

The Long Run View: Macroeconomic History

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Introduction

Economic history is back en vogue, and rightly so. For Joseph Schumpeter, probably the most famous economist who taught in Bonn, the importance of economic history was obvious. Schumpeter had no doubt that economic history formed part of the canon that a good economist had to master. In his *History of Economic Analysis*, he put it this way: "What distinguishes the 'scientific' economist from all the other people who think, talk, and write about economic topics is a command of techniques that we class under three heads: history, statistics, and theory."¹ Today, roughly 60 years after Schumpeter's book, it is often the practitioners of economics at international institutions and central banks – people who have to make critical economic decisions at times when the uncertainty about the 'right' model runs high – who stress the importance of economic history and bemoan the absence of historical training in many universities. Take Stanley Fischer, the former Governor of the Central Bank of Israel and previous Chief Economist of the World Bank and Deputy Managing Director of the International

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¹ Schumpeter, 1954 p. 12. A paragraph later, he even added that "of these fundamental fields, economic history – which issues into and includes present day facts – is by far the most important."

Monetary Fund. Looking back at his long and successful career in public office he summarized candidly: "I think I've learned as much from studying the history of central banking as I have from knowing the theory of central banking and I advise all of you who want to be central bankers to read the history books."² Or take Randy Kroszner, a former Fed Governor and professor at the University of Chicago, who took part in the critical meetings of the Federal Reserve Board at the height of the global financial crisis. He reports back from these meetings that an economic history book – Milton Friedman's and Anna Schwartz' "Monetary History of the United States" – was "the single most important piece of economic research that provided guidance to Federal Reserve Board members during the crisis" (Kroszner, 2010).

With the benefit of hindsight, it seems all too obvious that eschewing Schumpeter's original advice and, by and large, purging undergraduate and graduate education in economics from economic history was a mistake that is now slowly being reversed. The complacency with which much of modern macroeconomics treated economic stability during the so-called *Great Moderation* as the normal state of affairs might have arguably been avoided. Kevin O'Rourke recently suggested that a better historical training would have forced the discipline to acknowledge that big breaks and discontinuities in the economic process have occurred frequently in the past, and may happen again: "Zoom out, and that swan may not seem so black after all." (O'Rourke, 2013)

This brings us to the reasons why economic history is back in fashion. I see two. First, economic history and economic historians have changed. Economic historians today study history to help build better economics; the discipline is no longer just about using economics to write better history. Second, economics itself has changed. The global financial crisis has led to some critical introspection and a

² Cited in O'Rourke (2013)

greater willingness to take the evidence from economic history on board. This is particularly true in the fields of macroeconomics and financial economics where the crisis exposed a number of, say, blind spots that made business as usual difficult. In this sense – and borrowing from Schumpeter’s rich oeuvre one last time – one could say that crises are not only “a good, cold douche for capitalism”, but the recent crisis was also a refreshing shower for the discipline of macroeconomics. In this paper, I want to present two examples that illustrate why and how economic history can play a useful role for better macroeconomic thinking. Relying on recent research in the field of long run macro-financial history, including my own, the aim is to highlight why economists in particular should take the long run view from economic history seriously. As the astute reader will quickly see, both examples also speak at least indirectly to the crisis in the Eurozone. For, even in the case of the Eurozone crisis – arguably an event that is closely linked to the specific institutional structure of the European Monetary Union – some of the problems do not seem quite as unique if viewed from a historical perspective.

Global Financial Cycles

“We, Gregor 1st, sovereign Prince of the State of Poyais, to his most gracious majesty George IV” – thus opened the proclamation that appointed the new Chargé d’Affaires of the State of Poyais to the United Kingdom in the year 1823. The proclamation was written by no other than Gregor MacGregor, alongside Charles Ponzi one of the most famous fraudsters in financial history. MacGregor ambitiously invented an entire country, called Poyais, for which he then raised loans from investors in the London bond market in the 1820s.³

The fraud was professionally planned. MacGregor catered shrewdly to the commercial instincts of English investors. A 350-page guidebook described the Cen-

³ Sinclair (2004).

tral American territory in great detail, marveling at its natural riches, its open and friendly people and explaining convincingly why and how it managed to escape from Spanish domination despite its geographic position between Honduras and Nicaragua. A British naval officer with good knowledge of the region and apparently impeccable reputation confirmed that the territory "is excelled by no other under the influence of the British dominion."⁴ In audacious fashion, the fake guidebook left no doubt that an investment in Poyais was a once in a lifetime opportunity for those investors who were smart enough to connect the dots and think quickly on their feet to make the right investment decision. The investment case was clearly borne out by economic considerations and well supported by statistical evidence:

