Fratzscher, Mehl and Vansteenkiste

130 Years of Fiscal Deficits and Currency Crashes in Advanced Economies

Discussion by
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Two Main Themes

- Extension of real ER and deficit database back to 1880s
- Horse race between 1st-3rd gen. currency crisis models

Main Results

- Big role for banking crises
- Some role for debt structure
- Some role for reserve currencies

This comment

1. Praise
2. Method
3. Data
4. More Praise

Praise

Nested hypotheses: let the data speak

Nice validation of outcomes (scores)

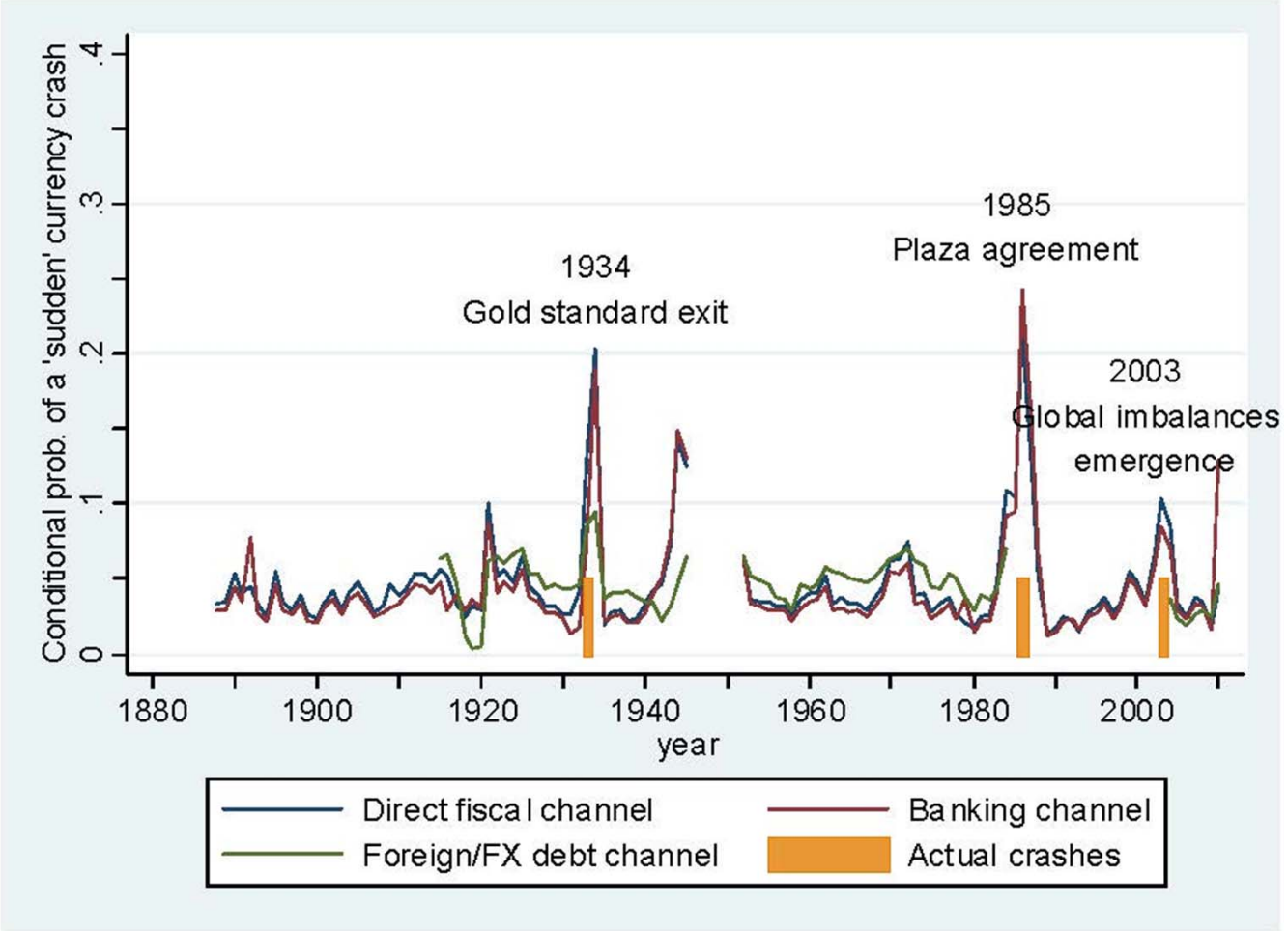
Appealing, very timely

Gets the evidence right

.. although .. action is mostly in interaction effects

Praise – an example

Figure 10a: A century of crash probabilities for the US dollar



Method: possible omitted variables

- 1st generation models not strictly tested
  - No controls for money growth
  - No controls for deficit monetization

    [Post-WW1 stabilizations, Sargent (1982)]
- FTPL not strictly tested:
  - No controls for overall debt/GDP ratios [?]
- Original Sin not strictly tested:
  - No controls for foreign currency debt [data problems..]

