Comments on Paper 1

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Professors Bordo and Lane have provided us with a sweeping analysis of the incidence and severity of global financial crises from 1880 to 2009. The analysis follows recent literature in distinguishing between three different types of financial crises: Banking crisis, currency crisis, and debt crisis. Their analysis builds on Anna Schwartz's (1986) observation that the essence of a financial crisis is a banking crisis. Banking crises have, however, changed appreciably over time. Prior to 1914, a banking crises typically occurred in a country without a lender of last resort; such a crisis could encompass banks that were solvent but temporarily illiquid. After 1914, the presence of a lender of last resort—the Federal Reserve System in the United States—or deposit meant that banks facing a liquidity crisis would receive assistance, whereas insolvent banks would not. Comparison of financial crises before and 1914 must, by their very nature, be looked upon skeptically due to the very different nature of banking crises in the two periods.

The authors identify global crises by searching for clusters of the three different types of financial crises in the country data. Country observations are weighted by the country's per capita GDP relative to U.S. GDP. "This weighted count thus reflects the relative importance of the country (in terms of its size) when deciding whether a cluster of banking crises constitutes a global financial crisis" (p. 11). This procedure clearly place more weight on observations of rich compared to poor countries but it also places the same weights on countries of vastly different size with similar per capita incomes, e.g., Sweden and the United States. Weighting by overall country GDP is also problematic, as this would entail assigning the same weight to a country with a large population and a low per capita GDP as a country with a small population and a high per capita GDP. Conducting additional tests to ensure that the paper's results are robust to changes in the method for weighting country observations would help to ensure robustness of results.

The values of each of the three aggregate crisis indexes vary substantially over time. The data on aggregate bank crises (Figure 1 in Bordo) is particularly interesting, as the value for the

2008/2009 period is clearly an outlier compared to the frequency patterns observed during the 1970-2005 period. While there is a notable increase in the value of the bank crisis index after 1970, the value of the 1982/1983 bank crisis index just exceeds the definition of a global banking crisis (the sum of the world crises must exceed a value equal to 5 US crises). Moreover, the value of the bank crisis index does not appear to be trending upwards over the 1970-2005 period. The outlier of 2008/2009 again stands out.

Bordo and Lane's conclusion that the output effects of the recent global financial crisis were relatively small because leaders of the major countries affected by the crisis took aggressive fiscal and monetary actions to stimulate their economies is clearly correct. It is, however, quite troubling to compare the foundations of the 1929-1933 Great Depression and the 2008-2009 Global Financial Crisis, as it is not clear that today's citizens and policymakers understood the nexus of their most critical problems any better than the policymakers in the 1920s did. The 1920s literature on the gold standard does not provide us with much confidence that economists, let alone policymakers, understood how the gold standard would work if its rules were violated by leading countries (Eichengreen), how gold reserve requirements might affect policies of central banks (Eichengreen), or how overlapping wage contracts might propagate monetary shocks from the United States to other countries with fixed exchange rates (Bordo). Similarly, it is absolutely clear that most of today's policymakers, citizens, and economists had no better understanding of how collateralized securities backed by subprime loan would ultimately bring down some of the world's oldest investment banks and largest commercial banks in the United States.

Perhaps there will always be a lack of understanding of aspects of economic institutions that were little used until called upon by a crisis. Markets exchange often involves specification of a complex bundle of rights and obligations that are sometimes not fully understood by both parties until one party moves to exercise an option or the other fails to meet an obligation. The role of the U.S. and European housing markets in providing dry kindling for the sub-prime debacle is more troubling. It's not the first time that expansionary monetary policy has resulted in a prolonged period of relatively low interest rates that lead to an asset boom