THIS TIME IS NOT DIFFERENT

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THIS TIME IS DIFFERENT

- Reinhart and Rogoff
- History of financial crises from 1810 to 2010 for 66 countries
- Key message: “We have been here before”.

AGENDA

- Sovereign Debt crises
  - Why people lend to governments
  - Illiquidity vs. Insolvency
- Banking Crises
  - "Equal Opportunity Menace"
  - Trends in the run up to a banking crisis: Capital mobility, capital inflows, financial liberalization, housing prices
- US 2007 Subprime Financial Crisis
  - Housing prices, current account deficit, real central government debt

EATON AND GERSOVITZ

- Why are people willing to lend to governments?
- Assumptions: frequency of borrowing, default and reentry
- Governments are concerned about their reputation as borrowers
- Implied credit ceiling; a maximum level of borrowing at which the costs just exceed the benefits
- Amount of the ceiling is determined by lenders' perception of borrowers' disutility of exclusion

LEGAL

- Challenged by Bulow and Rogoff: Why couldn't the country just have declared the debt null and void?
- Legal rights of creditors in the lenders' own countries; seizing the borrower's assets abroad
  - Threat of direct sanctions that lenders can impose by going to creditor country's courts
  - Can a small country have a reputation?
  - Exclusion from capital markets does not appear to be permanent nor significantly punished in the form of a premium over market interest rates(Evidence from borrowing in 1976-1979)
- Cash in advance contract
  - Collateral?

FOREIGN DIRECT INVESTMENT (FDI)

- FDI has a overall positive effect on economic growth
- Foreign company in a defaulting country might worry that their company will be seized
- Chile's seizure of its copper mines from American companies in 1971

"MORAL HAZARD" OF INTERNATIONAL LENDING

- Bargaining power over debt repayments is not completely unilateral
- Leverage of debtor countries: There is no direct benefit for lenders when the debtor countries are excluded from international capital markets
  - Lenders may in fact be harming themselves,
  - Side-payments
- The creation of the IMF since WW2 has coincided with shorter but more frequent cases of default

