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

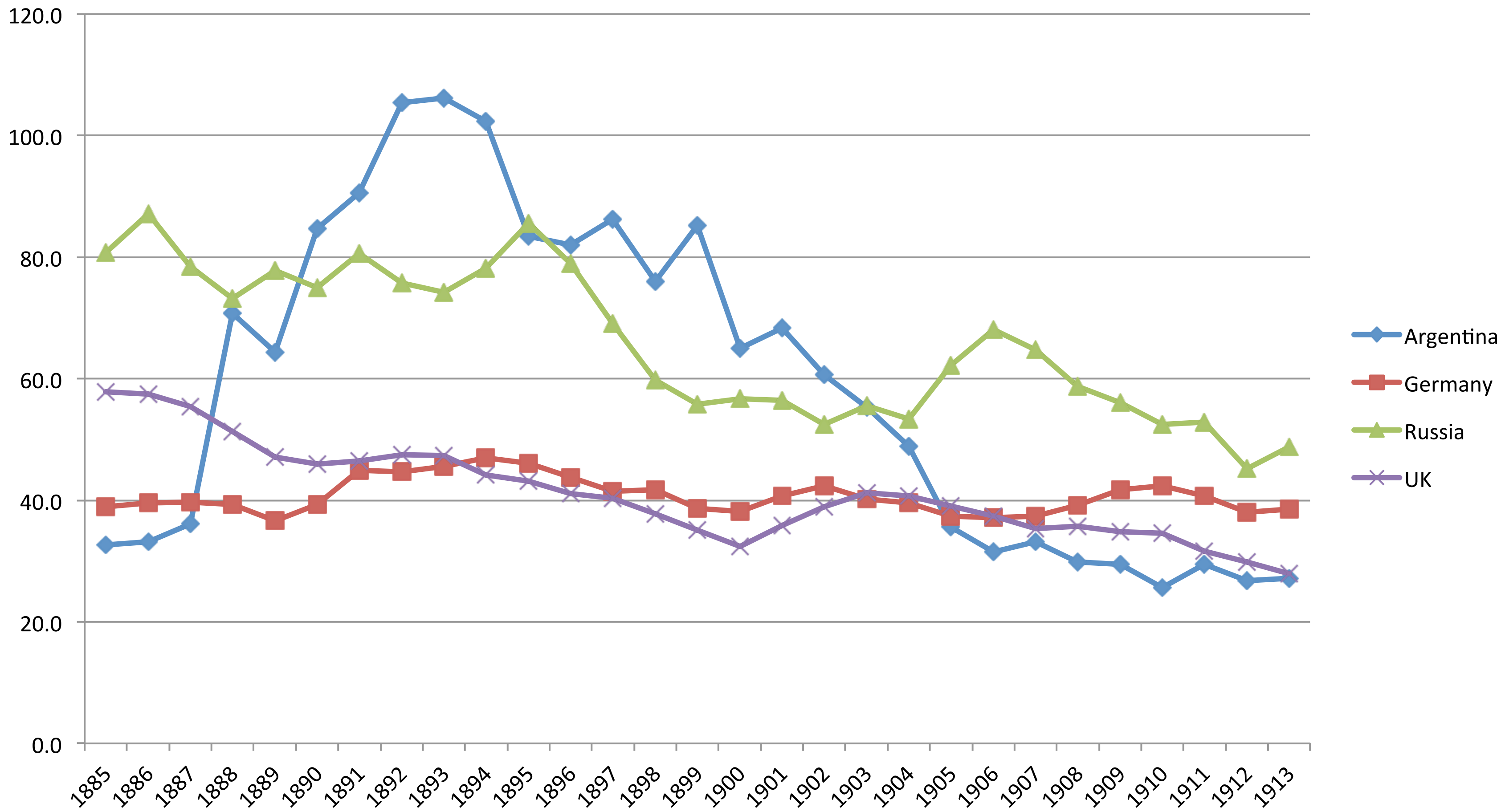
Systemic Requirements and Benefits

- - *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

S. Ali Abbas, Nazim Belhocine, Asmaa ElGanainy, and Mark Horton, A Historical Public Debt Database, IMF WP 10/245

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

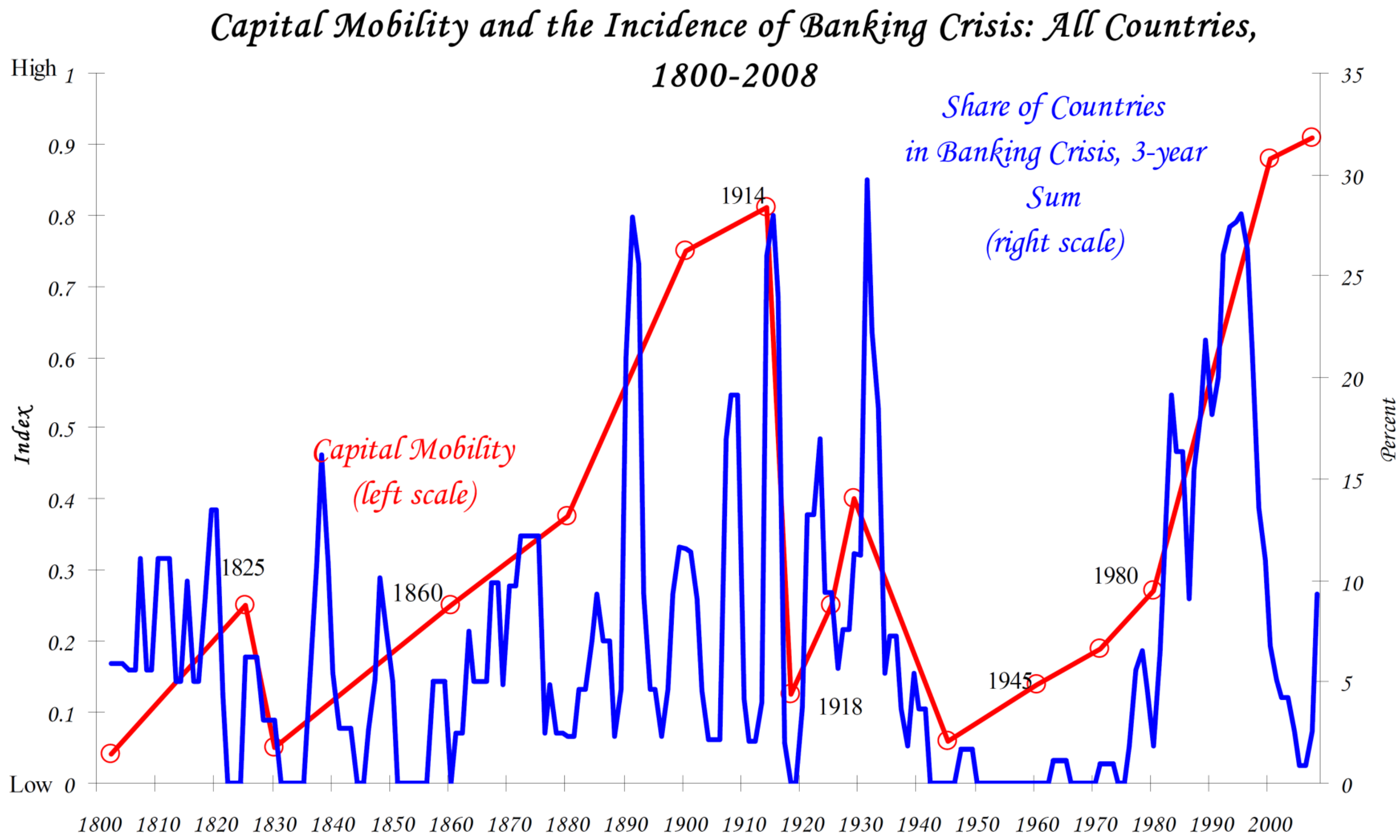
The Contingent Rule

- 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)


Capital Mobility and the Incidence of Banking Crisis: All Countries, 1800-2008
Share of Countries in Banking Crisis, 3-year Sum (right scale)
Capital Mobility (left scale)
Index
Percent
High
Low
1825
1860
1914
1918
1945
1980
1
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
35
30
25
20
15
10
5
0
1800 1810 1820 1830 1840 1850 1860 1870 1880 1890 1900 1910 1920 1930 1940 1950 1960 1970 1980 1990 2000

Consequences and Determinants of Flows

- Expansion of banking system
- State backing
- International Guarantees
- Absence of popular discontent

