Globalization and financial crisis

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Two questions

- Does globalization lead to more financial instability, and, if so, why?

- Do financial crises affect the path of globalization?

Globalization and crises

www.macrohistory.net/data

JORDÀ-SCHULARICK-TAYLOR MACROHISTORY DATABASE

The ***Jordà-Schularick-Taylor Macrohistory Database*** is the result of an extensive data collection effort over several years. In one place it brings together macroeconomic data that previously had been dispersed across a variety of sources. On this website we provide convenient no-cost open access under a license to the most extensive long-run macro-financial dataset to date. Commercial data providers are strictly forbidden to integrate all or parts of the dataset into their services or sell the data (see Terms of Use and Licence Terms below).

The database covers 17 advanced economies since 1870 on an annual basis. It comprises 25 real and nominal variables. Among these, there are time series that had been hitherto unavailable to researchers, among them financial variables such as bank credit to the non-financial private sector, mortgage lending and long-term house prices. The database captures the near-universe of advanced-country macroeconomic and asset price dynamics, covering on average over 90 percent of advanced-economy output and over 50 percent of world output.

Assembling the database, we relied on the input from colleagues, coauthors and doctoral students in many countries, and consulted a broad range of historical sources and various publications of statistical offices and central banks. For some countries we extended existing data series, for others we relied on recent data collection efforts by others. Yet in a non-negligible number of cases we had to go back to archival sources including documents from governments, central banks, and private banks. Typically, we combined information from various sources and spliced series to create long-run datasets spanning the entire 1870–2014 period for the first time. The table below lists the available series.

Download Data ▼	Documentation ▼	How to Cite ▼	Research ▼
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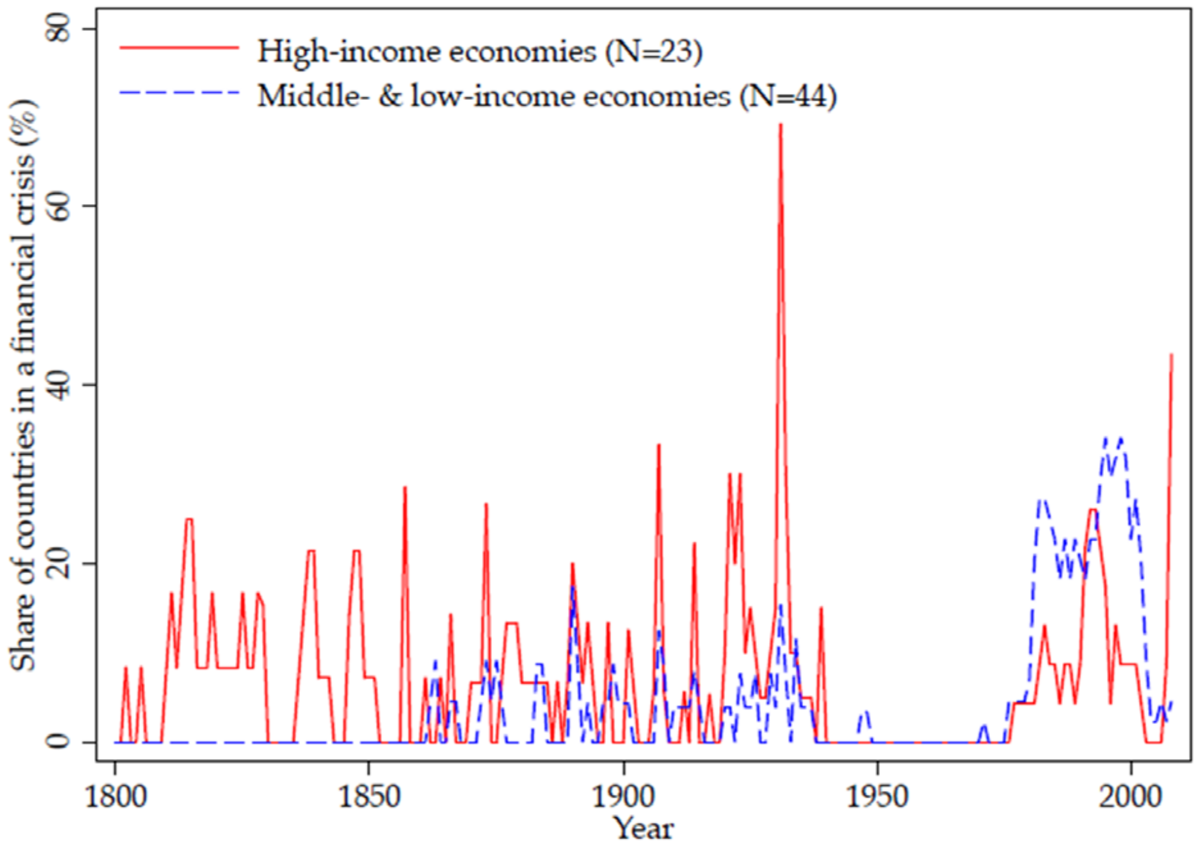
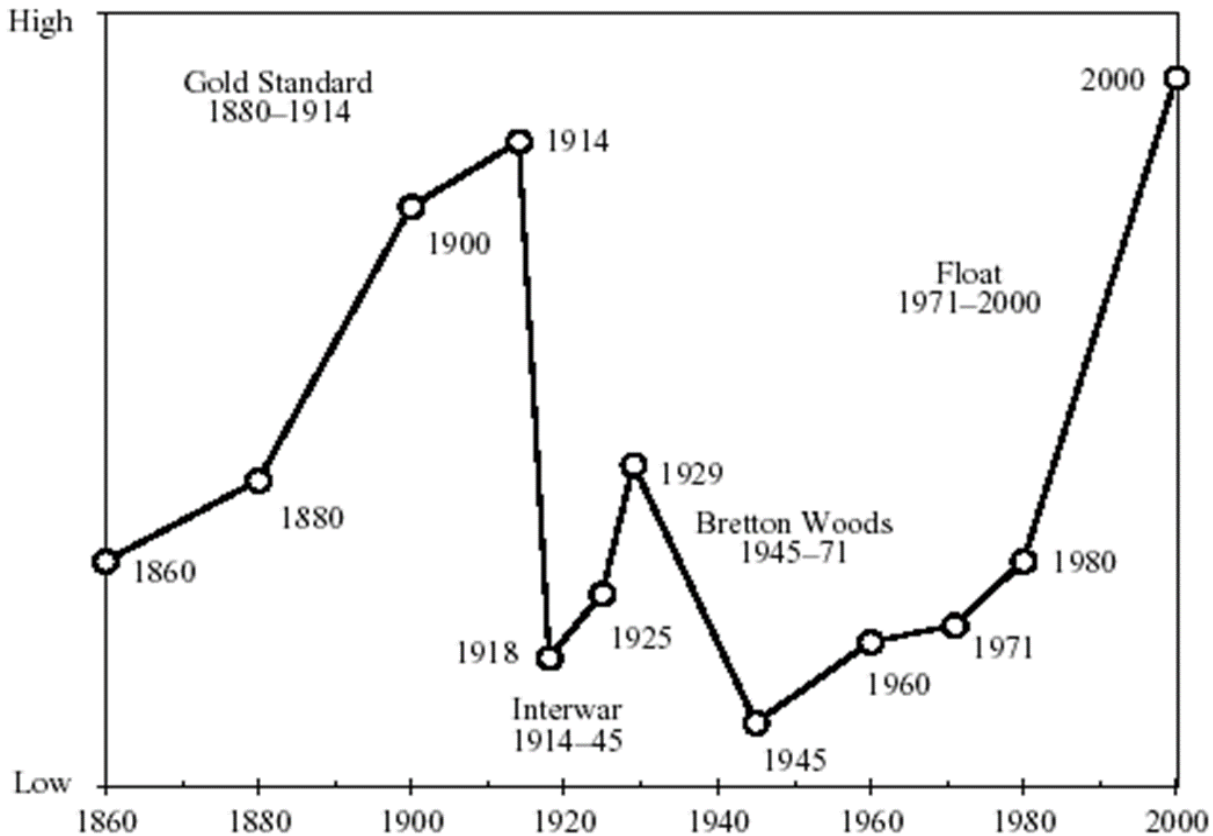
Financial crises



