Lecture 6 : Intro to Fin Crises

"This Time is Different" - Reinhart + Rogoff
(but it's always the same)

→ excessive debt accumulation (by gov't, banks, corporations, or consumers) poses greater systemic risks than ~~it~~ it appears during a boom

- make economy vulnerable to crises of confidence
- especially when debt is short-term and needs to be constantly refinanced

→ financial crises are NOT new

- present since the development of money + financial markets
- Reinhart + Rogoff collected data on 66 countries
- dataset spans 800 years

→ what's wrong with standard data sets?

- developed since dawn of computer era so they're confined to recent times (e.g. the past 30 years)

- financial crises occur less frequently than once every 30 years

  → 1929 – beginning of Great Depression

  → 2008 – beginning of "Second Great Contraction"

- so what is rarely observed in a 30 year span is frequently observed in an 800 year span

  → a US dataset from 1980 to 2010 only has ~~[illegible]~~ one or two crises

  → by going ~~[illegible]~~ far back in time + extending coverage to many ~~crises~~ countries we observe many crises

- data on gov't debt is difficult to obtain

→ Banking crises

- incidence remarkably similar in the high-income + the middle-to-low income countries ("an equal opportunity menace")
- associated w/ large decreases in tax revenue → on average, gov't debt rises 86% in the 3 years following a banking crisis
- the fall in tax revenues is an order of magnitude larger than the direct cost of the bailouts

→ Bank runs

- by nature, banks borrow short + lend long
  - → deposits can be redeemed at short notice
  - → loans have longer maturity
- bank may have bright prospects over the long term, but if all depositors try to withdraw at once
  - → the bank would have to sell its assets at fire sale prices
  - → may not be able to repay its depositors (when deposits not fully insured)

- in 2007-2008, the US "shadow banking system" (i.e. investment banks, hedge funds, money market funds + insurers) experienced the equivalent of a bank run

NOT depository institutions

→ lenders to the institutions refused to roll over short-term loans (from money market and commercial paper market)

→ note: short-term interest rates are lower than long-term interest rates, all banks (both depository and "shadow") profit on the difference

→ when housing market deteriorated, + value of mortgage-backed securities declined, the "shadow banks" had to sell assets at fire sale prices

→ downward spiral

→ Gov'ts can be subjected to similar losses of confidence

- refusal to roll over short-term debt at manageable interest rates triggers a credit crisis

→ Difficult to predict the timing of a financial crisis (bubbles build)

→ why financial crises so painful?

- fin mkts channel funds from savers to ~~[illegible]~~ borrowers
- so when crisis cripples the banking system, investment projects starved for funds & difficult for normal economic activity to resume

Varieties of crises & their dates

→ inflation crises

- prior to "fiat currency" (e.g. prior to WWI) inflation rate very low because paper currency linked to gold (& sometimes to silver)
- in such periods, relatively lower inflation rates could be shocking & traumatic to economy

→ currency crashes

- large depreciation versus USD or other anchor ~~curr~~ currency (eg UK pound, the DM, the French Franc or the euro)

→ currency debasement

- when exchange in metallic coins, sovereign could finance wars by reducing silver content
- in modern era, occurs when a new currency replaces much depreciated earlier currency

→ bursting of asset price bubbles

- equity or real estate

→ banking crises

- drop in relative price of bank equity
- large scale withdrawals of deposits
- large increases in non-performing loans
- closures, mergers, ~~#~~ takeovers &/or large scale gov't assistance

→ **external debt crises**

Argentina 2001

- outright default on payment to creditors of loan issued under another country's jurisdiction
- usually (tho not always) denominated in foreign currency + held by foreign creditors

→ **domestic debt crises**

Mexico 1994-95

- default on debt issued under own jurisdiction
- usually (tho not always) denominated in domestic currency + held by residents

→ **serial default** occurs when country defaults on external, domestic or publicly guaranteed debt on several occasions within a given time horizon

"This Time is Different"

→ **prior to emerging mkt defaults of 1930s**

why diff?
- there will never be another world war
- greater political stability
- strong global growth
- low debt burden in developing countries

☆ Latin Am, Asia + others defaulted during Great Depression

→ **debt crisis of 1980s**

NB: Latin America was commodity rich

why diff?
- commodity prices high
- interest rates low
- oil money (from OPEC) ~~[illegible]~~ lent to developing countries
- banks are lending so they're gathering information + monitoring

★ mass lending to Latin America
- Mexico defaulted in Aug 1983
- then Argentina, Brazil, Nigeria, Philippines + Turkey

cause: steeper interest rates when rich countries moved to tame inflation
→ higher costs of rolling over short-term debt
→ collapse of global demand caused commodity prices to fall

→ debt crises of 1990s in Asia

why diff?

- Asia has conservative fiscal policy
- stable exchange rates
- high growth & saving rates
- no remembered history of financial crises

- problem: exchange rate pegs
  - → when investors wanted to exit Thailand, they sold Thai Bhat to the Thai Central Bank in exchange for dollars
  - → eventually Thai CB ~~[illegible]~~ ran out of dollars

- Korea, Indonesia, Thailand & others needed IMF intervention

→ debt crises of 1990s & early 2000s in Latin America

why diff?

- bond debt, not bank debt
- so many debt holders that countries will hesitate to attempt renegotiation through default
- trade (NAFTA) & democratization (more stability)

→ eud: Mexico collapsed 1994
Argentina defaulted
Brazil has bin crises 1998 + 2002
Uruguay defaulted 2002

→ US in run-up to subprime mortgage crisis

why diff?
- globalization
- technology boom
- superior financial system
- better understanding of monetary policy
- securitization has spread risk

Reinhart + Rogoff's Data set

→ prices
→ consumer price indices
→ exchange rates
→ real GDP
→ exports

p. 11

→ public finances

→ national accounts

→ difficult to find data on public debt + domestic debt defaults

→ global variables

- world commodity prices
- econ + fin indicators for world financial center
  - → London prior to WWI
  - → NY since WWI

→ countries

- 13 African
- 12 Asian
- 19 European
- 18 Latin American
- 2 Canada + US
- 2 Australia + New Zealand

66

account for 90% of world GDP