Trilemmas

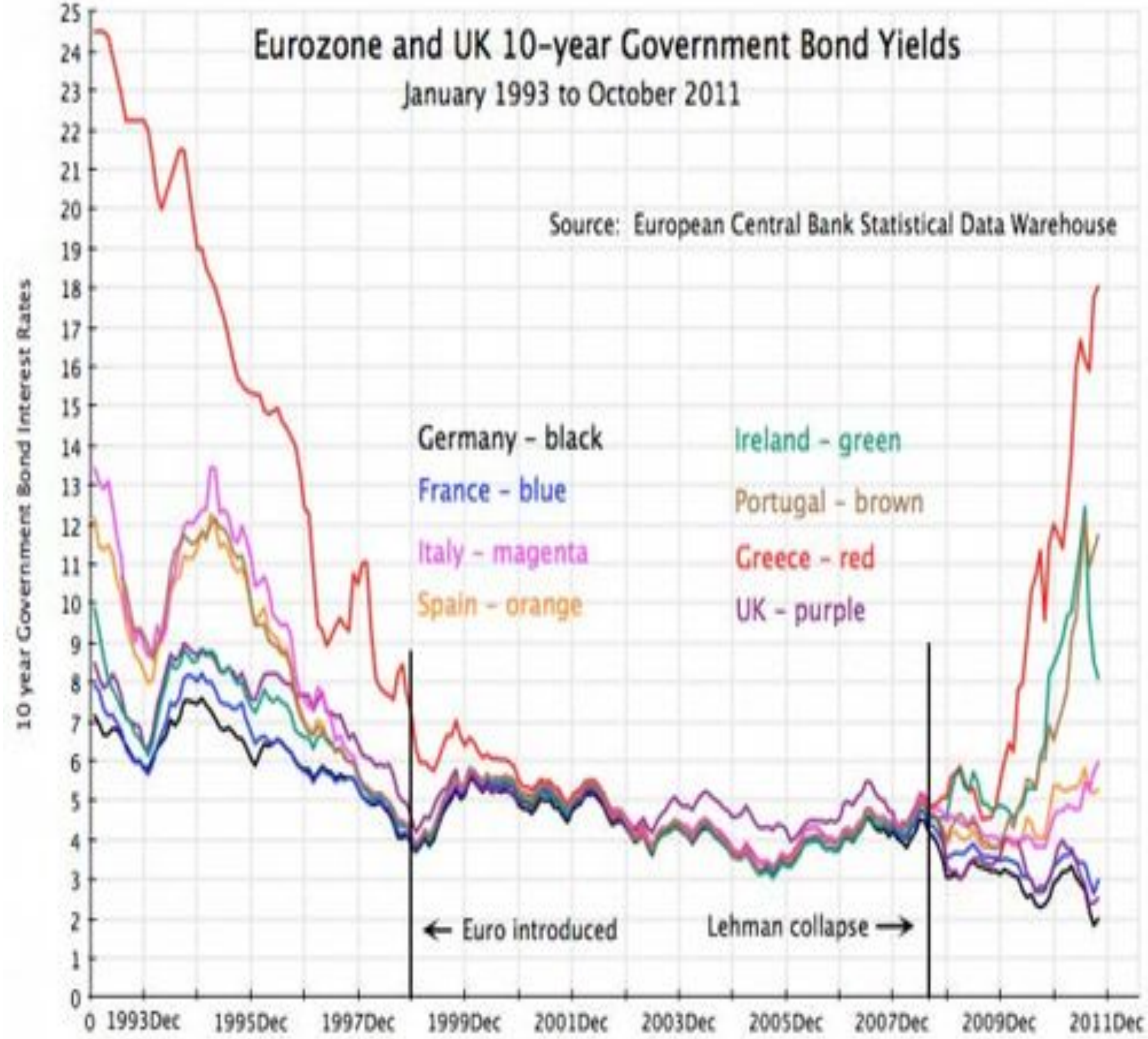
1. The macroeconomic classic: fixed exchange rates, capital flows, autonomous monetary policy
2. The financial sector: fixed exchange rates, capital flows, financial stability
3. The international relations setting: fixed exchange rates, capital flows, national policy independence
4. The political economy: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