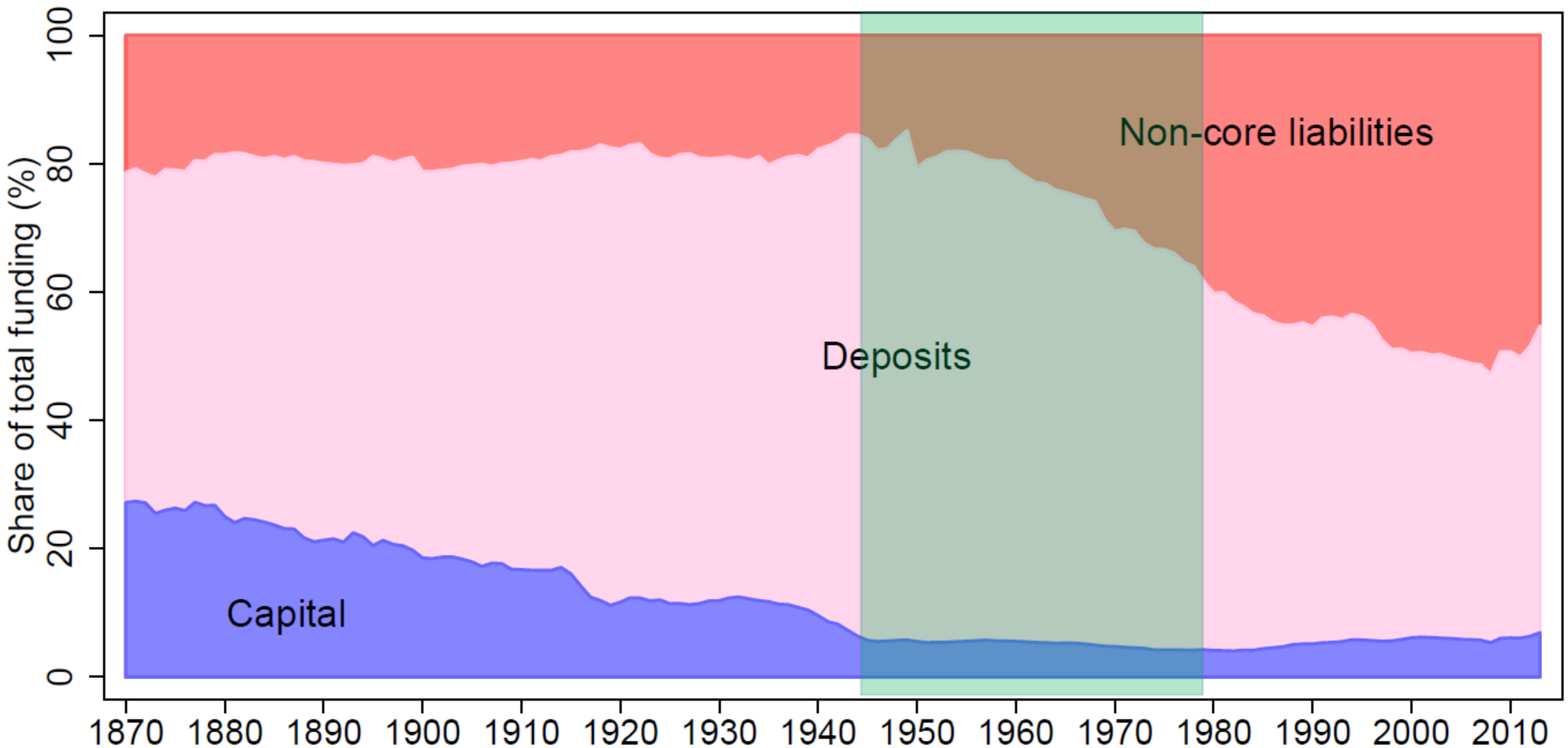
Sources: Reinhart and Rogoff 2009; Jorda, Schularick, and Taylor 2011.