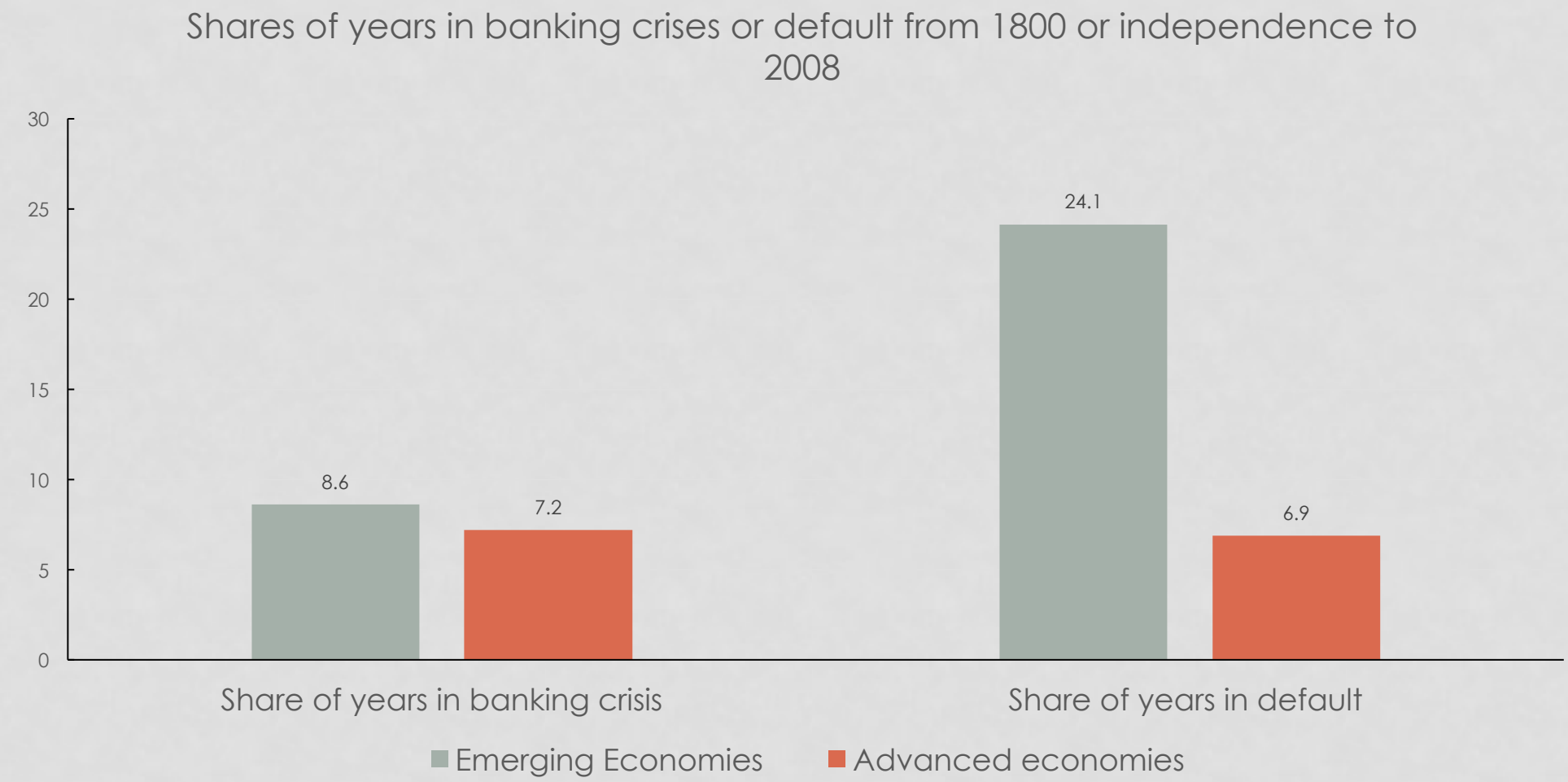
ILLIQUIDITY VS. INSOLVENCY

- Willingness versus ability to service debts
- Liquidity crisis : a country that is willing and able to service debts over the long run finds itself unable to roll over it debts
- Insolvency crisis: Unwilling or unable to repay in the long run
- Expectations of creditors is critical
- Default and no-default equilibrium, depending on lenders' confidence
- Herding behaviour