Interwar Reactions

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

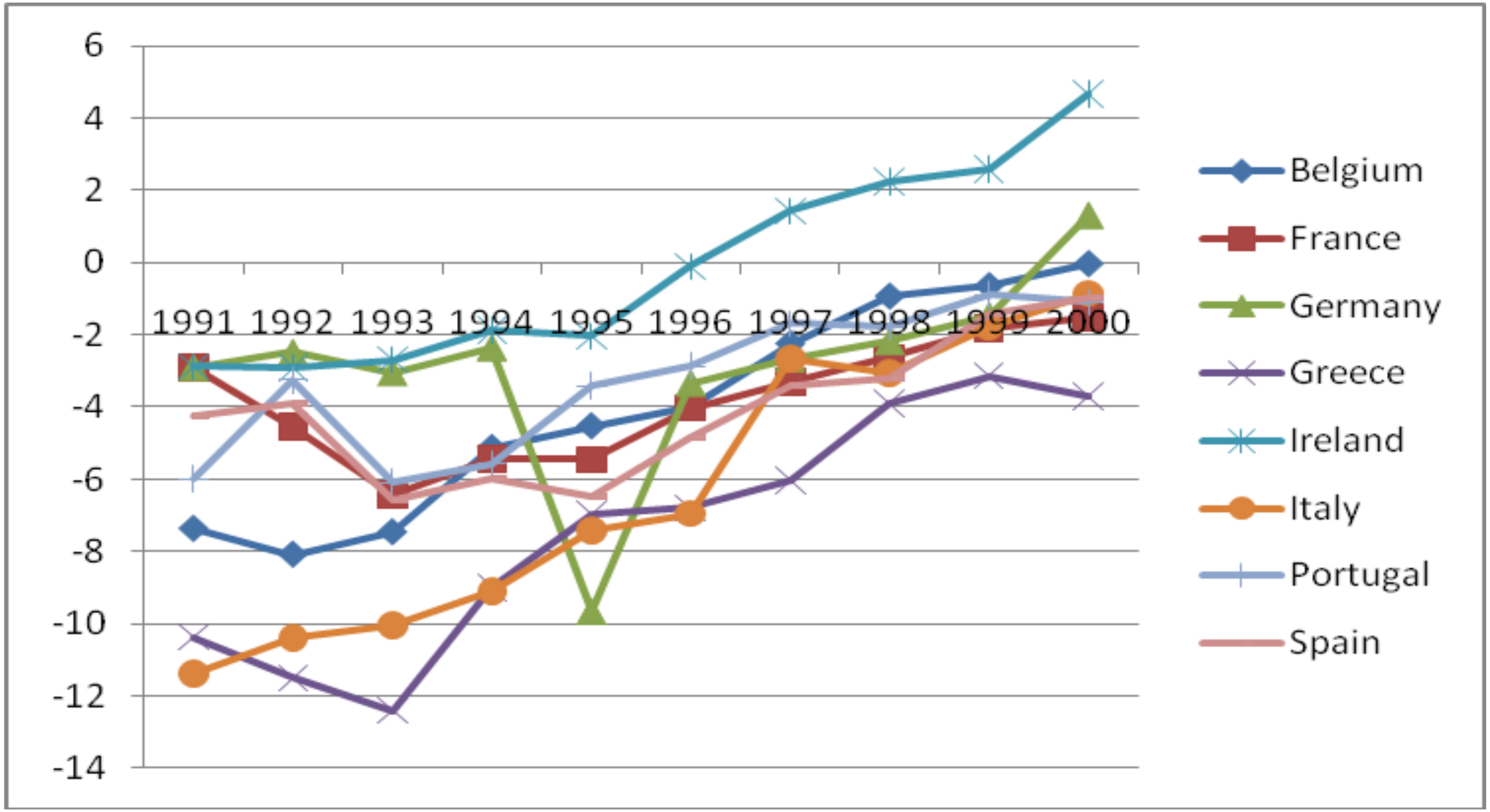
EMU

- weaker countries: a credibility enhancing mechanism that would lower borrowing costs
- Stronger countries (creditors): depoliticizing of the adjustment process



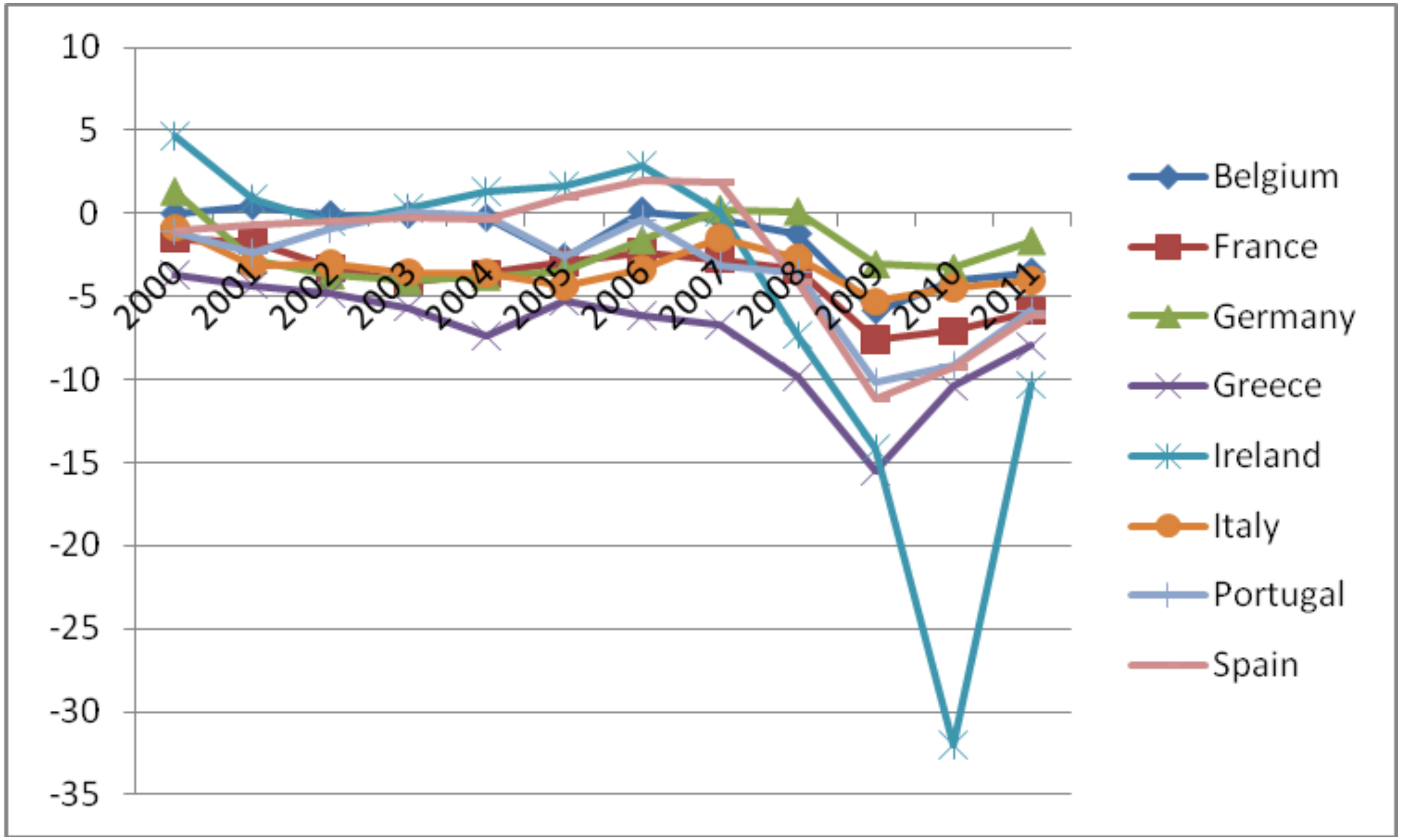
Eurozone and UK 10-year Government Bond Yields
January 1993 to October 2011
Source: European Central Bank Statistical Data Warehouse
10 year Government Bond Interest Rates
Germany - black
France - blue
Italy - magenta
Spain - orange
Ireland - green
Portugal - brown
Greece - red
UK - purple
← Euro introduced
Lehman collapse →
0 1993Dec 1995Dec 1997Dec 1999Dec 2001Dec 2003Dec 2005Dec 2007Dec 2009Dec 2011Dec
0 1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25