Financial globalization



Source: Obstfeld and Taylor 2003

Bank capital and short term debt



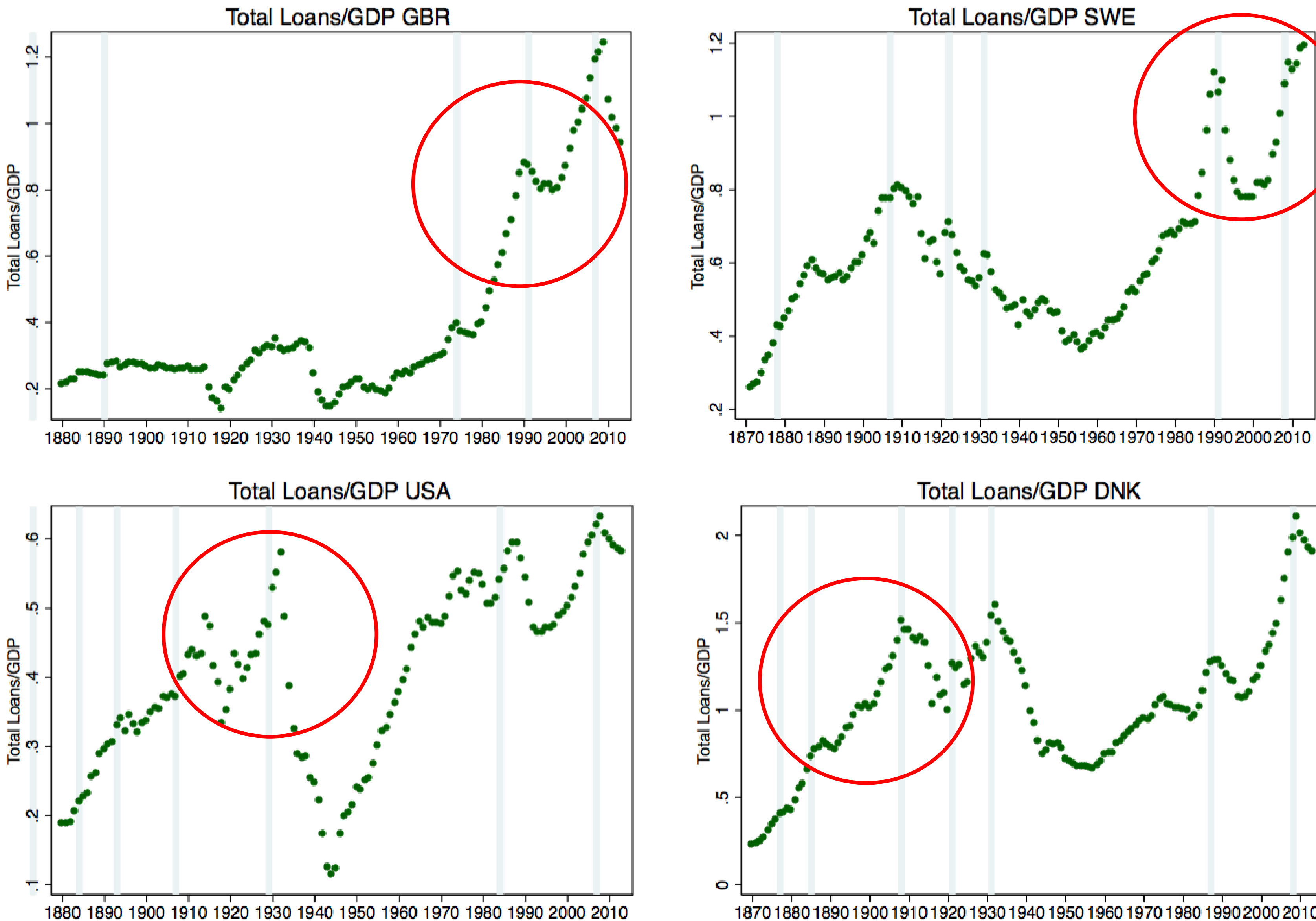
Liability structure of banking system in 17 advanced economies.
Source: Jorda et al 2017

The Holy Grail of Macrofinance

- Why do financial crises happen?

- For predictive purposes: credit booms
  - Best early warning is credit: Schularick/Taylor, AER, 2012
  - Evidence on current account deficits less compelling
  - Hint: borrowers and lenders get into trouble