ILLIQUIDITY VS. INSOLVENCY

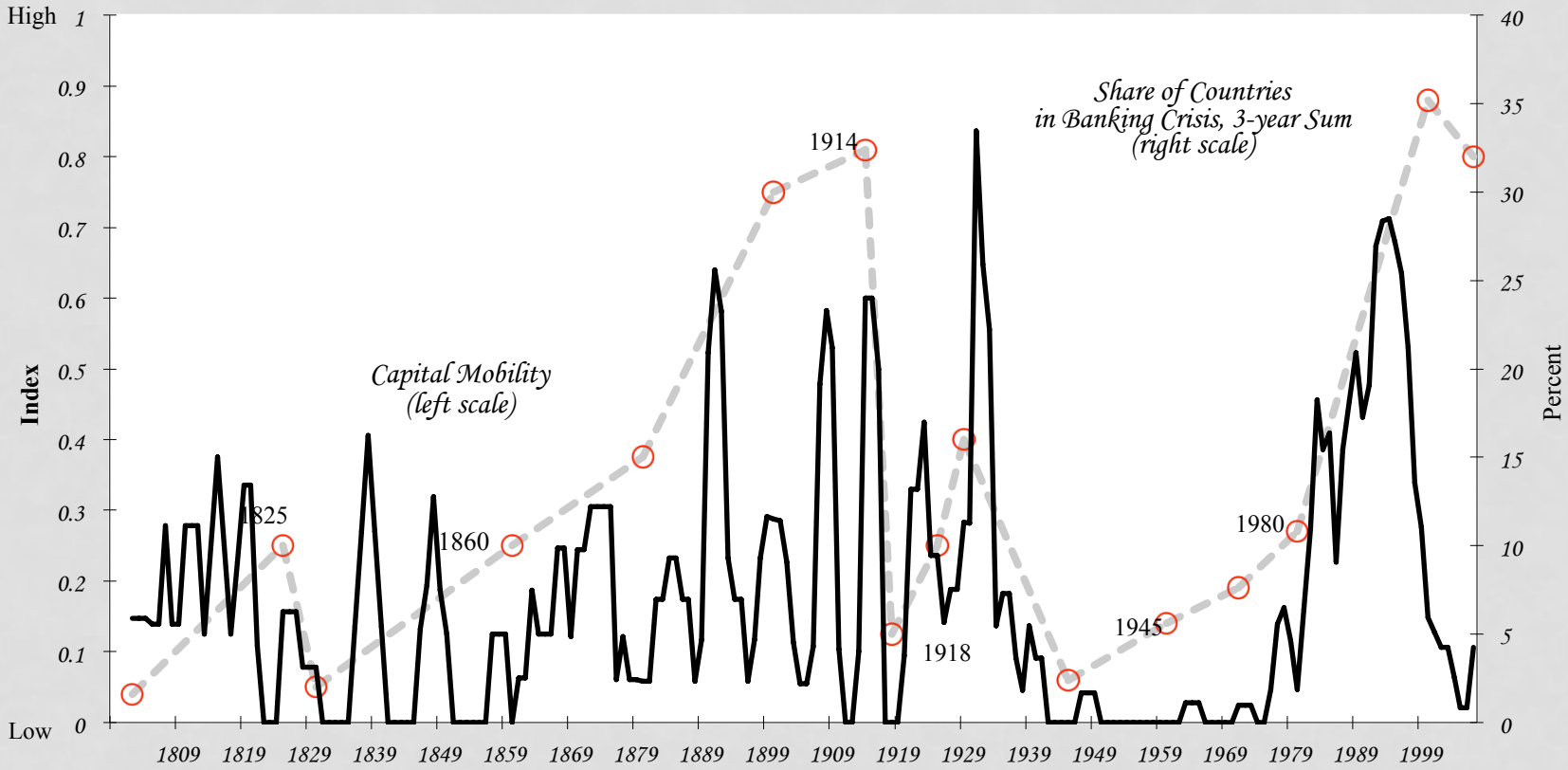
- Illustration of financial fragility
- Multiple equilibria
- Sunspot driving no default to default equilibrium
- Diamond-Dybvig model

EQUAL OPPORTUNITY MENACE



Source: Reinhart, Carmen M. and Kenneth S. Rogoff. *This Time is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press, 2009)

