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

Diàz-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...

LATAM (1982) / Mexico (1994) / East Asia (1997) / Russia (1998) / Brazil (1999) / Argentina (2001)...

It all seems so predictable!

Why then, why there?

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)

- Potential source of instability for global economy (Caballero et al (2016), Fornaro and Romei (2016), Eggertsson et al (2016))

- 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'.