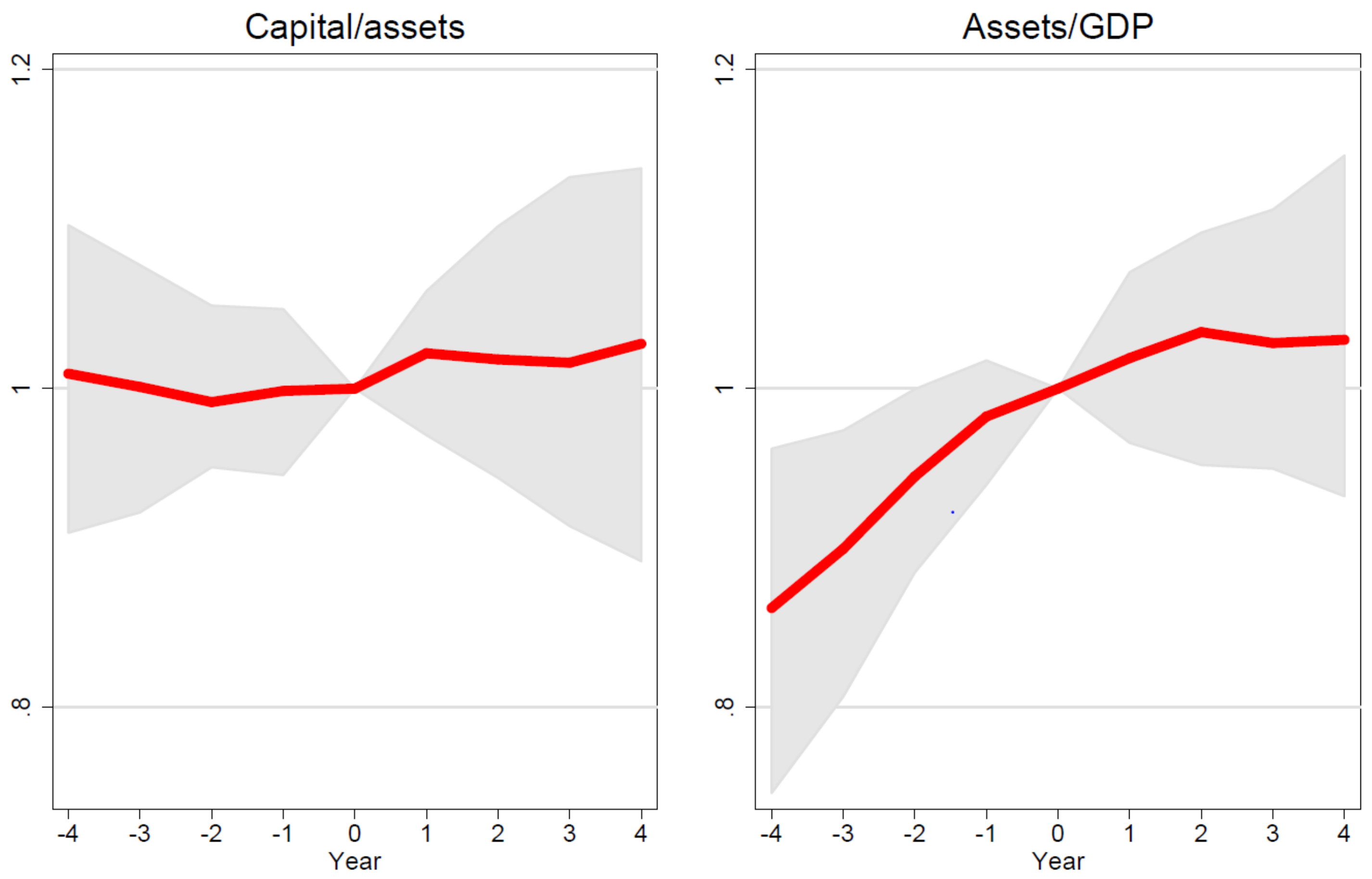
Crisis prediction



But what *causes* credit booms?

- The capital view: excessive risk taking by rational actors
  - Incentive and agency problems lead to excessive risk-taking of rational agents
  - Close correlation between “skin in the game” and financial stability
- Minsky-Kindleberger behavioral view
  - Crises are caused by spurts of credit-fueled mispricing of assets and their sudden repricing (e.g., Gennaioli, Shleifer, Vishny (2013); Baron and Xiong (2016))
  - Crises are orthogonal to bank capital. Everyone is caught in the same heuristic bubble.
  - If anything, liquidity matters when the mispricing is apparent.

Balance sheets around crises



Notes: This figure presents the path of balance sheet variables around financial crises (Jordà et al. 2016). The values of the respective variable are scaled to equal 1 in year 0. The solid line corresponds to the mean and the grey bands to the interquartile range.

So where does globalization fit in?

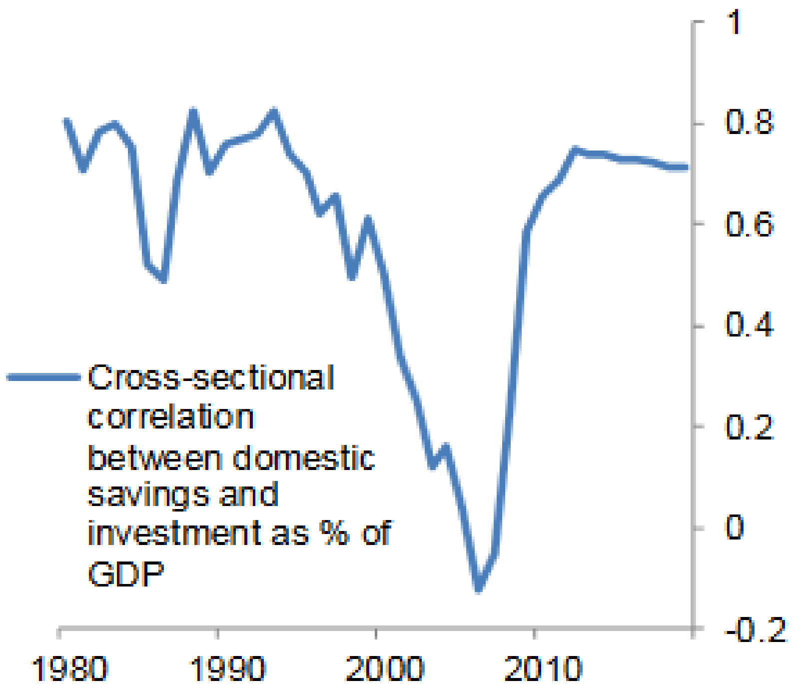
- International capital flows provide fuel for the fire of credit booms (cf. subprime, reserve accumulation)
- International lending booms can set domestic leverage cycles in motion
- Global financial intermediaries transmit and amplify crises

→ Some role for international factors in making economies more crisis-prone, esp. EM

→ Yet ultimate causes for financial instability likely to be found elsewhere (behavioral, etc)

