Globalization and the Current Financial Crisis in Historical Perspective – A Tale of two crises

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Motivation and Methodology

- Many theories ‘explain’ current crisis

- Use the ***past*** to sort the culprits out of the ‘usual suspects’ in the ***present***

- Rediscover the ***past*** using the ***present***.

Why Baring 1890?

- Had all the makings similar to the subprime crisis:

1. Globalization and global financial system
2. Post industrial economy expanding its financial sector
3. Practically unregulated financial system
4. The (probably) largest bank in the world exposed to defaulting assets
5. Potential disastrous impact on British financial system

Preliminary conclusions

Popular explanations

1. Globalization
2. “The end of capitalism”
3. Limited regulation
4. Moral Hazard

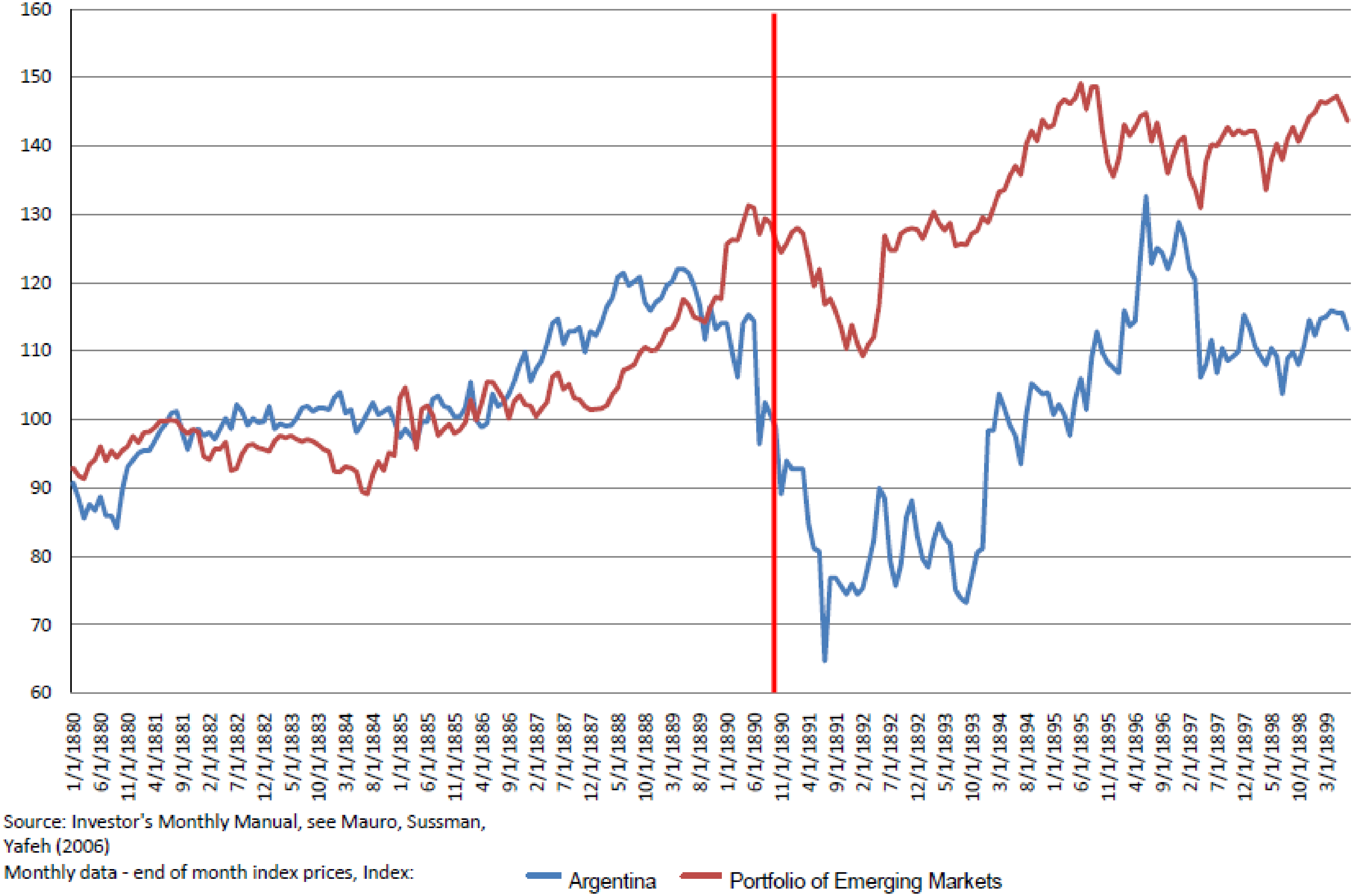
All Existed in 1890 – but no worldwide crisis

Baring Crisis in 3 (long) sentences

- Baring 1890 – the world largest investment bank. Heavily exposed and underwrote Argentinean debt
- Debt funded real estate bubble in Argentina – defaulted provincial debt assumed by national government that then defaulted owing to bursting of sovereign lending bubble in London
- Baring on verge of default saved by Bank of England – short lived financial crisis for UK – not so short for Argentina

Chart1

Sovereign Bond Prices: Argentina and a Portfolio of Emerging Markets



Source: Investor's Monthly Manual, see Mauro, Sussman, Yafeh (2006)

Monthly data - end of month index prices, Index:

Is the comparison relevant?

Table 1: The Macroeconomic Magnitudes of the Baring Crisis and the Current Crisis