CAPITAL MOBILITY AND BANKING CRISES



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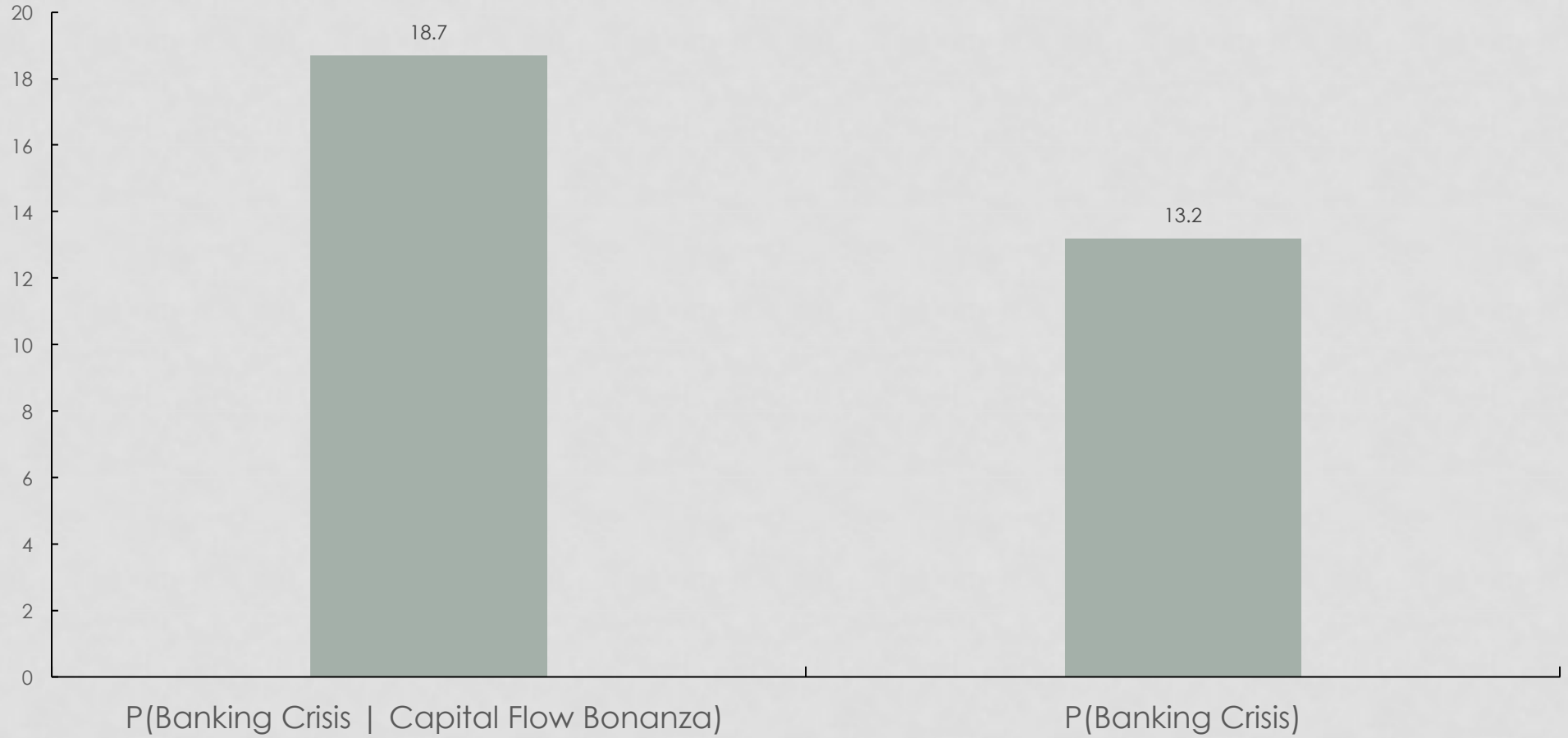
CAPITAL FLOW BONANZAS

Effect of a capital flow bonanza on the probability of a banking crsis, 1960-2007