General Government Net Borrowing/Lending 1990s (% of GDP)



Source: IMF

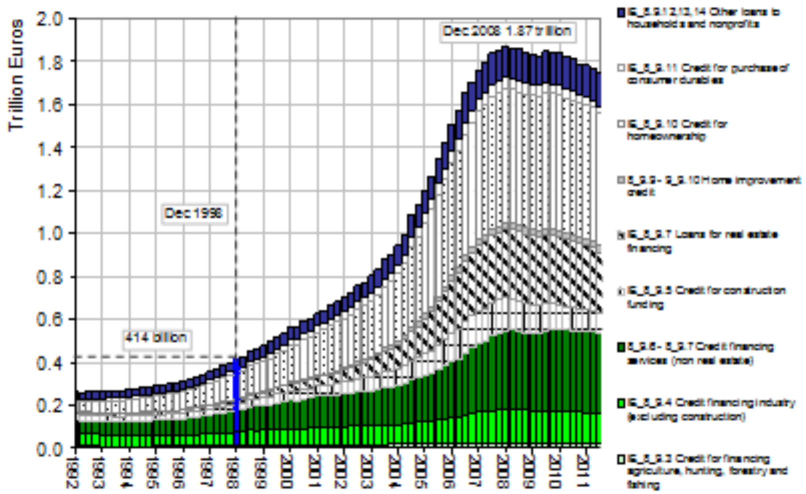
General Government Net Borrowing/Lending 2000s (% of GDP)



Source: IMF

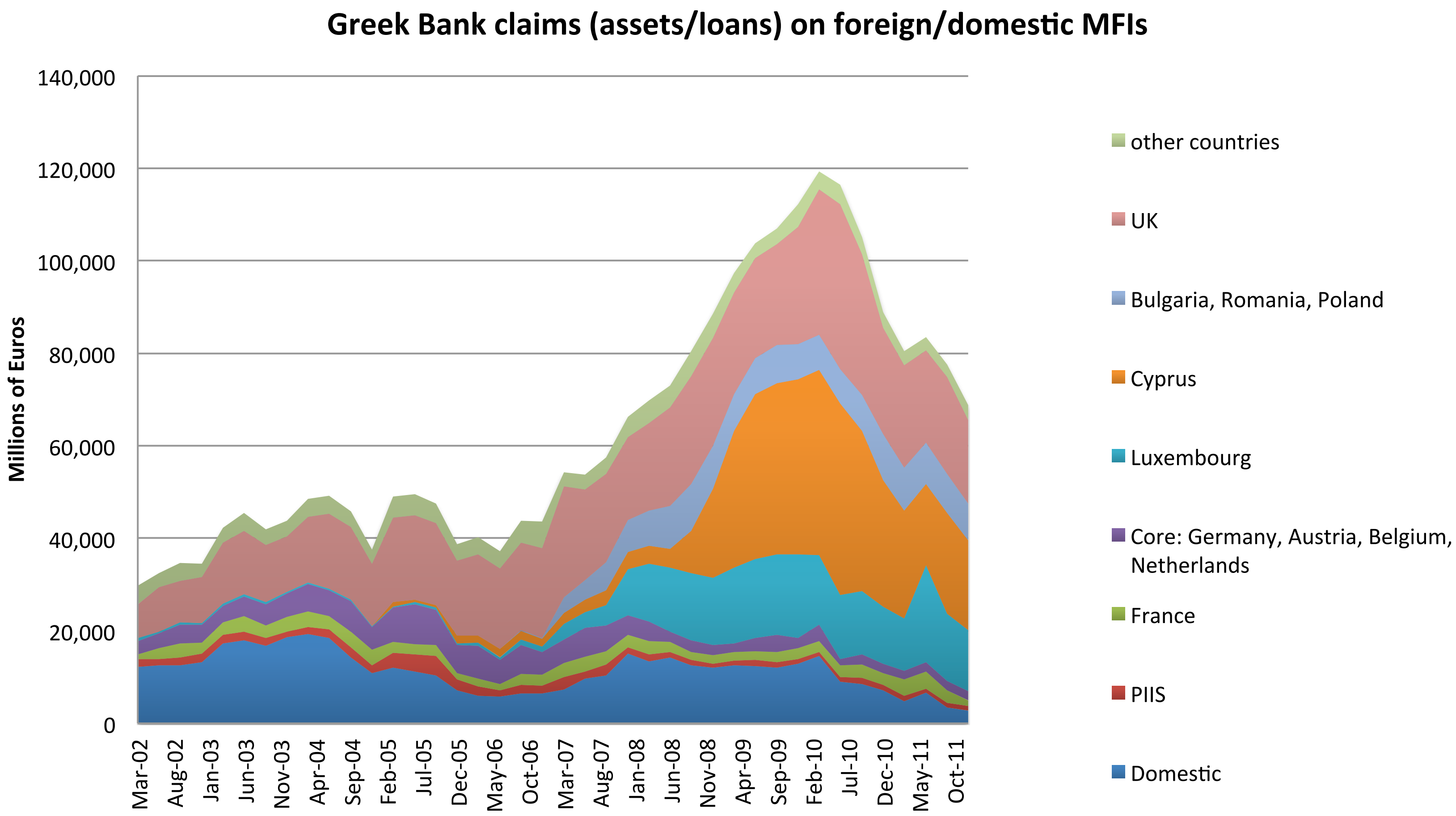
1. Banking glut (Shin) and then collapse