Crises and globalization

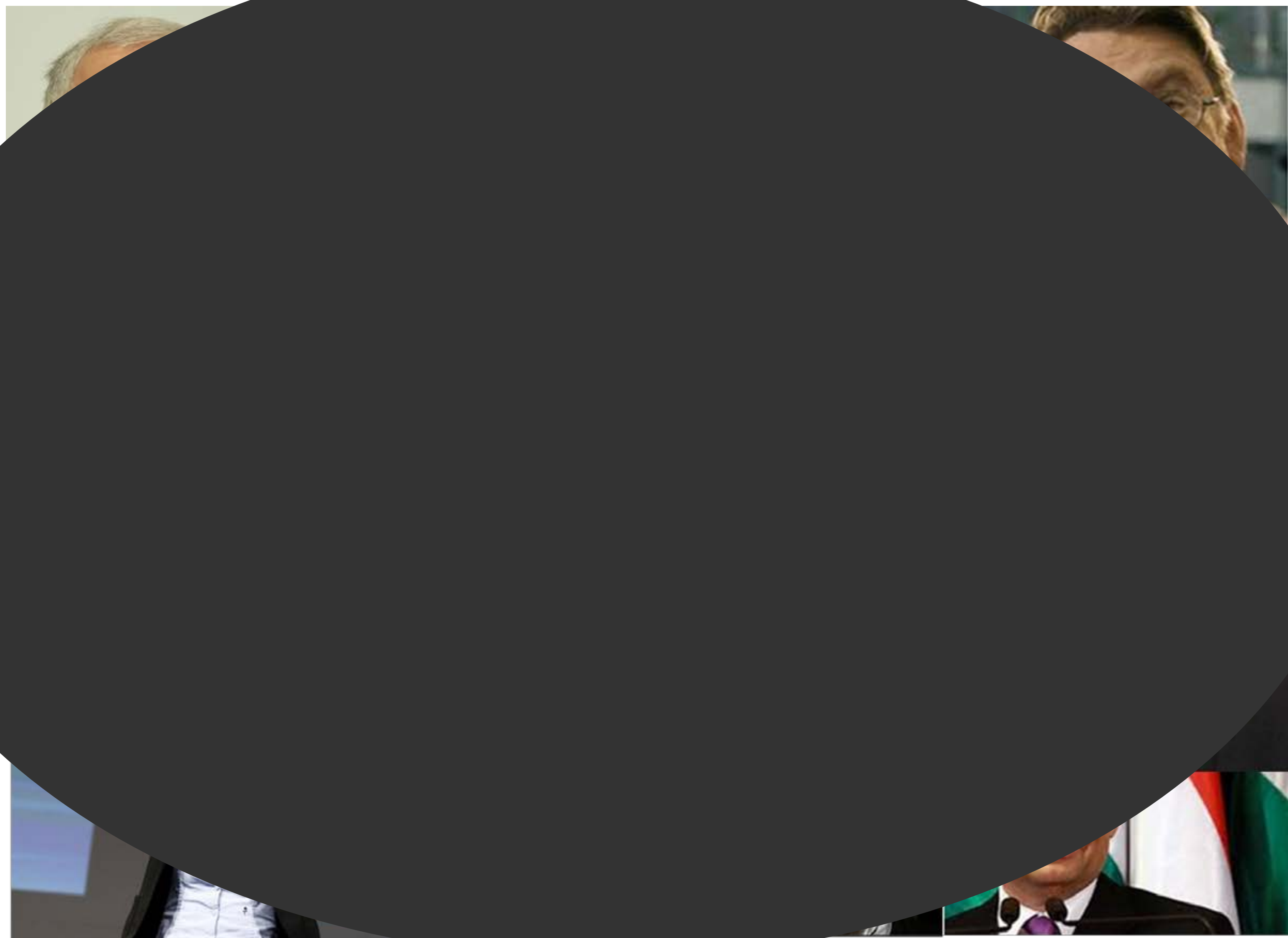
Capital market integration: back to the 1980s



Source: Bank of England

- Feldstein-Horioka test
- Correlation (β) between domestic saving and investment
- β could be zero in open capital market

Political after [redacted]



[redacted]

Goodbye financial crisis, hello political crash

European Economic Review ∎ (∎∎∎∎) ∎∎∎–∎∎∎

Contents lists available at ScienceDirect

European Economic Review

journal homepage: www.elsevier.com/locate/eer

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Going to extremes: Politics after financial crises, 1870–2014

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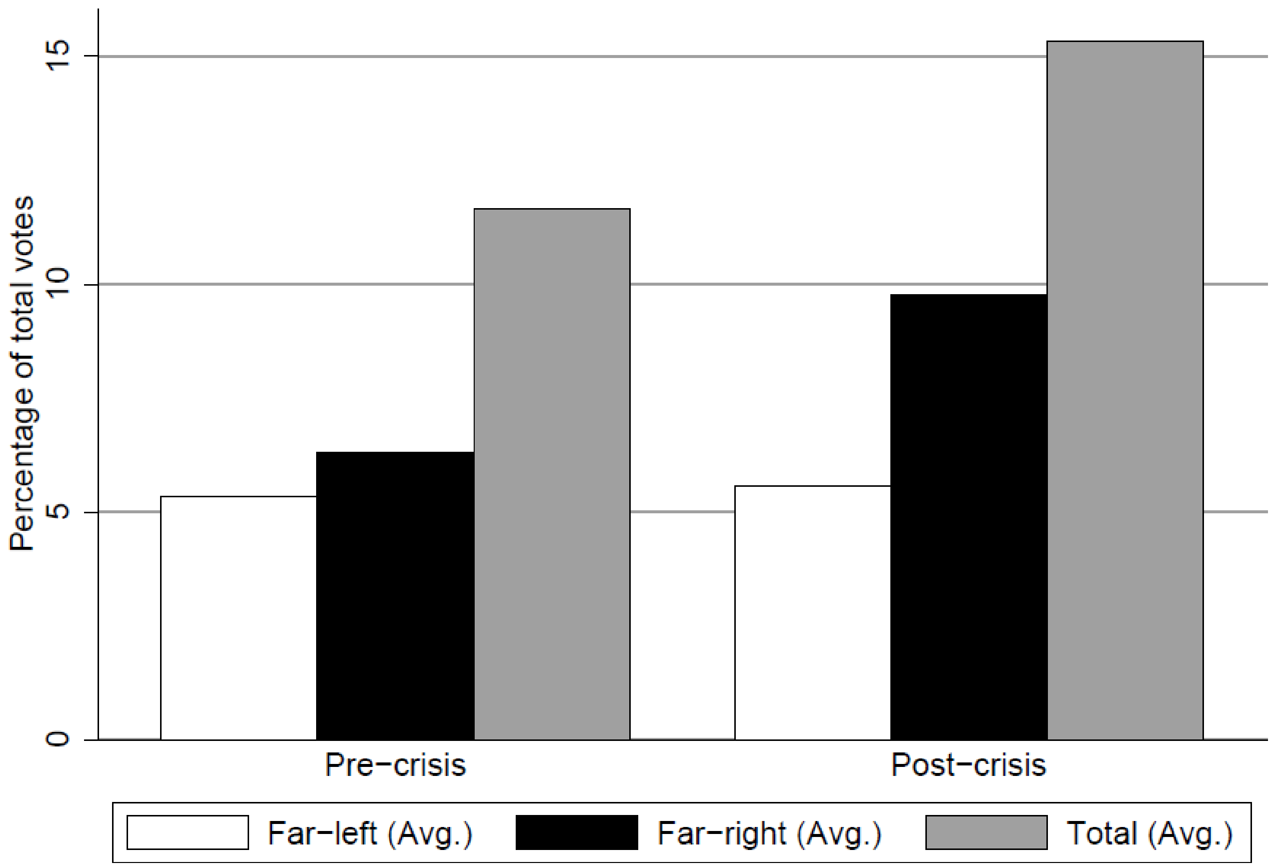
Post-crisis politics

