Cecchetti, King and Yetman, “Weathering the Financial Crisis: Good Policy or Good Luck?”

Comments by Richard Berner, Morgan Stanley

Steve Cecchetti, Michael King and James Yetman in this paper try to answer important questions about the differential impact of the global financial crisis on macroeconomic performance across 46 countries. Did prudent design of pre-crisis policy and financial structure help the outperformers weather the storm better? Or were better outcomes simply a case of luck, with outperformers being less exposed to the factors causing the crisis than others?

I commend the authors for their imaginative use of data to begin answering these questions. Using principal components, nonparametric statistics and exhaustive regressions to extract signals from noisy data, they are able to arrive at some significant conclusions.

Their answers are comforting in some respects because they confirm that certain aspects of sound policy and structure matter: Outperformers possessed better-capitalized banking sectors, current account surpluses, and a central bank with sole responsibility for banking supervision. According to the authors, luck also played a role, in that financially closed economies did better.

However, their answers are not so comforting in two respects.

The first discomfort relates to omissions, and thus some of the conclusions and their policy implications: Securitization and more specifically leverage in nonbank financial institutions are omitted from their analysis. The authors do not explore the tradeoffs between the benefits that accrue from financial openness in a global financial marketplace and financial stability Although the authors find that the size of government matters, sovereign debt seems to be unimportant. With most of the euro area economies included in the sample, perhaps a second look inform the connections between sovereign debt and financial crises. This last issue is the subject of the next panel.

The second discomfort relates to conclusions derived from the statistical results. It is always difficult to distinguish causation from correlation. But the finding that countries whose central bank is the sole banking supervisor fared better may be misleading. Many such economies are those of smaller, less developed, countries. That they outperformed in the crisis may have more to do with the simplicity of their economic and financial structure than with the institutional nature of bank supervision. Also, the imprecision of the supervisory variable undermines the strength of the statistical findings. For example, the Fed is not the sole US banking supervisor. In any case, I suspect that more precise measures of the strength of the supervisory infrastructure could provide more robust results.

In addition, difficulties in measurement and limited degrees of freedom dilute some of the conclusions. For example, many believe that EM economies weathered the recent storms well owing to a combination of structural reforms, improved policy management, and high levels of FX reserves (rather than the flow of current account surpluses), all of which insured against capital flight. Indeed, the authors show the importance of FX reserves in the univariate tests, but these reserves drop out in multivariate regressions.

In fairness, the authors point out that accurately measuring the impact of the crisis would require a crisis-free counterfactual, which is impossible to construct. That would require a model in which default, leverage, financial frictions, and both banks and "shadow banks" play an essential role. Such models don't exist, or at least they did not a few years ago, and while recent efforts to remedy these analytical shortcomings are bearing some fruit, it is still early days.[1]

Neither the lack of a formal model nor the use of informal tools to analyze data is a fatal shortcoming; far from it. But comparing crises across time as well as space might strengthen the results.

Three examples illustrate the point. Ken Rogoff and Carmen and Vincent Reinhart provide enormous insight into the nature, causes and implications for policy of financial crises by finding and describing systematic patterns in economic and financial data from past episodes.[2] Pierre-Olivier Gourinchas and Maury Obstfeld use econometrics to tease out common factors in past EM and DM financial crises.[3] They find that emerging and advanced economy financial crises over the past century have been qualitatively similar because they arise from booms in credit and leverage. Emerging economies displayed surprising resilience in 2007-2009 primarily because they generally avoided a credit boom and pursued more stable monetary and fiscal policies. Oscar Jorda, Moritz Schularick and Alan Taylor looked across 140 years of crises to trace the connections between global imbalances and credit booms.[4] They find that external imbalances magnify the instability arising from credit booms, and that abnormally low natural short-term interest rates (measured by the gap between rates and real growth) contributed to crises. The common thread in all three cases is that the authors provide both cross-country and historical context for their conclusions, finding common themes in varying circumstances.

---

[1] See for example, Charles A.E. Goodhart, Dimitrios P. Tsomocos and Alexandros.P. Vardoulakis, Modelling a Housing and Mortgage Crisis, in *Financial Stability, Monetary Policy and Central Banking*. Edited by C. Echeverria, R. Fuentes and D. Gray, Series in on Central Banking, Analysis and Economic Policies. Central Bank of Chile, forthcoming.

[2] Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009, and Carmen M. Reinhart and Vincent R. Reinhart, "After the Fall," at the Federal Reserve Bank of Kansas City Economic Policy Symposium, Jackson Hole, Wyo., Aug. 26 – 28, 2010.

[3] Pierre-Olivier Gourinchas and Maurice Obstfeld, "Stories of the Twentieth Century for the Twenty-First," prepared for the American Economic Journal: Macroeconomics session on Financial Crises and Macroeconomics at the American Economic Association annual meeting, Denver, CO, January 8, 2011.

[4] Oscar Jorda, Moritz Schularick and Alan Taylor, "Financial Crises, Credit Booms, and External Imbalances: 140 Years of Lessons," NBER Working Paper 16567, December 2010.

Comparing these three studies offers an important research agenda for the future. Here are four suggestions:

First, I think the conclusions derived in this paper would be more robust if the authors could expand their data set historically to verify whether the results were replicated in other periods of financial crisis.

Second, in the BIS tradition, the authors find that the ratio of private credit to GDP is a significant determinant of performance. I would suggest that they also look at the asset side of balance sheets, especially asset price booms, as causal factors in financial instability.

Third, and related, the authors might try to answer a series of questions arising from the crisis: Did countries with bank-centric financial systems, holding other factors the same, fare better than those in which capital markets/securitization play a bigger role? Can the authors expand the definition of “better capitalized banking system” to examine whether, controlling for other factors, the quality or composition of capital made a significant difference? Other things equal, do systems reliant on wholesale funding fare worse than those more dependent on retail deposits? Holding other factors constant, do external imbalances and saving gluts set the stage for financial crises? What is the role of monetary policy in contributing to credit booms?

Fourth, is big also beautiful? Some large economies may have done better in the crisis than smaller ones because they were shielded from the crash in global trade. And taking account of other factors (i.e., in multivariate analysis), how important are big FX reserve war chests in providing a buffer against externally generated financial shocks?

The authors have started to answer these important questions, but there is much more to be done. Getting the answers right is crucial in order to develop policies that balance the benefits of a free and open global financial system with those of financial stability.