It has been computed that, even in the uncivilized state of the country, and independent of the native consumption, manufactured goods to the value of upwards of fifty thousand pounds pass annually into the Spanish American provinces through this territory alone, yielding, under every disadvantageous contingency, a very large profit to the adventurers; and there is no doubt that this trade, protected by a wise and liberal policy on the part of the Government of Poyais, may be carried to an extent, much beyond any calculation which can at present be formed, and it will amply remunerate those who may become interested.⁵

The end of the story was that in 1822, Gregor MacGregor actually managed to raise 200,000 pounds in the London market for his country of Poyais. In today's money, this is equivalent to about 300 Million Euros.⁶ The swindle became apparent when hopeful settlers arrived on two ships in the Bay of Honduras and found out that neither the country nor its port of St. Joseph actually existed. These were the very first days of an organized market for overseas lending in London. British investors clearly lacked sound information to distinguish good

⁴ Cited in Sinclair (2004, p. 6) .

⁵ Cited in Sinclair (2004, p. 7).

⁶ See <http://www.measuringworth.com/>

risks from bad at the time. Otherwise, nobody would have bought the Poyais bond issue. But the same lack of knowledge did not prevent investors from buying when others did. The 1820s was a decade of abundant, risk-laden appetite for investment in emerging markets. The mood of the market in the 1820s was so exuberant that MacGregor's fictitious country could borrow at virtually the same interest rate as legitimate issuers such as Chile and Peru. The voraciousness of the London market was described as follows by the *Annual Register*:

All the gambling propensities of human nature were constantly solicited into action and crowds of individuals of every description . . . hastened to venture some portion of their property in schemes of which scarcely anything was known except the name.⁷

What the Poyais episode demonstrated was that in phases of market optimism, virtually any country – even a fictitious one – could borrow at relatively cheap interest rates. Such boom phases of foreign lending, when the "risk appetite" of international investors is very healthy, have been a common feature of international financial markets throughout modern economic history. When times are good and optimism runs high, the market is wide open even to high-risk borrowers. In bad times, good borrowers too may find it hard or even impossible to raise funds in the market. From the 1820s, to the post-WWI imbalances of the 1920s, the Asian crisis in the late 1990s, global imbalances in the 2000s and the recent experience of the Eurozone – the list of such boom and bust episodes in capital flows in modern economic history is long. In the 19th century alone, there were no less than four big waves of capital flows to developing countries – and each of them ended in financial crises and government bankruptcies in at least a handful of countries. Arguably the largest boom and bust episode in the 20th century occurred in the 1920s – and ended in the Great Depression. Back then, Germany was on the recipient end of international capital flows and, by 1935,

⁷ Cited in Marichal (1989, p. 24).

99% of foreign bonds issued by German borrowers in the 1920s were in default. Carmen and Vincent Reinhart and Kenneth Rogoff have recently told the story of these boom and bust in various papers and in a best-selling book "This Time is Different." (written by Carmen Reinhart and Kenneth Rogoff).⁸ Based on meticulous historical work, they documented the historical regularity with which financial crises occurred and how banking crises and sovereign debt problems have often been closely linked. Some of the salient features of the Eurozone crisis have indeed striking historical precedents. Many of the historical episodes follow a relatively simple pattern that sounds all too familiar to European observers: asset prices in the countries at the receiving end of capital flows typically appreciate during the inflow boom and the real economy often grows briskly, supporting the original investment thesis by embellishing the underlying fundamentals. Yet economic fortunes change quickly when the inflows dry up. Now the positive feedback between financial flows and the real economy goes into reverse gear. The probability of default, banking crises or currency crashes is significantly higher in the wake of a capital inflow boom, in particular in emerging markets.⁹ Reinhart and Rogoff blame this repeated short-sightedness of investors on what they call the "this-time-is-different-syndrome." From the outside it would seem that investors are making the same mistakes over and over again and are not learning from past mistakes. Yet, as Reinhart and Rogoff point out, a narrative routinely develops in the market in boom times why the lessons of past boom and bust episodes do not apply in the specific case. In other words, investors convince themselves that the standard valuation metrics do not apply and that this time things are different: because dot.com stocks and the internet are different; because China is different; because the American housing market is different, etc. Eventually, economic logic and common sense catch-up with the market euphoria

⁸ Reinhart and Rogoff (2009).