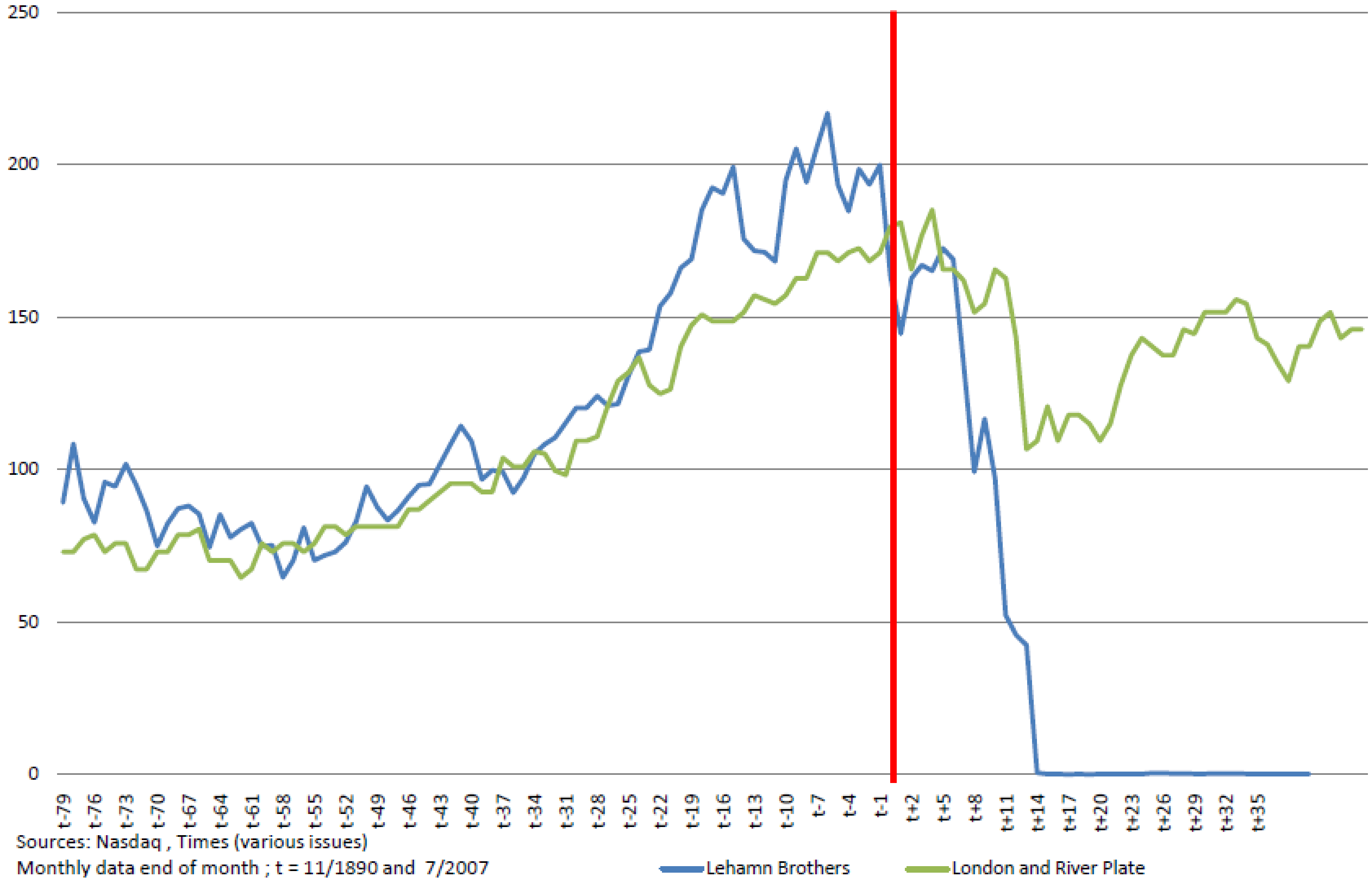
UK figures in millions of pounds, US figures in billions of US dollars. Problematic assets are defined as defaulted mortgage-based securities, 2007-8 figures based on reports in the financial press, e.g. Bloomberg, May 17, 2008.

	Baring Crisis		**Sub-prime Crisis**
UK GDP	1,442	US GDP	14,061
Value of Latin American debt	140	Value of sub-prime related assets	1,400
Latin American debt relative to GDP	9.8%	Sub-prime related assets relative to GDP	10.0%
Value of Argentinean bonds	49	Value of problematic sub-prime assets	475
Argentinean bonds relative to GDP	3.4%	Problematic sub-prime assets relative to GDP	3.3%
Value of Baring's balance sheet "difficulties"	21	Value of Lehman Brothers' problematic balance sheet assets	175
Baring's balance sheet "difficulties" relative to GDP	1.5%	Lehman Brothers' problematic balance sheet assets relative to GDP	1.2%

The price of underlying asset prices - Subprime and Aregntina
5 years before to two years after

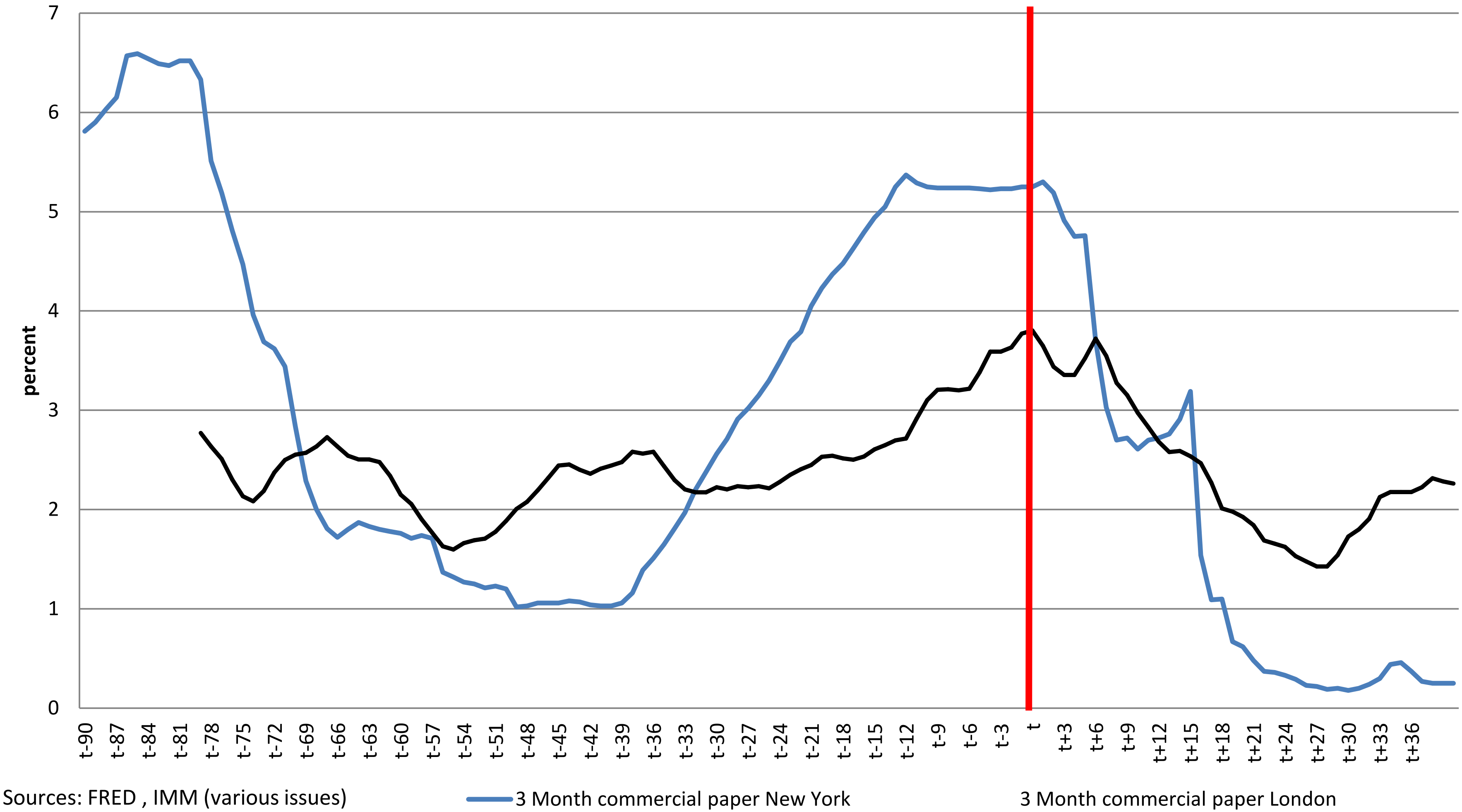
Sources: FRED, IMM (various issues)
Monthly data