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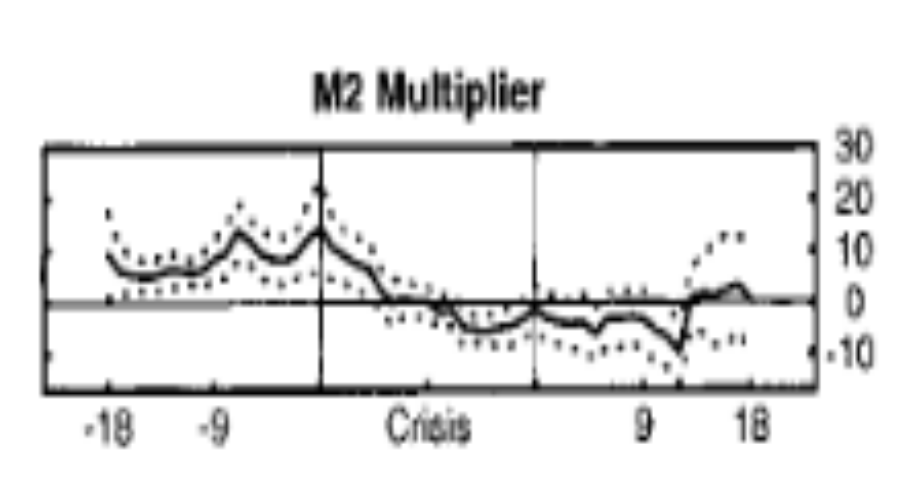
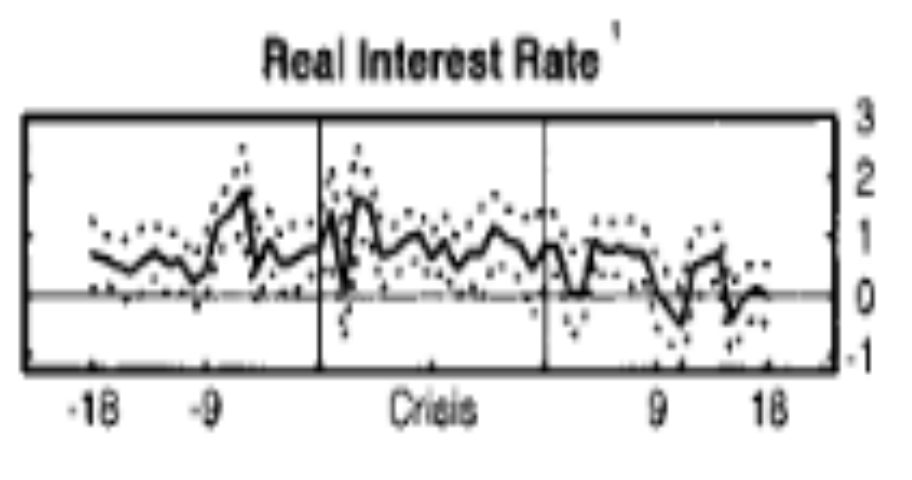
FINANCIAL LIBERALIZATION

- P(Banking Crisis | Financial Liberalization) > P(Banking Crisis)
- (# months in the banking crisis window that also occurred during financial liberalization) ÷ (# months of financial liberalization)

FINANCIAL LIBERALIZATION





Source: Kaminsky, Graciela L. and Carment M. Reinhart. 1999. "The Twin Crises: The Causes of Banking and Balance-of-Payments Problems." *American Economic Review*

