets of Other Banks:

March 2008 - March 2010

- Cyprus
- Luxembourg
- Bulgaria, Romania, Poland
- France
- Core: Germany, Austria, Belgium, Netherlands
- Other countries
- PIIS
- Domestic
- Britain
5. Backlash

• rejection of international/cross-border political commitment mechanism
Public Debt as Share of GDP in some EMU countries

IMF Historical Database
Conclusions

• Ability to overcome “original sin” and to absorb debt in a sustainable fashion does not lead itself to any easy metric or rule

• Institutional arrangements play an important part in shaping the nature of the commitment mechanism

• Countries with immature financial markets and evident growth or catch-up potential can increase their ability to borrow by entering into political agreements with powerful creditor countries
• asymmetric character of crisis adjustment is more apparent in the modern era (and in the interwar experience) than it was under the classic gold standard

• a design that intentionally excluded a contingent clause made the system at first apparently more robust, but aggravated the eventual adjustment issue
Real GDP after Financial Crisis