Chart3
Stock Prices - Crisis-affected Banks, Then and Now



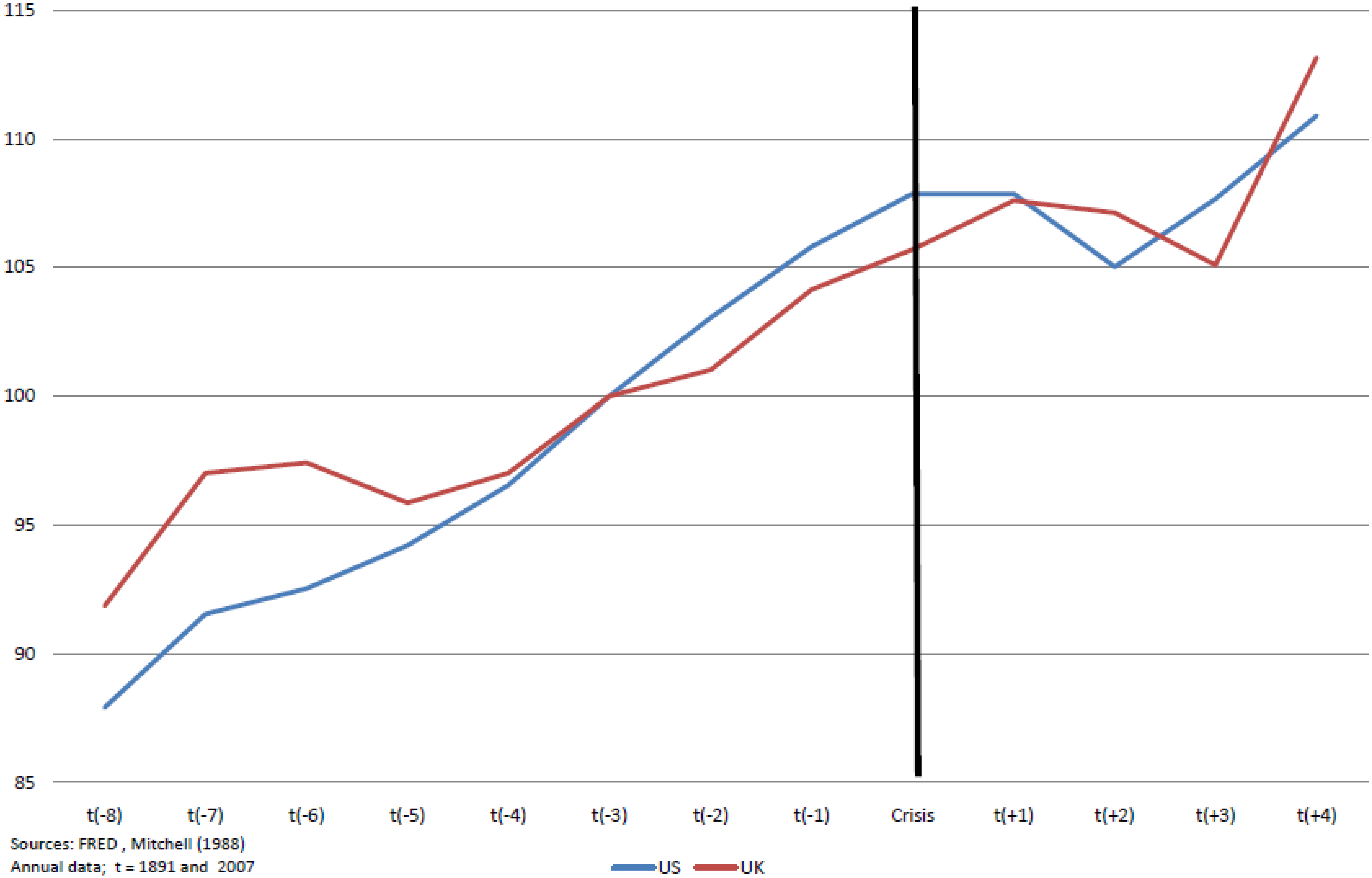
Sources: Nasdaq , Times (various issues)
Monthly data end of month ; t = 11/1890 and 7/2007
Index: ;1887 and 2005=100

Chart 4
90-Day Commercial Paper Rates: London and New York



Sources: FRED , IMM (various issues)
Monthly data ; Monthly average t = 11/1890 and 7/2007

Chart 5
Real GDP: UK and US



Sources: FRED , Mitchell (1988)
Annual data; t = 1891 and 2007
Index; 1887 AND 2005 = 100

A short lived crisis

Table 2: Collapse and Recovery of Bonds Prices – November 11 to November 27, 1890