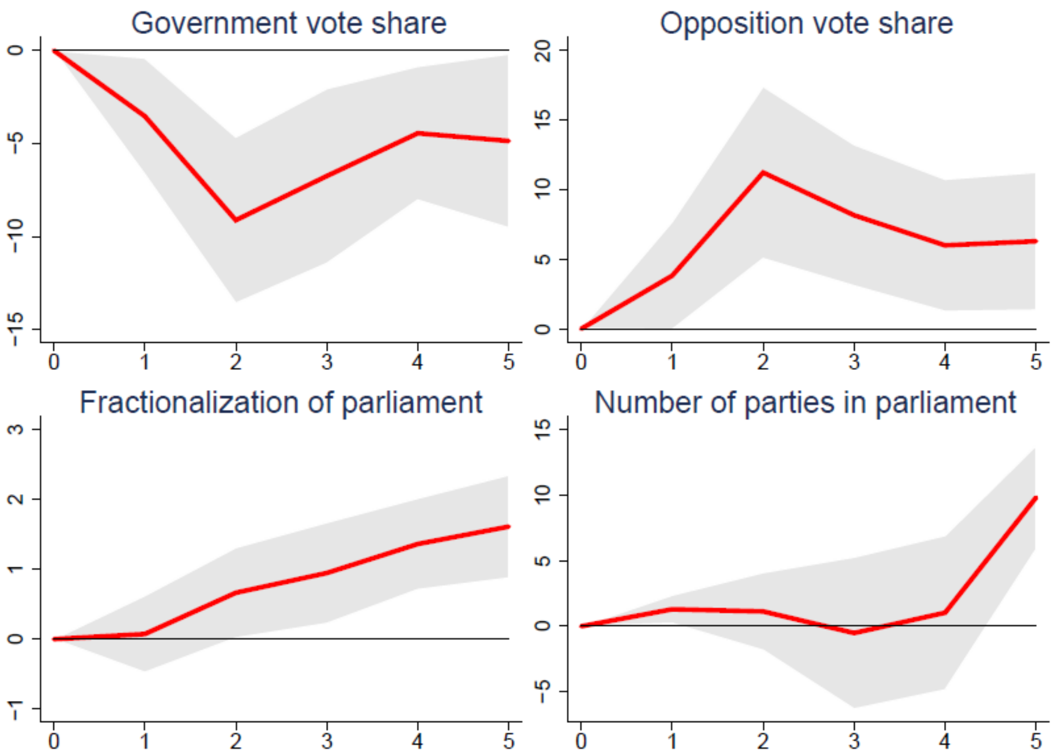
- How does the political landscape change after financial crises?
- We coded a new large dataset covering 800 general election results in 20 countries since 1870
- We then quantified the political after-effects of more than 100 systemic financial crises

Tragedy of the left



Source: Funke, Schularick, and Trebesch (2016)

Political polarization after crises



Notes: Each path shows local projections of the cumulative change in 100 times the logged variable relative to peak for years 1-5 of the recession/recovery period. The red line refers to the average path in financial crisis recessions and the shaded region is a 90% confidence interval. The controls are contemporaneous and 1-year lagged values of the growth rate of real GDP per capita and the CPI inflation rate at peak. Post-WWII sample: 1950-2014.