Spain: Total Bank Credit to Domestic Borrowers



Source: Bank of Spain

2. Problem of government backstop

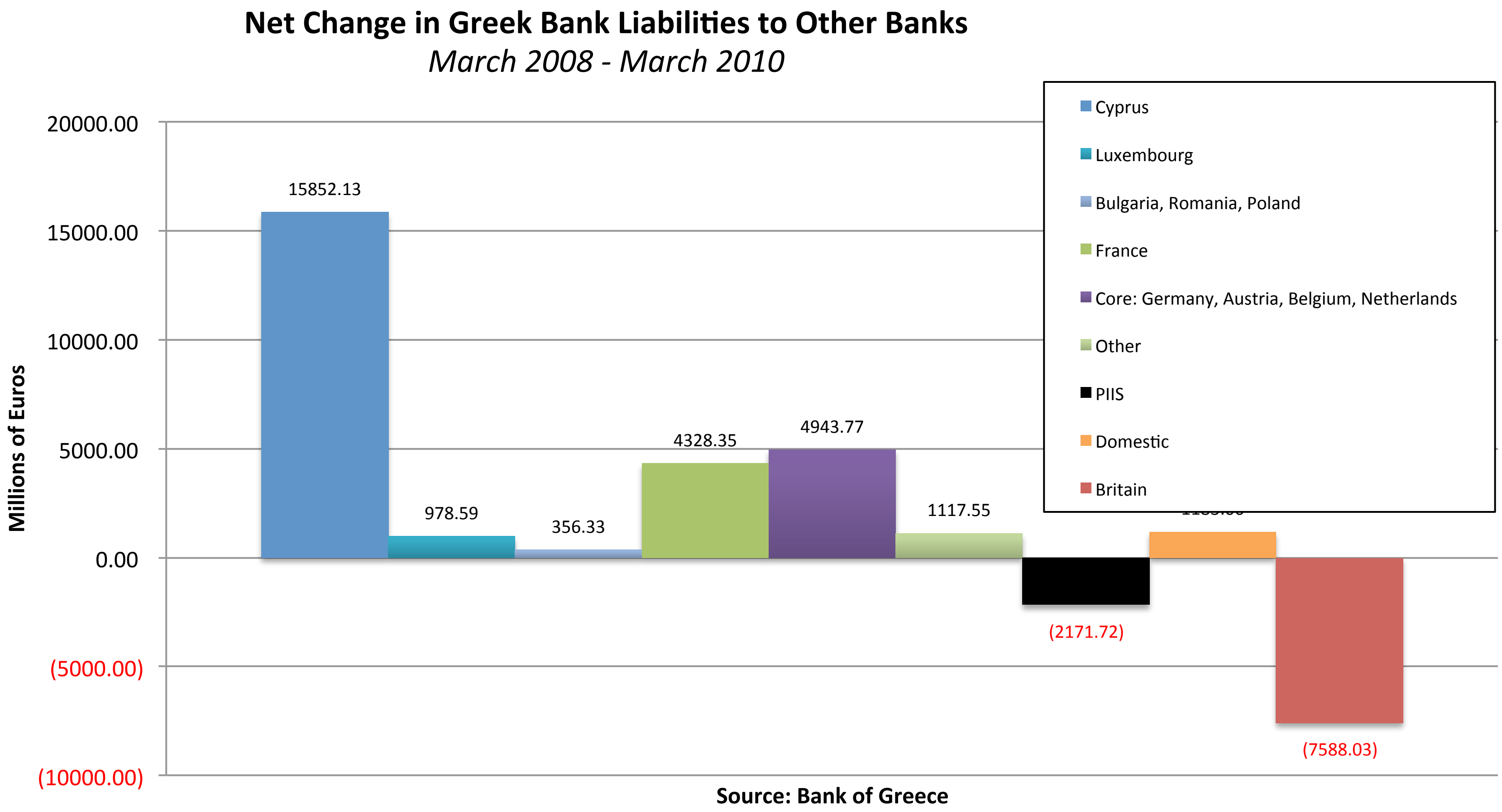


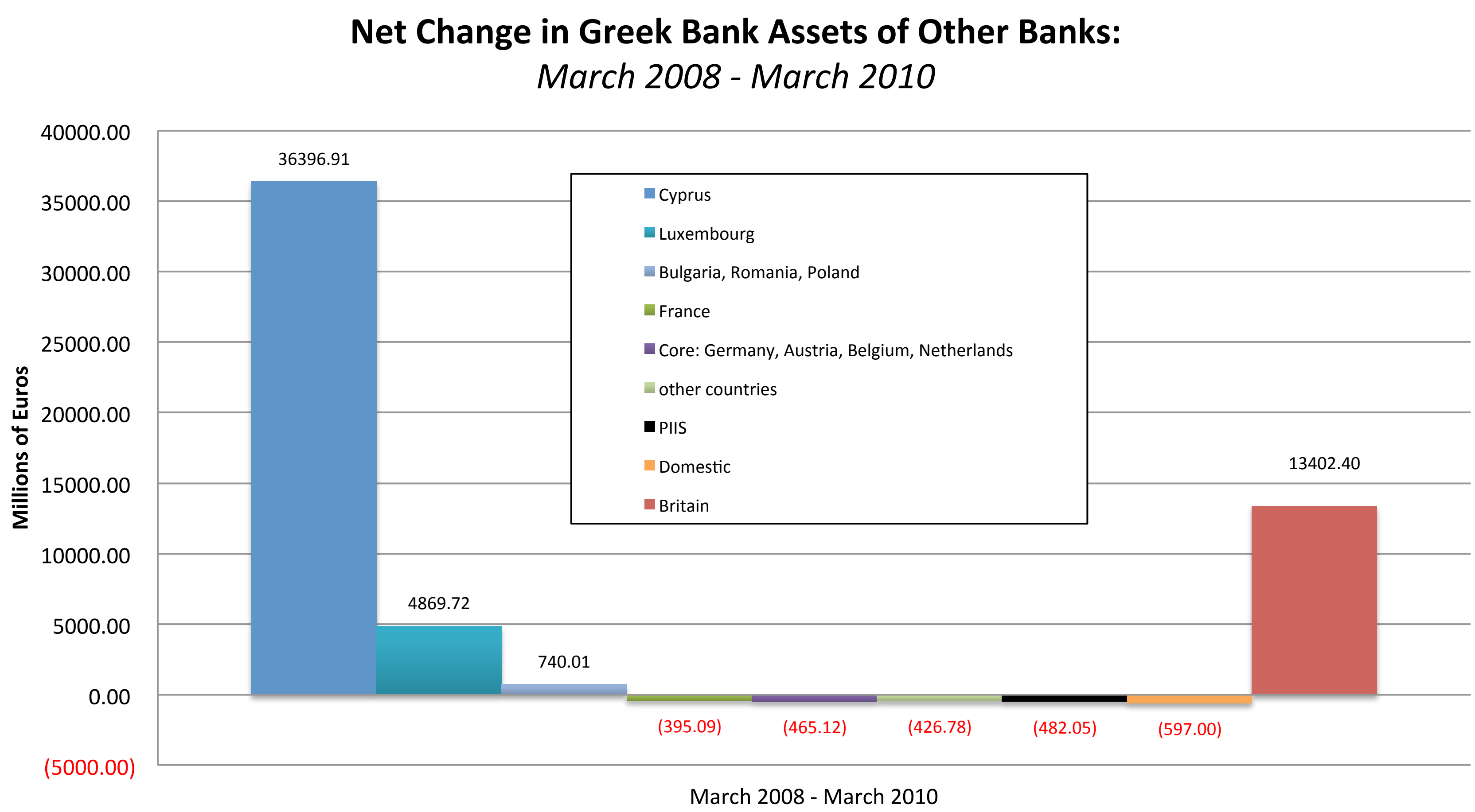
3. International Confidence

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
20000.00
15000.00
10000.00
5000.00
0.00
(5000.00)
(10000.00)
Millions of Euros
15852.13
978.59
356.33
4328.35
4943.77
1117.55
(2171.72)
(7588.03)
Cyprus
Luxembourg
Bulgaria, Romania, Poland
France
Core: Germany, Austria, Belgium, Netherlands
Other
PIIS
Domestic
Britain
Source: Bank of Greece