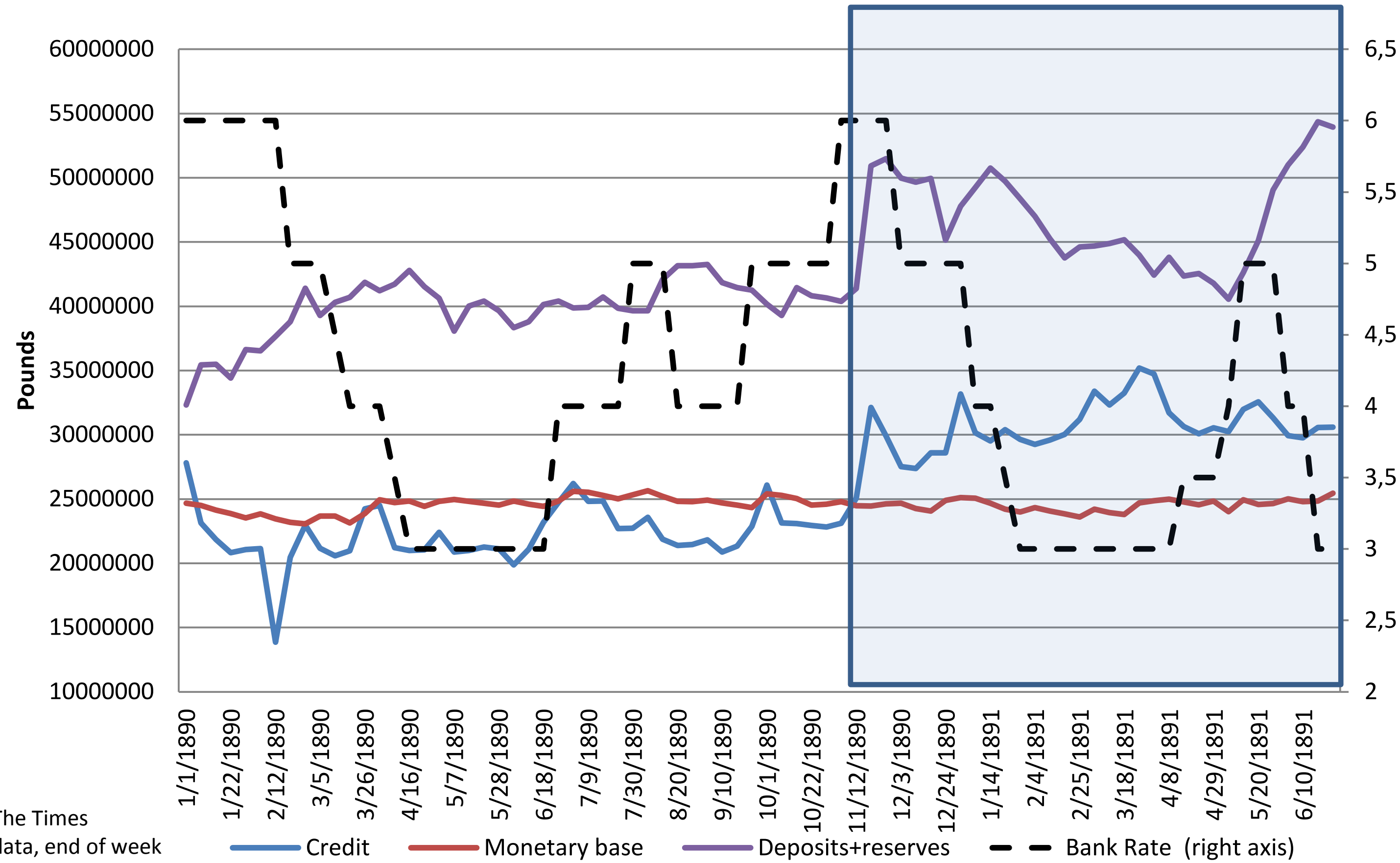
Source: *Investor's Monthly Manual*, December 31, 1890

Country/ bond	Price on November 11th	Price on November 19th	Percent change	Price on November 27th	Percent change
Argentina 1884 5%	80.00	67.50	-15.6	75.00	+11
Brazil 1889 4%	89.00	77.00	-13.5	81.00	+5.2
Mexico 6%	91.50	86.00	-6.0	92.00	+7.0
Uruguay 5%	53.00	39.00	-26.4	54.00	+38.5
Greece 1881-4 5%	89.25	86.50	-3.1	91.00	+5.2
Hungary Gold rentes	89.50	87.50	-2.2	89.50	+2.3
Italy 5% rentes	92/00	91.00	-1.1	92.50	+1.6
Portugal 3%	56.25	53.75	-4.5	56.25	+4.6
Russia 4%	97.50	96.75	-0.8	97.00	+0.3

The classical explanation

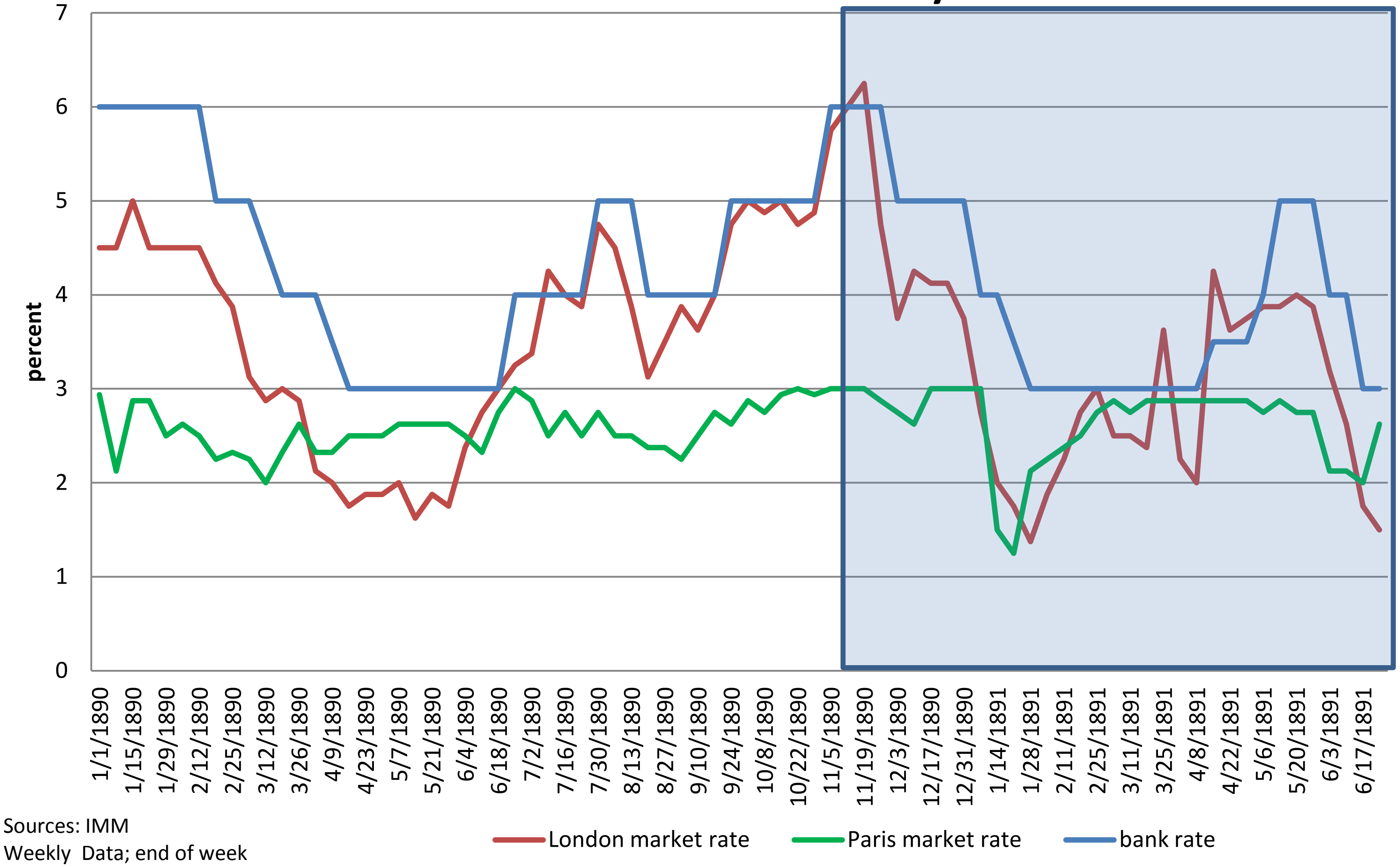
- Central bank intervention was done right then vs. now:
- *“The past month will long be remembered in the City. The downfall of … Baring… perhaps the greatest firm of merchant banking in the world… but it will be even more distinguished by the fact that a crisis of the gravest character has been averted by the action of the Bank of England, aided by joint-stock and other banks”*
(Investor’s Monthly Manual, November 29, 1890, p. 564).