HOUSING CYCLE

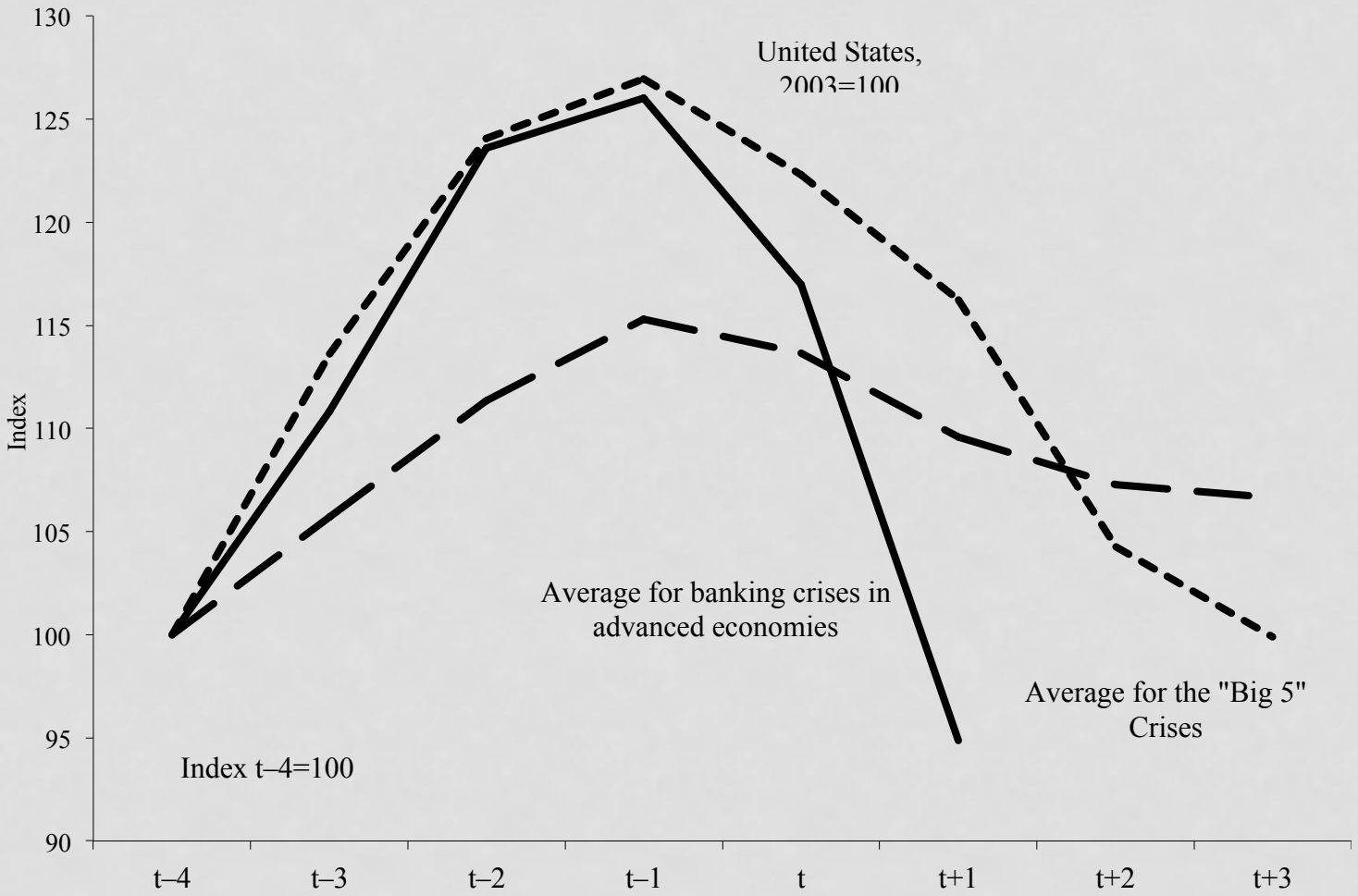
Country	Crisis date	Peak	Trough	Duration of downturn (in years)	Magnitude of decline (in percent)
Advanced economies: The Big 5					
Finland	1991	1989:Q2	1995:Q4	6	-50.3
Japan	1992	1991:Q1	Ongoing	Ongoing	-40.2
Norway	1987	1987:Q2	1993:Q1	6	-41.5
Spain	1977	1978	1982	4	-33.3
Sweden	1991	1990:Q2	1994:Q4	5	-32.0
Asia crisis: The Big 6					
Hong Kong	1997	1997:Q2	2003:Q2	6	-61.3
Indonesia	1997	1994:Q1	1999:Q1	5	-50.5
Malaysia	1997	1996	1999	3	-19.0
Philippines	1997	1997:Q1	2004:Q3	8	-56.2
South Korea	1997		2001:Q2	4	-21.4
Thailand	1997	1995:Q3	1999:Q4	4	-20.0
Other emerging					
Argentina	2001	1999	2003	4	-25.5
Colombia	1998	1997:Q1	2003:Q2	6	-40.5
Historical episodes					
Norway	1898	1899	1905	6	-25.5
US	1929	1925	1932	7	-12.6

Source: Reinhart, Carmen M. and Kenneth S. Rogoff. *This Time is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press, 2009)

US SUBPRIME CRISIS

- Was this time different?
  - Frequently argued: financial innovations like securitization improved risk management, that rising prices for risky assets were justified
  - Greenspan on the current account deficit
  - High housing prices justified by new financial markets

