Beliefs that Lead to the Crisis

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Global Financial Crisis ©10
July 2018, NBER Summer Institute, Cambridge MA
The Key Message

• 'Financial crises follow credit expansions, are long time coming and in part predictable’

• ‘Yet, when they happen, they come as a surprise’

• Crises are due to non-rational beliefs:
  Excess-optimism, followed by harsh reckoning, then excess pessimism
As an international economist, and a student of the late Rudi Dornbusch, I can only agree...

“The crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought”

(R. Dornbusch, Frontline interview, 1995?)
Wile E. Coyote seen updating his beliefs...
A canonical boom-bust cycle in EMEs

Diáz-Alejandro (1983), Reinhart & Rogoff (2009)

• starts with (e.g.) a poorly regulated financial liberalization
• followed by a surge in foreign capital (capital flow bonanzas), intermediated by the domestic banking sector
• credit to the non-financial sector rises quickly, together with the leverage of domestic financial intermediaries;
• asset prices increase, relaxing collateral constraints.
• along the way, loan quality worsens, but optimism stays high
• the balance sheet of financial intermediaries deteriorates, mismatch increases
• then... something happens... the music stops and the mood sours...
• capital runs for the exits, the currency collapses, the banking system implodes and the sovereign becomes insolvent...


It all seems so predictable!
Behavioral biases are not new, so why then, why there?

• Common view: postwar financial and economic collapses limited to EMEs. Large catalog of structural weaknesses.

• This time: ADV are vulnerable too, perhaps even more so than EMEs. Global Financial Crisis, but also Eurozone crisis in 2010.

  Reinhart & Rogoff (2009), Gourinchas & Obstfeld (2012), Jordà, Schularick & Taylor (2013)

• What changed?
Did we all become EMEs?

• The vanishing ‘triple coincidence’ (Avdjiev, McCauley, Shin, 2018):
  • currency area
  • economic area
  • decision-making unit

Defines the perimeter of economic measurement and the associated scope for national stabilization policies.

• For EMs, the triple coincidence never really applied (small, often commodity dependent, weak decision-making units,....)

• For ADVs, the triple coincidence used to apply, but financial and trade globalization have undermined it.

  Increased corporate and financial interlock without an equivalent trans-national monitoring, regulatory or stabilizing agency.
Asset Scarcity and Safe Haven

- Absence of trans-national stabilizing authority and increased exposure to global shocks especially financial shocks (global financial cycle) increases desire for self-insurance

- Increases demand for safe assets (US Treasuries) mostly from foreign official sector + new mandates for financial sector (Basel III, Solvency II)

- Underlying trends already at work pre-crisis (decline in global real rates)


- Puts the US in an advantageous position as the world’s safe asset provider
A Changing World

• Beliefs changed b/c the world changed...

• This is how I prefer to understand Hélène Rey’s (2013) ‘Trilemma vs. Dilemma’ argument: Not (only) about monetary policy and FX regime

• More broadly, about the scope for regulatory arbitrage, jurisdiction shopping, and the potential loss of effectiveness of traditional stabilizing tools.

• This new environment is rife with spillovers that the literature is exploring actively (capital controls, G-SIFIs monitoring...) [Note: banking competition is not necessarily welfare-enhancing (Rajan)! Being over-optimistic is not a license for mayhem!]

• Yet, it may be facing a more existential threat: the populist shift in many ADV can be understood as an attempt to reclaim economic control and restore the ‘triple coincidence’.