Chart 6
Bank of England Intervention During the Baring Crisis



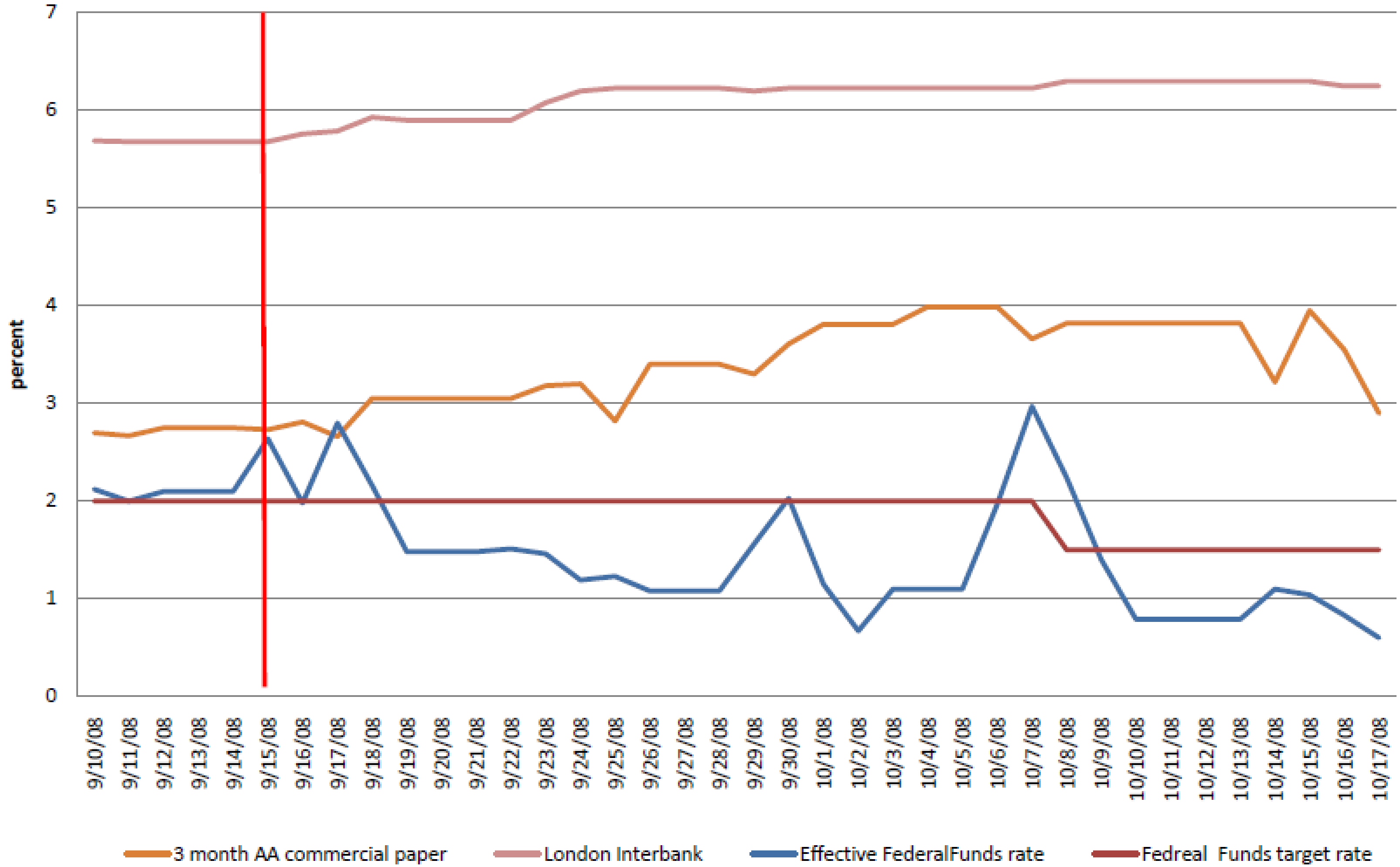
Source: The Times
Weekly data, end of week