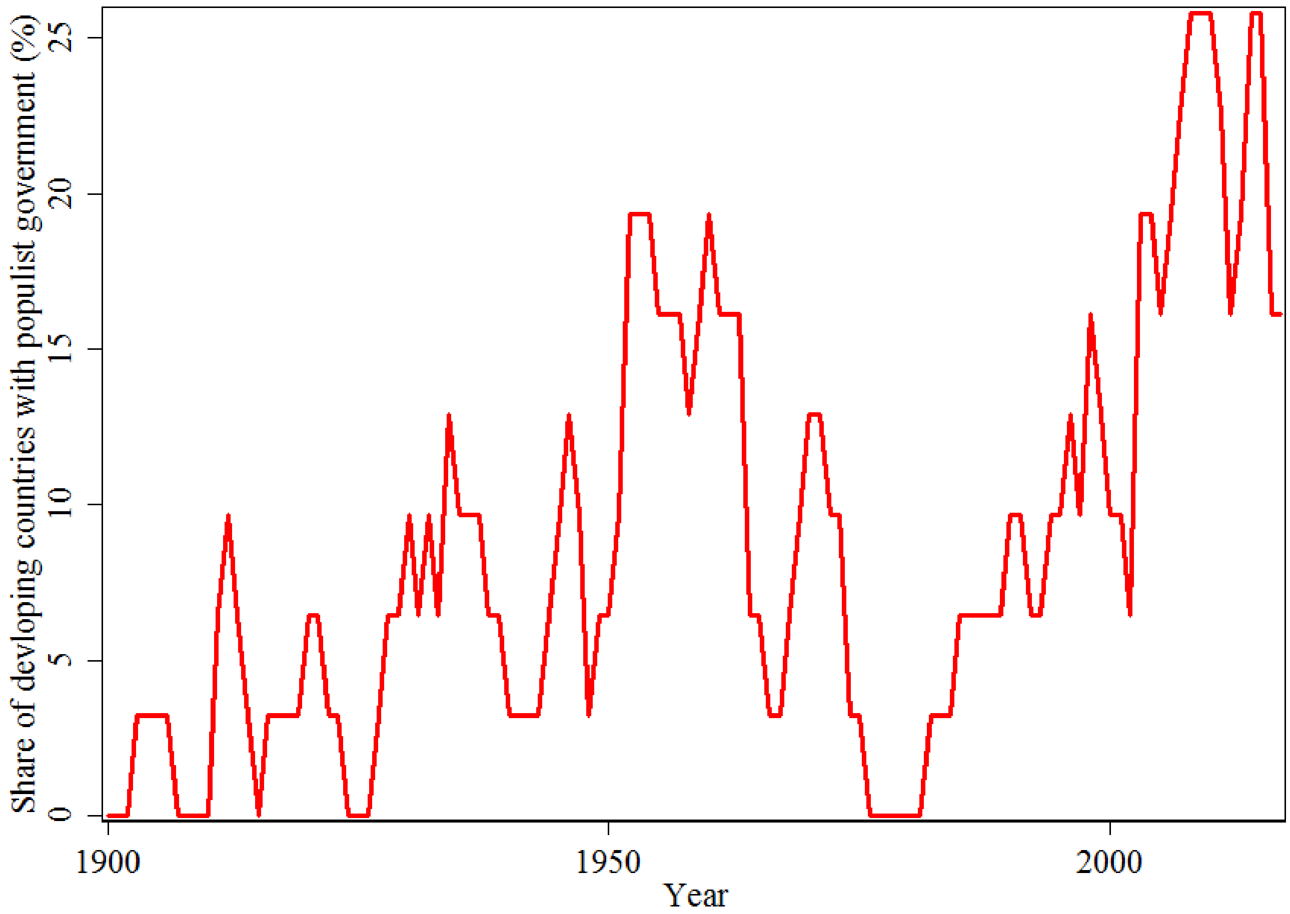
Political aftermath of crises

- Crises and disappointment with elites gives rise to populism and political polarization

- Hard right turns
  - The political far right is the biggest beneficiary from financial crises
  - Rise of nationalism and rightwing populism typical: effective in blaming other groups
  - Governance becomes harder when it matters most

- The effects are specific to the aftermath of financial crises
  - Not observable in either normal recessions or non-financial macro-disasters