HOUSING PRICES



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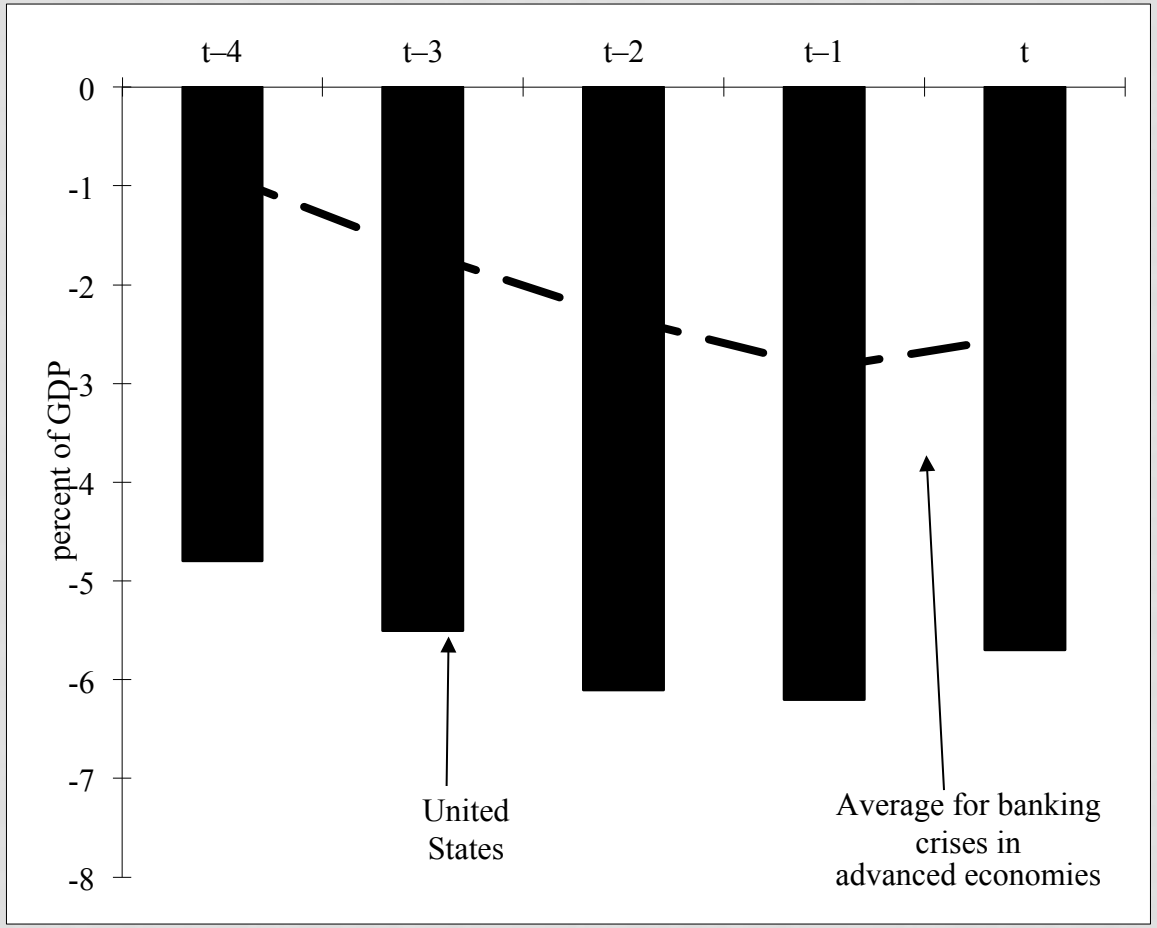
CURRENT ACCOUNT DEFICIT