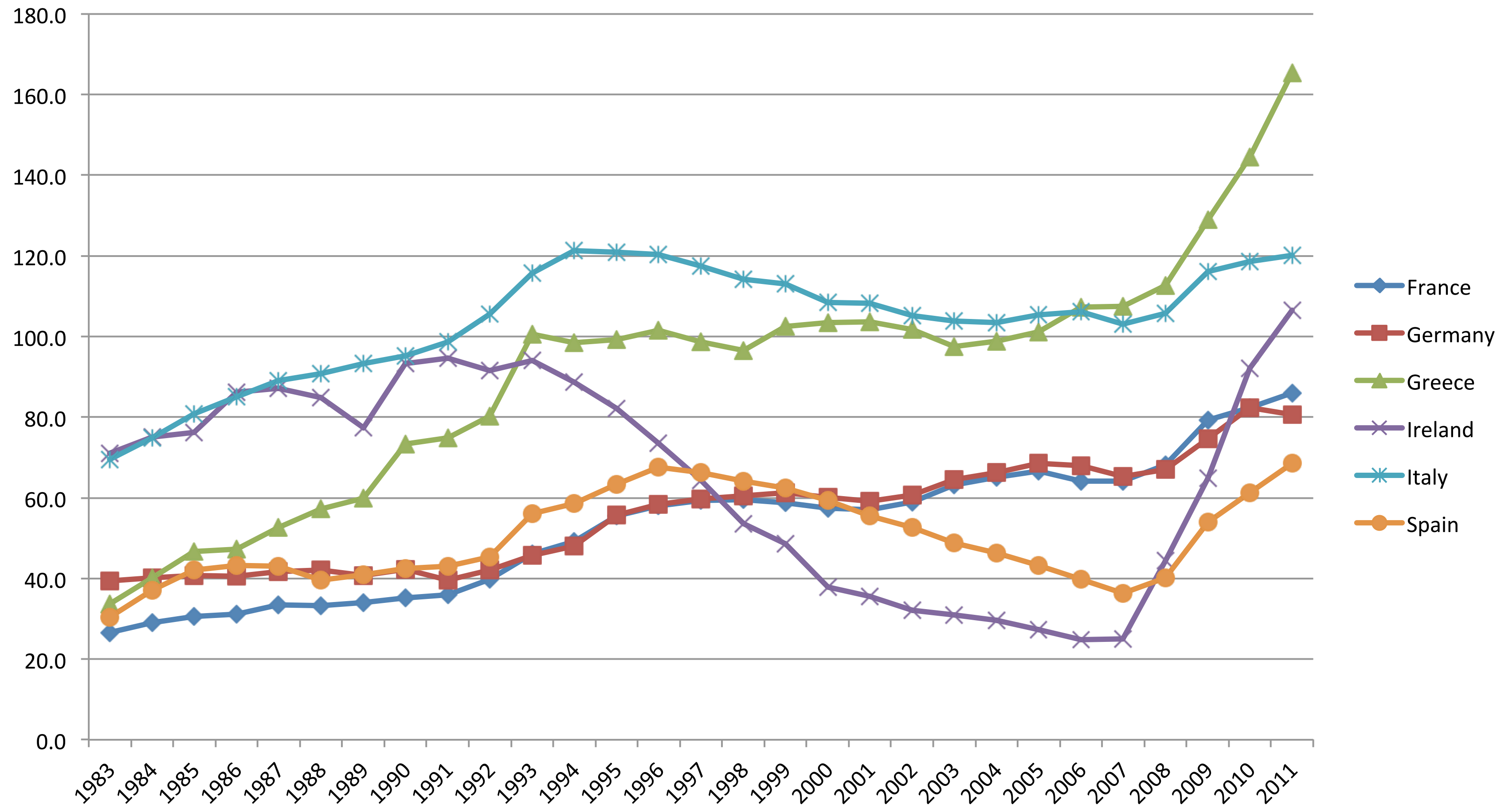


Net Change in Greek Bank Assets of Other Banks:
March 2008 - March 2010
Millions of Euros
40000.00
35000.00
30000.00
25000.00
20000.00
15000.00
10000.00
5000.00
0.00
(5000.00)
36396.91
4869.72
740.01
(395.09)
(465.12)
(426.78)
(482.05)
(597.00)
13402.40
Cyprus
Luxembourg
Bulgaria, Romania, Poland
France
Core: Germany, Austria, Belgium, Netherlands
other countries
PIIS
Domestic
Britain
March 2008 - March 2010

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