Chart 7
London and Paris 90- day Market Rates



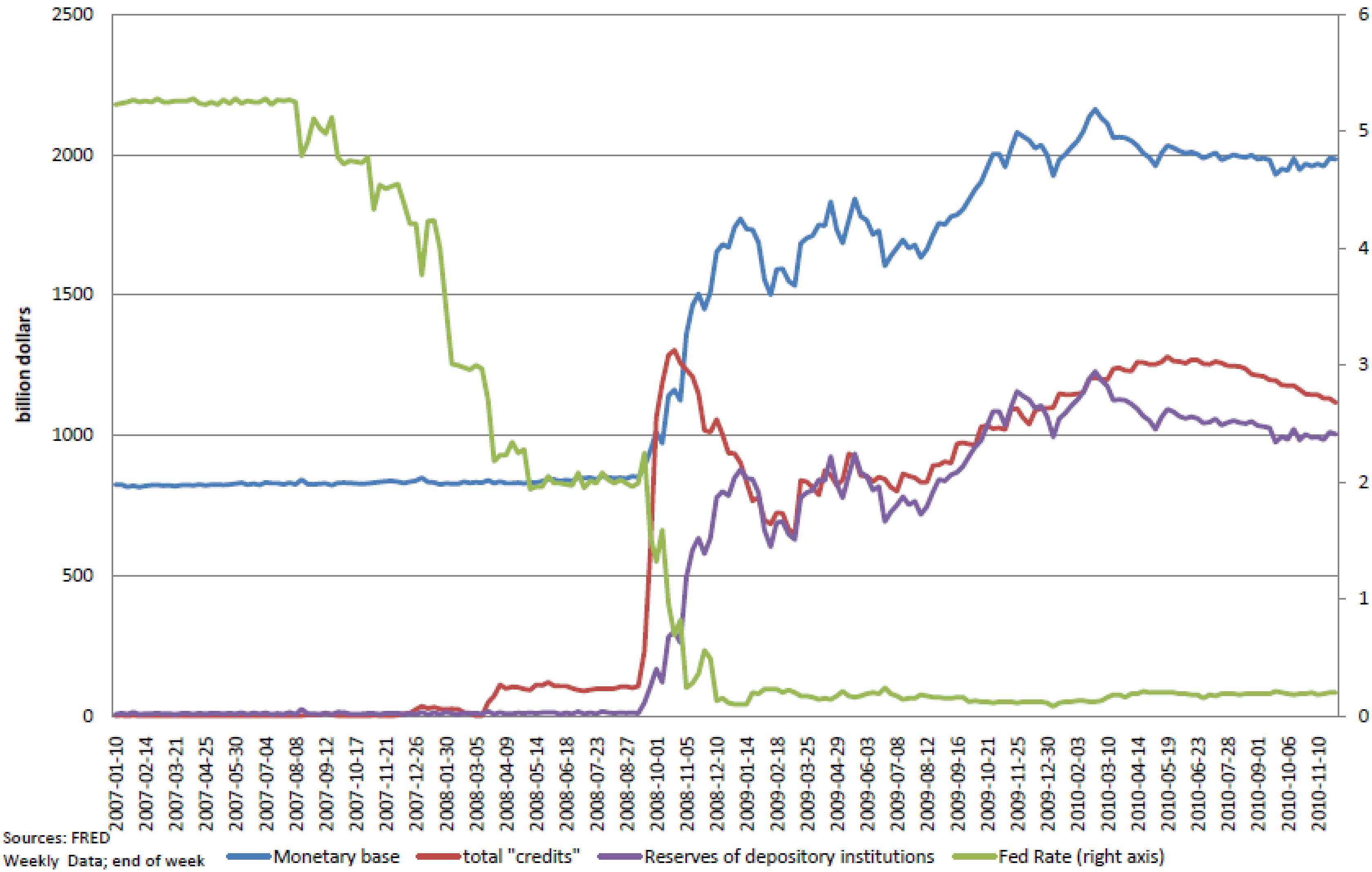
Sources: IMM
Weekly Data; end of week

Chart 8
Market and Federal Reserve Interest Rates - Lehman Brothers Crisis



Sources: FRED
Daily Data

Chart 9
Federal Reserve Bank Actions during the Lehman Brothers Crisis



Central bank reaction - summary

Then

- Bank of England intervened immediately
- Effective in preventing worldwide liquidity crisis
- Immediate effect on money market

Now

- FED let Lehman fail
- Intervened massively thereafter
- world money markets affected slowly