⁹ See Reinhart and Reinhart (2008).

and the boom deflates.

It is a popular idea among economists that a key cause of the Eurozone crisis was the presence of moral hazard, i.e., an expectation of financial market participants that governments or the European Central Bank would ride to their rescue in a crisis. That the Eurozone crisis shares some features with the much older and regular economic phenomenon of capital flow bonanzas does not invalidate the moral hazard argument. But students of financial history and historically trained policymakers know that the risk of losing one's own money does not necessarily make the mood swings of financial markets less capricious. We do not yet understand the undercurrents of such waves of optimism and pessimism in markets very well. But the recent work of Reinhart and Rogoff demonstrates that cycles of overoptimistic lending and borrowing are part and parcel of the operation of international financial markets – and taking this historical evidence seriously might eventually help to build better economic models and design better policies. One recent example is provided by the work of H el ene Rey who, in a much debated contribution to the annual Jackson Hole conference, argued that economists have to rethink the so-called 'trilemma' or 'impossible trinity' – a central tenet of international macroeconomics. While the standard view is that under conditions of capital mobility, floating exchange rates provide room for independent monetary policy, Rey (2013) argues, partly on the basis of the historical evidence, that there is much less autonomy than commonly thought. This is because co-movements in capital flows, credit growth and asset prices – global financial cycles – effectively overwhelm the insulation provided by flexible exchange rates. In this view the trilemma is in fact a dilemma and only by managing the capital account can countries pursue monetary policies independent of financial conditions in international financial markets.

Public and Private Debt

Hardly any other topic is currently as voraciously debated in the media on both sides of the Atlantic as the issue of public debt. Two opinions in particular can be encountered frequently in the media. The first is that public debt has climbed to dangerously high levels and its reduction should be a key concern of policy; the second is that reckless public borrowing is closely linked to financial crises, as evidenced by recent events in the Eurozone. It's not hard to see the background of these concerns. A simple lesson that the wider public took from the financial crisis is that high debt harbors risks. This lesson holds for foreclosed homeowners in Florida as well as for governments in Southern Europe. When circumstances suddenly change, and they sometimes do in history, levels of indebtedness that seemed perfectly fine before may turn out to be highly problematic.

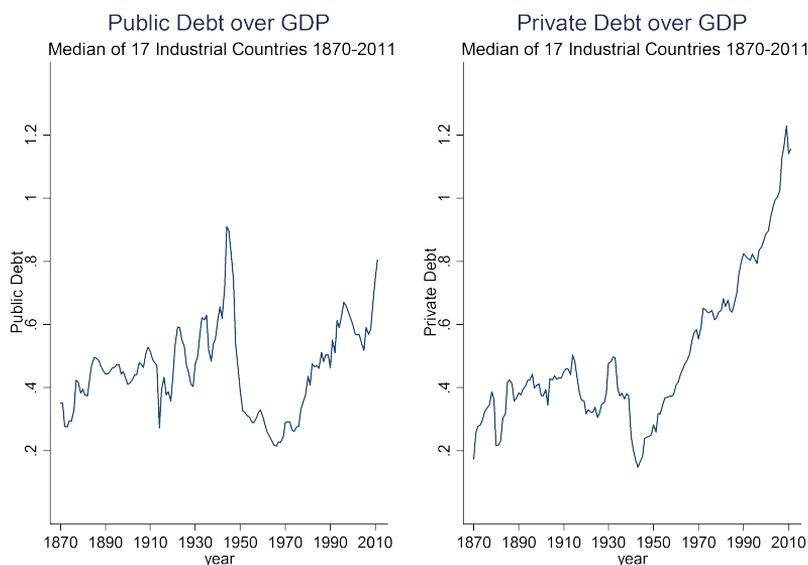
However, it is much less evident what debts one should worry about: public or private? *A priori*, most economists would intuitively point to the public sector where incentive problems of politicians might lead to reckless debt financing. Private households and companies, by contrast, are supposed to be acting in their enlightened self-interest. Many observers, often with great conviction, see the Eurozone crisis accordingly through the lens of public finance. The key source of financial fragility, in this view, was the inherent inability of governments in the so-called periphery to live within their means. It is true that in some countries, financial fragility was indeed located on the public sector balance sheet. When the economic outlook worsened, the sustainability of high public debts became an issue and doubts about the solvency of the sovereign quickly spread to banks with large holdings of government debt resulting in what Markus Brunnermeier has called a 'diabolic loop' (Brunnermeier et al., 2011).