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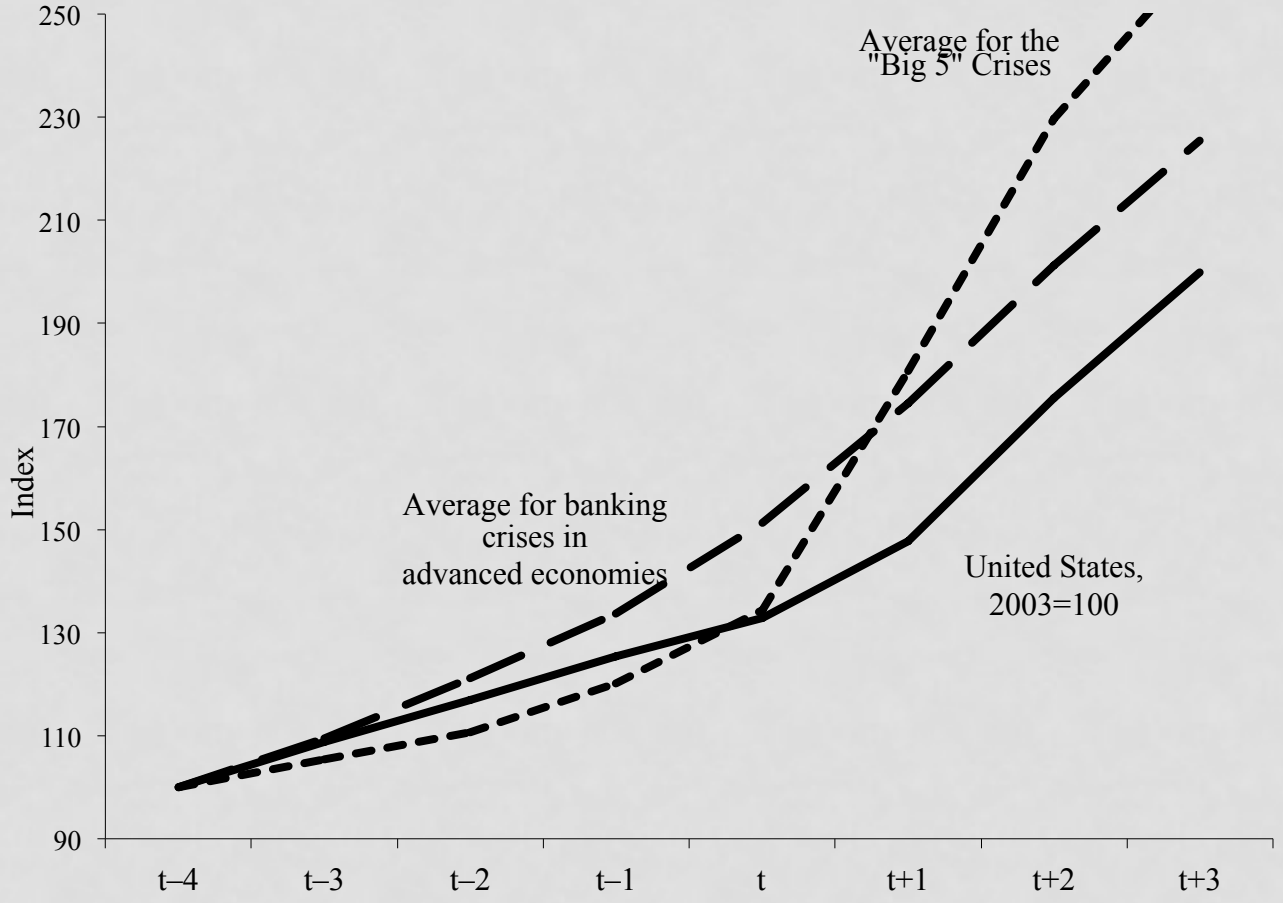
REAL CENTRAL GOVERNMENT DEBT



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WARNINGS OF CRISES?

- Monitoring key reliable indicators (real housing prices, current account balance, real stock prices)
  - Useful for showing classic symptoms
- Hurdles
  - Lucas critique

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