Looking elsewhere - contagion

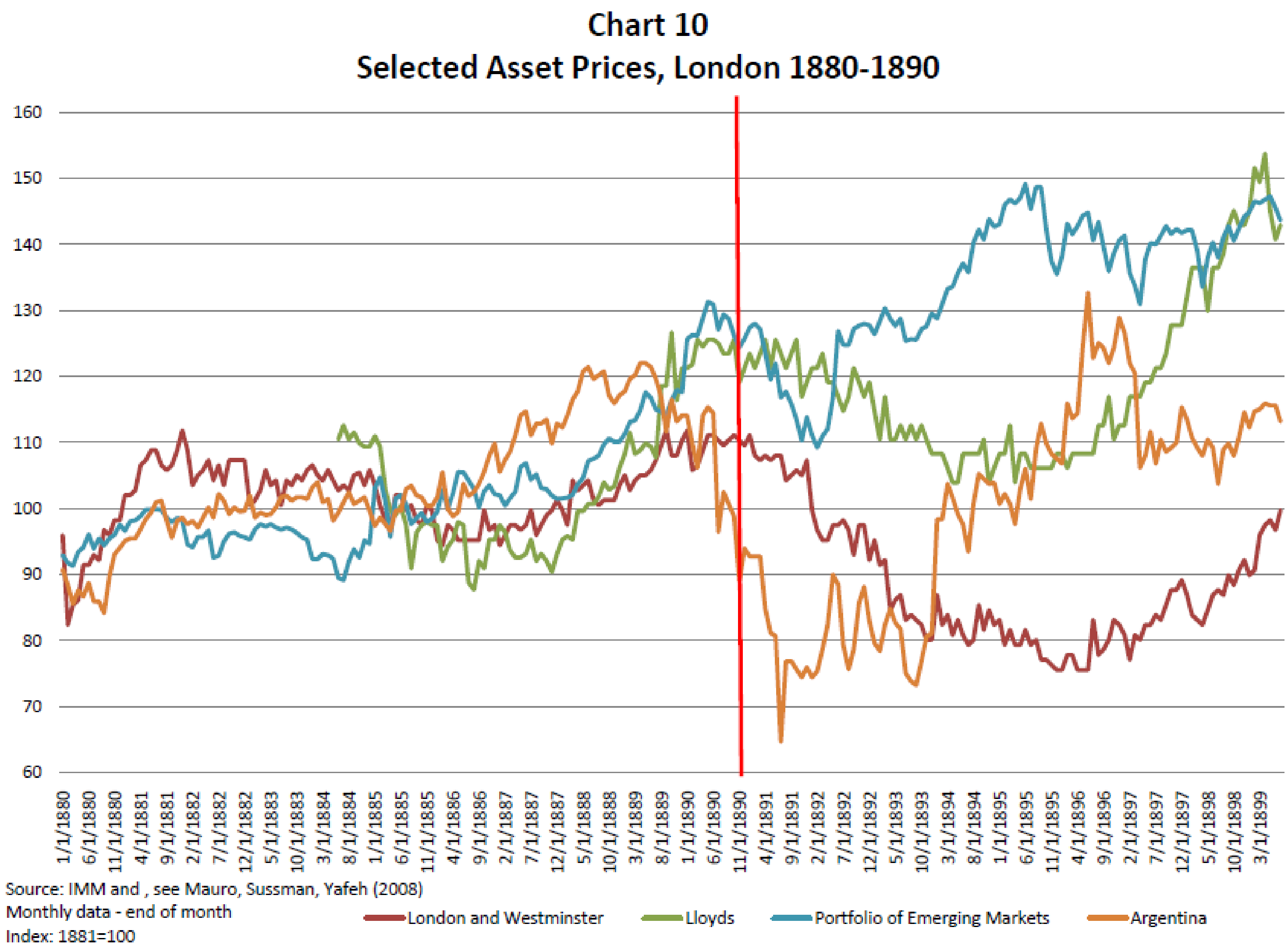
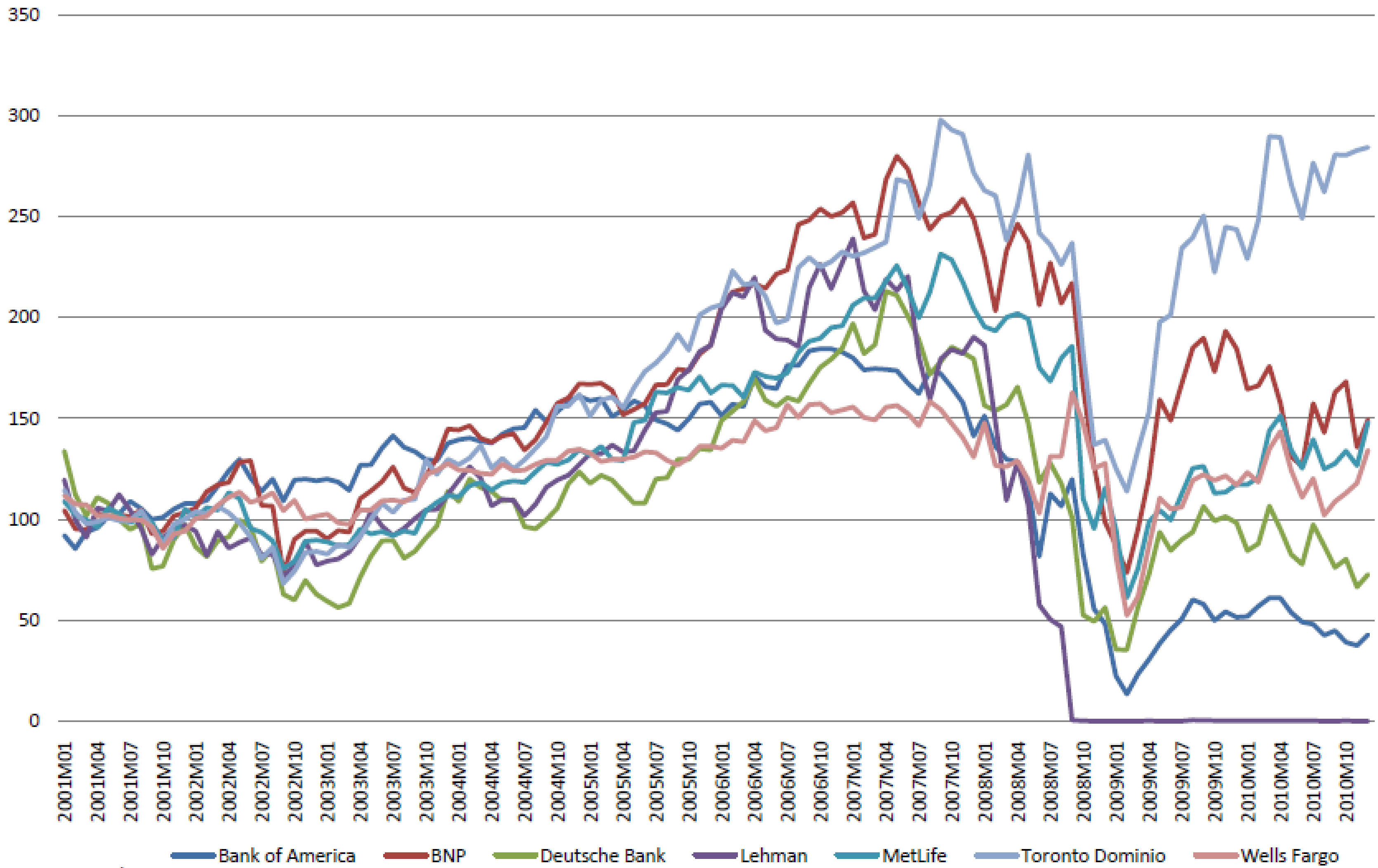


Chart 11
Banks Share Prices, New York 2001-2010



Sources: Nasdaq
Monthly data end of month Index: 2001=100

Contagion and co-movement - summary

Then

- Less co-movement
- Pre-crisis – “the tide lifts all boats”
- During crisis – investor discriminate between assets based on exposure to fundamentals

