Alan Taylor: "The Great Deleveraging"

Professor Taylor has written a very Machiavellian paper. It was of course Machiavelli who wrote, "Whoever wishes to foresee the future must consult the past, for human events ever resemble those of preceding times. This arises from the fact that they are produced by men who have ever been, and ever shall be, animated by the same passions, and thus they necessarily have the same results." Or in the words of that even greater authority, Anonymous, "History repeats itself because no one was listening the first time."

Alan's wide ranging paper places the current crisis in historical context. The analysis is impressive for its geographical and temporal scope, which encompasses fully 140 years and 14 now high-income countries. It offers many important observations, all of which it is impossible to address in a set of short remarks. Let me highlight eight points and offer a comment on each.

1. **The crisis problem is a hardy perennial. It has been with us throughout history. The truly anomalous period from this point of view is the third quarter of the 20th century, when crises were few and far between.**

   Comment (really a question): *why* was the third quarter of the 20th century anomalous? According to Alan, the explanation for the singular stability of this period lies in either strict regulation of domestic financial institutions and markets (internal factors) or strict regulation of international capital flows (external factors). Those of us of eclectic temperament will suggest, predictably, that it was both. Indeed one can go further and argue that neither strict domestic regulation nor limits on capital flows would have been effective without the other. I would like to see more analysis of the interaction of these two potential determinants of financial stability, in other words.

2. **Recessions associated with financial crises are deeper and longer than other recessions. Moreover, when the crisis is international in scope, the depth and length of the associated recessionary are even greater.**

   Comment: While this is point is plausible, surely the relationship is less than mechanical. The depth and length of recessions, including recessions associated with financial crises, depend importantly on the policy response. If the policy response is particularly inept in the wake of crises, whether for the same political reasons that brought on the crisis or for others, then the point carries over. But one can also imagine effective policy responses (rapid bank cleanup in the Scandinavian crisis countries in the early 1990s for example) that abbreviate the crisis and violate the Taylor rule in question. In addition, there appear to be a number of notable differences in pre- and post-World War II recessions and crises warranting further investigation. Professor Taylor suggests that modern crises are characterized by less deflation (no surprise here to observers of the recent crisis, in response which central banks have taken aggressive anti-deflationary action). But modern crises are also characterized by more rapid declines in the ratio of credit to GDP, a fact that presumably explains the depth of the subsequent recession.

The explanation for that credit contraction (or “great deleveraging” in the language of the paper) is unclear. By definition, the decline in credit reflects changes in supply (owing to the fact that financial crises are characterized by bank balance-sheet distress). But this is true equally before and after World War II. Deleveraging also reflects changes in credit demand (which goes down in recessions). But this too is the case in both periods. It may be that the typical pre-crisis credit boom is larger in the post-World War II period. It may be that post-World War II financial systems, being more highly leveraged, are more responsive to the cycle. The question is worth exploring further.

3. **Leverage is greater today than at any previous time in the 140 year period covered.**

   Comment: the author’s explanation for rise of leverage – financial development and liberalization – is not obviously complete. The decline of private partnership in investment banking, a model which arguably discouraged excessive risk taking, may be part of the story. So too may be the development of modern risk-management practices and the excessive confidence they engendered.

4. **The current crisis is first and foremost a banking crisis and only laterally a sovereign debt crisis.**

   Comment: this is now widely acknowledged. In the main, sovereign debt problems have resulted from banking problems, as opposed to causing them, the Greek case notwithstanding. At this point, however, the distinction is largely irrelevant: at this late stage in the European crisis, banking problems are being compounded by sovereign debt problems as well as the other way around. Spain’s banking problems, we were reminded at the time this conference was held, are proving more intractable because of growing questions about the sovereign’s credit worthiness. And those questions about the sovereign’s credit worthiness are in turn further undermining the position of the banks.

5. **The shift in policy in emerging markets toward current account surpluses and reserve accumulation has paid off in terms of insulating them relatively successfully from the global crisis.**

   Comment: but did the shift in policy in emerging markets also play a role in fomenting the crisis (or, to put the point more conventionally, did global imbalances play a role)? My own view is that the credit boom and housing bubble in the West were created primarily by the West. But it is hard to imagine that the boom and bubble would have scaled such extreme heights absent the enabling role of emerging markets.

6. **When seeking to anticipate crisis risk, keep your eye on credit growth.**

Comment: the importance of surges in domestic credit growth (credit booms) as leading indicators of subsequent financial problems is indisputable. Kris Mitchener and I emphasized it in a paper we wrote for the BIS annual conference, entitled "The Great Depression as a Credit Boom Gone Wrong," (Eichengreen and Mitchener 2004) We showed that the credit boom of the 1920s, appropriately measured, exceeded anything seen in the high gold standard period. In the present paper Alan similarly shows that the credit boom in the period leading up to the recent crisis, appropriately measured, exceeded even that seen in the 1920s.

7. **Compared to the impressive predictive power of domestic credit growth, the predictive power of external imbalances is less, and even a distraction.**

Comment: the assertion is that large current account deficits and capital inflows have predictive content for crises only insofar as they accentuate credit booms. So long as domestic credit growth is restrained, there is no reason to worry when much of a country's investment finance comes from abroad. This conclusion is difficult to reconcile with the literature on "sudden stops," which suggests that external imbalances, when allowed to grow large, can cause problems through other channels (if they force the sharp contraction of domestic spending, which can no longer be financed, or if they cause the collapse of the exchange rate which then gives rise to balance sheet problems). My work with Muge Adalet (Adalet and Eichengreen 2007) suggests that the output effects of sudden stops were every bit as large before 1913 as after 1970. (We control for credit growth, at least in a rudimentary way, when drawing that conclusion). The major difference is not in the impact of sudden stops but in their frequency: sudden stops simply occurred less often under the gold standard. Perhaps Alan's more limited country coverage (recall that he is focusing on 14 now advanced economies) accounts for the difference. Be that as it may, this is another question that deserves further investigation.

8. **After a crisis, mark down your forecasts of inflation and economic growth. When the private sector enters the crisis with heavy debts, market down your forecasts even more. And when sovereign also enters the crisis with heavy debts, mark down your forecasts still more.**

Comment: I can only say amen. Unfortunately.

References

Adalet, Muge and Barry Eichengreen (2007), "Current Account Reversals: Always a Problem?" in Richard Clarida (ed.), *G7 Current Account Imbalances: Sustainability and Adjustment*, Chicago: University of Chicago Press, pp.205-246.

Eichengreen, Barry and Kris James Mitchener (2004), "The Great Depression as a Credit Boom Gone Wrong," *Research in Economic History* 22, pp.183-237.