"Autopsy of a regime change: International effects of New Deal financial Acts"

by Marc Flandreau

Discussion by Øyvind Eitrheim, Norges Bank

Past Present and Policy 4th International Conference: "The sub-prime crisis and how it changed the past", Geneva, 3-4 February 2011

Disclaimer: The views expressed are those of the discussant and do not necessarily reflect those of my colleagues or the official views of Norges Bank

3 February 2011

NORGES BANK

Key research questions

- What's new? Why care? How can we tell?
- Reassessment of New Deal Financial Acts of 1933-34
- .. and their effects in the short run (1930s) and the long run (1980s onwards)
- A counterfactual story about financial globalization
- .. with focus on financial intermediaries, their incentives and constraints
- Testing ground: the market for foreign government debt over almost two centuries

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- .. and to what extent did the New Deal Financial Acts permanently change the market for foreign government debt?
- .. why did the regime change? how did the changes come about? and which institutions changed ?
- .. also, shed new light on the roles of bondholder committees (CFBs), rating agencies, and the Bretton Woods institutions in the post-WW2 period
- ⇒ Contribution to understand long run developments in international financial markets and regulations

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- Combines anecdotal and statistical evidence for global financial markets since the early 19th century
- 1820-1914: the London market for foreign government debt is dominating, Rotchild lead in a hierarchical market
- Post WW1: the focus of the London market changed from being international to become more domestic
- 1900-20s: the New York market became gradually more important for foreign government debt, with JP Morgan in the lead in a hierarchical market
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- 1980s onwards: after 50 years of sleeping beauty
- The role of underwriting banks has changed, certification outsourced to rating agencies
- The Securities and Securities Exchange Acts deprived prestigious banks from their informational advantages
- The dominant business model for underwriters is changed from "firm commitment" to "best efforts"
- The crowding out of the international banker led to more, not less, investors' risk taking in foreign government debt
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- .. with a clear hierarchy among international underwriters (Rotchild $\succ$ Baring $\succ$ others), (2009, JEH with Flores)
- .. the top of the pyramid prevailed, invested in their reputation and intervened actively, small turnover, [strongly concave Lorenz curves of defaults]
- 1920s: a similar hierarchy in New York (JP Morgan $\succ$ National City and others),
- .. concern for reputation, but no evidence of "banksterism" (2010, IHEID WP, with Gaillard and Panizza),
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Lorenz curves for bond defaults

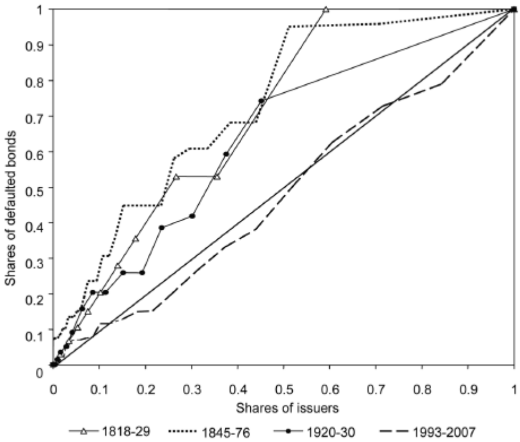

Fig. 5. Lorenz curves: three debt crises (1820s, 1840s–70s, 1920s) versus today. The straight line (diagonal) is the 45° line. Sources: Authors' database; see appendix A.

Main findings

- The New Deal Acts fundamentally changed the market for foreign government debt
- 1930s: the hierarchy model breaks down
  - Glass-Steagall crowded out reputational capital
  - Facing less monopoly power prestigious banks were discouraged from actively stabilizing markets
  - The wave of defaults throughout the 1930s is consistent with a view that the old regime had been destroyed
  - shifting powers from bankers, now deprived of their prestige, to the government, from personal to impersonal exchange
  - Public authorities took over some of the tasks, e.g. bondholder committees (CFBs)
  - Rating agencies took over the certification of foreign government debt, substituting (soft) private information with a public grading system

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Bond grades before/after regime shift

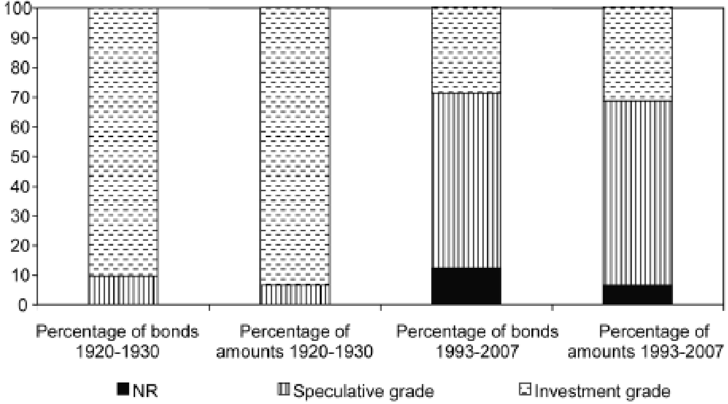

Fig. 7. Percent investment grade and speculative grade securities (interwar period and now). Sources: Authors' database; see appendices A and C.

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