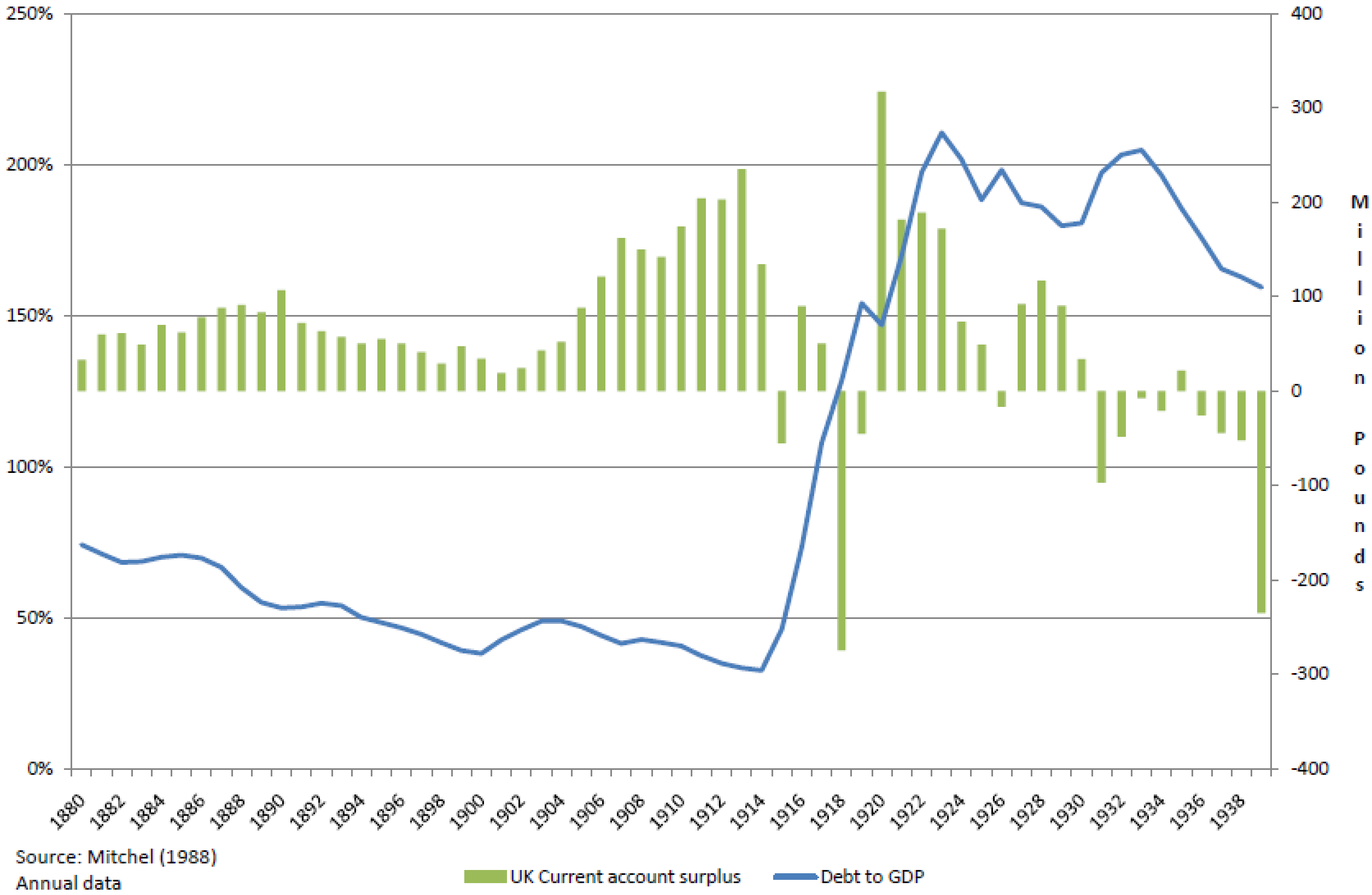
Now

- More co-movement
- Pre-crisis – “the tide lifts all boats”
- During crisis – severe contagion.

Looking at Fundamentals

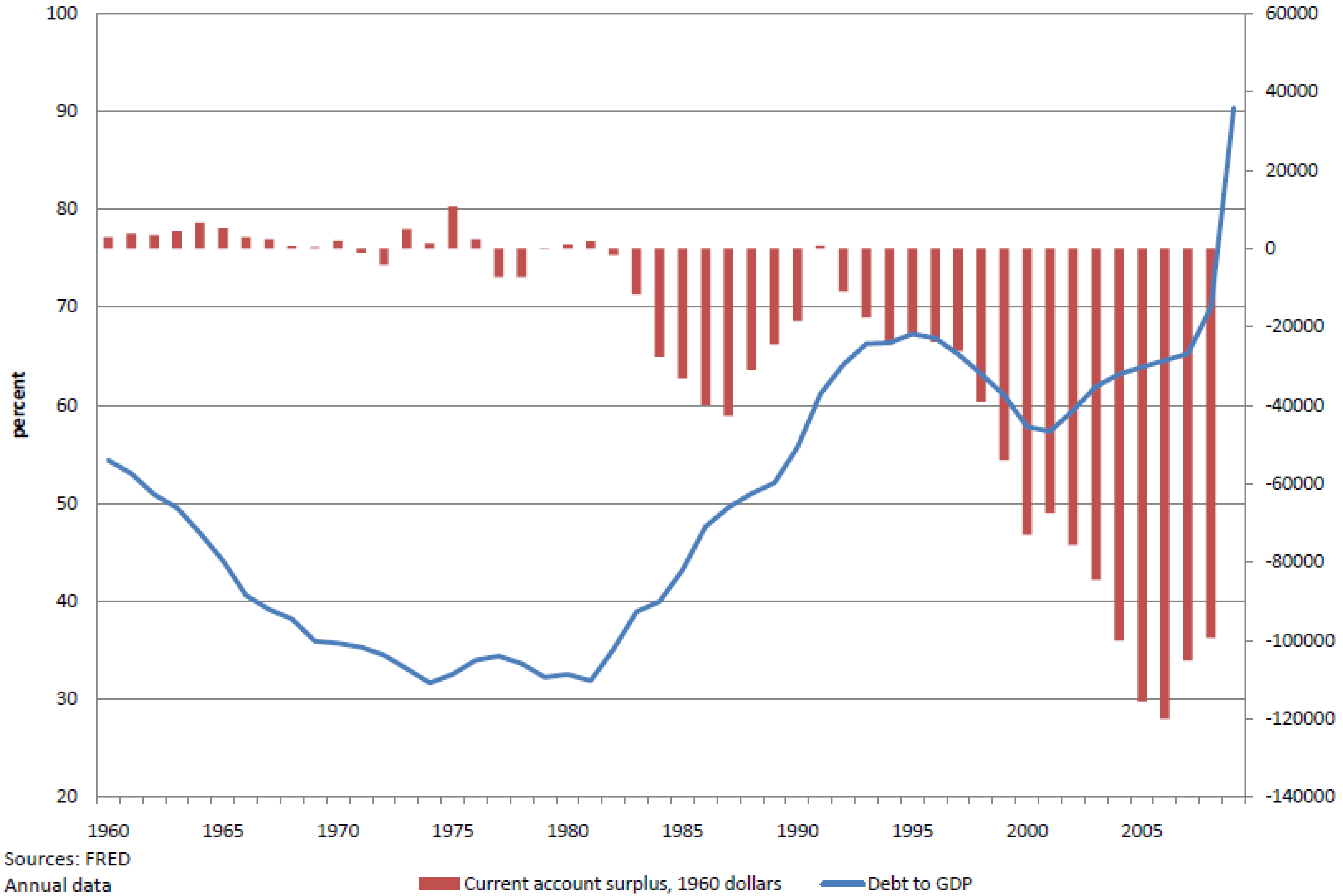
- Main argument – macroeconomic fundamentals matter
- Looking beyond the initial financial crisis
- Slow recovery
- It matters if bubbles burst in a **'stable' (1890)** macro environment or **unstable (2008)**
- Basic Economics can account for what had happened.

Chart 12
UK Current Account and Debt to GDP, 1880-1937



Source: Mitchel (1988)
Annual data

Chart 13
US Current Account and Debt to GDP, 1960-2008



Sources: FRED
Annual data

Chart 14
US.Trade-Weighted Exchange Index: Major Currencies

Sources: FRED
Monthly data daily averages Index: March 1973=100

Conclusions

- The past and the present differ in:

1. Financial contagion
2. Macroeconomic instability
3. Initially hesitant policy response

In hindsight – Bagehot (Bernanke) alone would not have averted the crisis of the **past** from looking much like that of the **present**