However, on closer inspection it turns out that in 2007 Spain's public debt was below 36 percent of GDP, the overall budget was in surplus and the primary

budget balance even posted a whopping surplus of three percent of GDP. In Ireland, the figures looked similar: 25 percent for the debt ratio and a little less than 1 percent for the primary surplus. In other words, both countries operated well within the Maastricht rules and were the poster children of sound fiscal management measured by the criteria of the Maastricht treaty. None of this prevented the collapse that followed. In the space of two years, the financial systems in Spain and Ireland imploded, the economies crumbled, unemployment soared, and both countries were, albeit to different degrees, forced to seek financial help from other European countries. The lesson of this episode seems to be that there was next to nothing in key indicators of public debt that indicated the imminent catastrophe. The build-up of financial fragility occurred on private sector balance sheets. From this perspective, the rise in public debt is merely an epiphenomenon and distracts from the real source of vulnerability: namely unsustainable leverage accumulation on private balance sheets.

What does history have to say about these issues? Looking at the experience of 17 advanced Western economies – Belgium, Canada, Australia, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, U.K. and U.S. – it turns out that public debt to GDP ratios have indeed increased rather markedly in most, but not all, economies in the second half of the 20th century (Figure 1). Yet one must add that it is evident from the left hand panel in figure 1 that at least until the outbreak of the global financial crisis of 2008, public debt to GDP ratios had more or less stayed within their historical peace time range.

The right hand side of the graph shows the development of private debt – proxied by bank lending to the private sector. The visual impression is stark. The break with historical trends is much more evident in the private sector where debt and leverage levels have climbed to unprecedented heights in the post WWII period.



Source: Jorda, Schularick, and Taylor (2013)

Figure 1: Public and Private Debt in the Long Run

What the consequences are of such high levels of private debt in terms of financial stability or macroeconomic risks, is not yet well understood. But the long view from history clearly suggests that it is not only the rise in public debt that should be of concern for economists, but also the apparent changes in the borrowing behavior of private agents and much higher levels of private sector leverage.

If anything, a stronger focus on the interaction between public and private sector borrowing is also reinforced by recent comparative studies looking at the behavior of public and private sector credit before and after financial crises (Jorda, Schularick, and Taylor, 2013). Simply put, this study runs a horserace between private and public borrowing as a predictor of systemic financial crises. It specifies a standard forecasting framework relating the log-odds ratio of a financial crisis event occurring in a country in a given year to lagged changes and levels of the private and public debt-to-GDP ratio. Using data for 140 years of economic

history, a surprising result is that in Western economies financial crises appear to have very little to do with public debt. Financial crises are rarely preceded by a rapid build-up of public liabilities and are not more likely at high levels of public debt than at low levels. The idea that financial crises have their roots in fiscal misbehavior is, by and large, not supported by history. Clearly, some cases exist — the recent Greek experience comes to mind — but at least in peacetime such cases have been the exception and not the rule. By contrast, high rates of private credit growth are closely associated with higher crisis probabilities. Like in Ireland and Spain today, systemic financial crises can be typically traced back to developments in the private sector (Schularick and Taylor, 2012).

It is not hard to understand why economists tend to be outspoken about the risks of public debts, but much quieter about the risks of private debt accumulation. When governments borrow, the intuition is that incentive problems abound. The temptation to finance wasteful pet projects or serve special interests at the cost of future generations is too big to be contained. Private actors, by contrast, face no similar incentive problem, at least not in the absence of moral hazard. But this might not be the only reason why economists lost sleep over of the accumulation of public, not private debts. Excessive private sector debt accumulation — as it could be observed in recent years in countries like Spain, Ireland, the US and others — raises a number of theoretically much more demanding problems. It is considerably easier to explain the political economy logic of over-exploitation of common pools or problematic incentives for re-election-hungry politicians than it is to integrate an endogenous build-up of financial fragility into modern macroeconomic models. Yet the historical evidence shows that financial crises are typically 'credit booms gone bust' implying that they are endogenous to economic developments, not simply exogenous shocks.

The overall message is once more that taking the historical insights about the

causes of financial fragility seriously can help build better theories and design better policies. To some extent, this is already happening. Based on the historical evidence that connects financial crises to private sector credit indicators, many countries and international institutions are currently debating macro prudential policies that pay special attention to private credit indicators. This shows that historical insights, derived from serious quantitative research, can inform discussions about monetary and financial policies at a time when policymakers are searching for lessons from the recent crisis.

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