Method: possible omitted variables

- Power of Debt/GDP ratio:

Germany 1931:

Deficit/ GDP:	< 2%
Debt/GDP:	~ 100%
Original Sin/GDP:	~ 90%

→ Banking crisis, debt default, capital & exch ctrls

→ “Greece on steroids” w/o deficits!

Method: possible omitted variables

- Power of Debt/GDP ratio:

Britain 1931:

Deficit/ GDP:	< 2%
Debt/GDP:	~ 180%
Original Sin/GDP:	~ ?

→ Devaluation, partial debt default (1st since 1688)

Method: selectivity & endogeneity

1. Classical Gold Standard (pre-1914)

- Low deficits select countries into GS (Bordo/Rockoff 1996)
  - Generates negative risk premia
  - Centered on Britain, not US
  - Stable pattern from mid-1750s to 1914

Method: selectivity & endogeneity

1. Classical Gold Standard (pre-1914)

- But credible GS adherence allows higher deficits (Bordo/Kydland, 1995; Bordo/White, 1998)
  - War finance on credit
  - Suspension of gold convertibility during wars
  - Full debt service afterwards
  - Negative UK risk premium throughout

Method: selectivity & endogeneity

1. Classical Gold Standard (pre-1914)

- Others take piggyback ride on GS
  - Negative risk premia on GS membership
  - Banking crises (eg 1890, 1907) but almost no exits (EXCEPT Southern Europe)
- Empire effect (Ferguson/Schularick, 2006-11)
  - Belonging to British empire has same effects
- Considerable leeway in fiscal & monetary policy
  - Flandreau et al (2010), Jobst (2008), Morys (2010)

Method: selectivity / endogeneity

2. Bretton Woods

   (only exception: British devaluations in 1940s)

3. OECD [?]
   - 1950s stabilization programs
   - European Payments Union / endogenous capital controls

Method: selectivity / endogeneity

How to maybe circumvent this?

Suggested two-step approach

1. build selection model for GS membership
2. eval crash probs relative to ctrl group

Method: relevant subperiods

- Classical Gold standard pre-1914
  - Centered on Britain, take relevant measures relative to Britain not US
- Interwar Gold Standard and its breakup
  - Try both British and US centered comparisons
- Bretton Woods 1946-71

Method: systemic effects, contagion

Spillovers

- Case: US 1933

Deficit/GDP:	~ 1%
Debt/GDP:	< 60% [?]
Foreign debt/GDP:	0

Banking crisis 1933, devaluation 1933, exit from gold 1934 → victim of German [..,UK, F] default

→ ~ 20% of US GDP in 1933

→ To this add effects of Latin American defaults

Method/Data: the time series dimension

- What to gain from including pre-1960 data?

→World Wars (to a lesser extent: Vietnam War 1960s, Franco-Prussian War 1870/1) as major deficit shocks in core countries

→Attempts to sustain debt/GDP ratios >>100% over extended periods

Method/Data: the time series dimension

- Essentially three observations
- Late 19th c: high debt sustained successfully

  UK : 300% in 1820 → 30% in 1913

  F: 100% in 1880 → 66% in 1913
- Interwar period: inflation and devaluation

  UK, F: ~180 % in 1920 → same in 1938
- Postwar period: delayed stabilization

  UK, F: ~180 % in 1950 → still high in 1971 → inflation

  D: ~3-400% in 1948 → 20% in 1953 → low inflation

Data

Deficit data back to 1880s

Pre-1914: Mitchell (not bad but can be improved)

Interwar: League of Nations (mostly central gov't)

- Masks increase in public sector overall, e.g. social security
- Data often incompletely reported (e.g. Germany)
- BUT: lots of recent research on most OECD counties

→ Upgrade database!

Conclusion: more praise

Paper makes serious effort to use historical evidence

Nice & plausible results, very well presented

Food for thought: selectivity & endogeneity issues

Data: great but there is more available

→ Nice paper!