Populist backlash

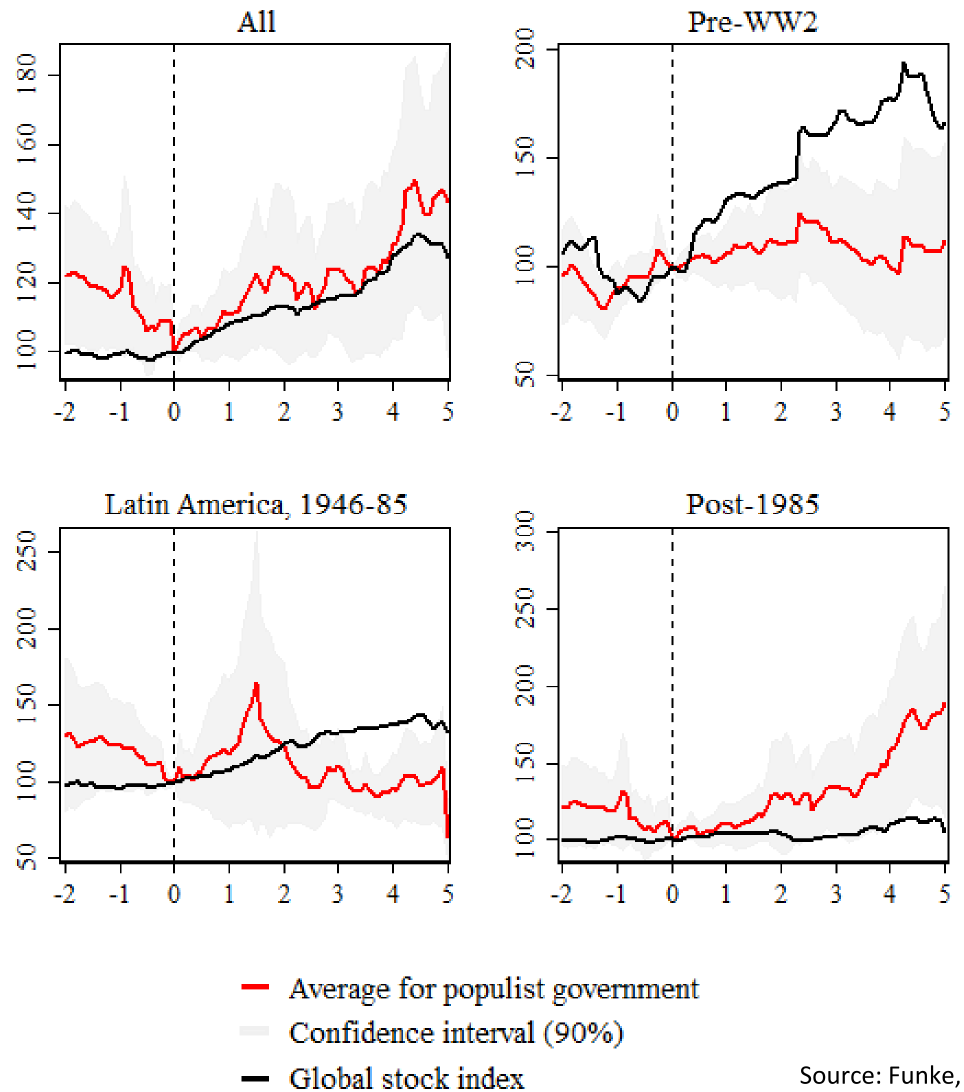


Source: Funke, Schularick, Trebesch 2017

Populists in power

- How do financial markets react to populist takeovers?
- What do populists do in power?
- In Funke et al (2017) we study virtually all episodes of populist governments in the past 100 years
- We show that – against conventional wisdom – financial markets often embrace populist agendas
  - Stock markets often rally, the ‘Trump trade’ is no exception
  - Don't bank on financial markets to keep populism in check: there is no market disciplining.

Financial markets and populists



Source: Funke, Schularick, and Trebesch (2017)

Why do markets like populists?

The economic record is often not a disaster, sometimes the policies work

- Economy recovers after crises, populists catch the upswing

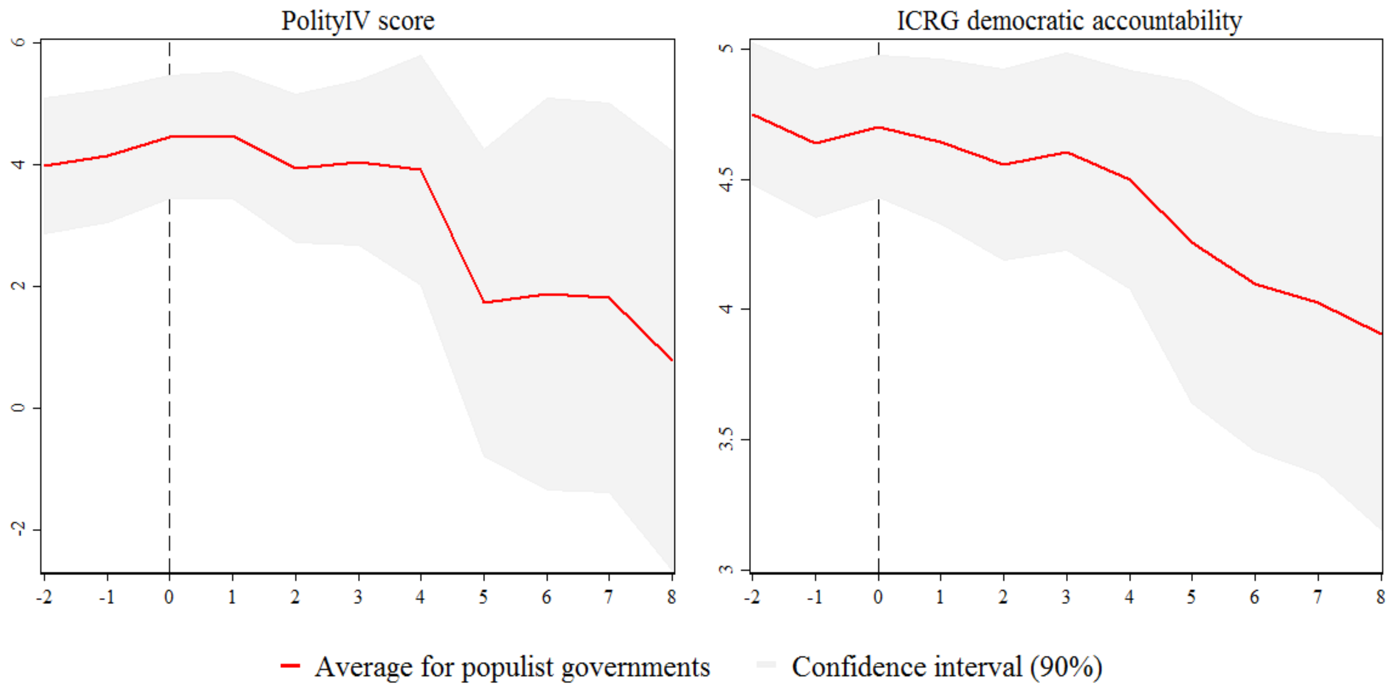
Populist policies a boon for earnings of national companies

- Devaluations increase profitability in local currency
- Public spending boosts demand
- Protectionism reduces competition

Populists often get into power in times of intense distributional struggles.

- Right wing populist minimize taxation of "capitalists“ so that business confidence gets a boost

Democracy is the main victim



The figure shows the average level (red lines, y-axes) of the PolityIV score (left panel), the ICRG "democratic accountability" risk rating (right panel). PolityIV ranges from -10 (full autocracy) to +10 (full democracy). ICRG "democratic accountability" ranges from highest risk in autocracies (0 points) to lowest risk in alternating democracies (+6 points). PolityIV covers 1870-2015 and ICRG 1984-2017. The shaded area is a 90% confidence interval. Year -2 to +8 relative to the populist takeover are shown. Entry and exit dates of leaders come from the Archigos database.

Source: Funke, Schularick, and Trebesch (2017)

Conclusions

The liberal view of globalization

“It may be said without exaggeration that the (…) increase of international trade (…) is the great permanent security for uninterrupted progress.”

John Stuart Mill, Principles of Political Economy, 1848

The realist view

Globalization always contains the seeds of its own destruction:

1) It polarizes the income distribution within countries.

2) It leads to the rise of new antagonistic powers.

3) It brings contagious financial instability.

Globalization and crisis

- Back to the questions from the beginning about globalization and crisis: a two-way street
- Globalization can spread financial contagion and magnify financial vulnerabilities
- Crises and their after-effects can trigger political turns that threaten an open international order
- This second channel clearly vey present today