

Golden Fetters or Credit Boom gone bust?

A reassessment of Capital Flows in the Interwar Period*

Lukas Diebold[†]

Discussion

Rui Esteves

WHAT I LIKED

Practically Everything

- New evidence on the spread of the Great Depression
 - Focus on procyclical capital flows more than on the constraints to monetary policy (*Golden fetters*)
 - By using largely-forgotten BoP statistics compiled by the League of Nations 1922-1939
- Provides evidence on:
 - Negative output consequences from international credit booms over medium-run (suggestive of excessive financial elasticity in Borio and Disyatat 2011)
 - Gross capital flows (esp inflows) drive the effect, rather than net flows (the ‘capital account view’ of Borio-James-Shin)
 - Gold standard heighten instability twice: increased inflows and limits to monetary autonomy (capital controls and exchange rate flexibility)
 - Gross capital inflows and crises, and crises and credit crunches (sudden stops)
 - Differential effects by size of liability exposure (↑) and foreign assets (↓)
- Bonus: validation with recent OECD data (1970-2020)

WHERE I WOULD WORK

1. Interpretation/ Placement in the Literature
2. Data
3. Analysis

INTERPRETATION

An International Credit Boom Gone Bust

- “the Great Depression as an international credit boom that went bust. This more strongly affected countries, if they were more exposed to gross foreign inflows. The Gold Standard was instrumental to these developments by increasing exposure to the global financial cycle.”
- “The argument is that the gold standard fundamentally constrained economic policies, and that it was largely **responsible for creating the unstable economic environment** on which the policies acted”
- “The dual bases for the prewar system were the credibility of the official commitment to gold and international cooperation: the credibility induced financial **capital to flow in stabilizing directions**, buttressing economic stability; the cooperation signaled that support for the gold standard in times of crisis...Both were eroded by the economic and political consequences of the Great War
- “**Commercial banks** around the world pursued strategies of **aggressive expansion that heightened their vulnerability** when the Depression struck...These destabilizing **linkages between domestic and international financial systems** operated most powerfully where foreign deposits were most prevalent. Europe's banking systems were interconnected by a network of foreign deposits.”

Eichengreen (1992) *Golden Fetters*

INTERPRETATION

Gold vs. Capital Flows

- “Putting gold flows into the larger context of the BoP reveals, that gold made up only a tiny fraction of international flows during the Gold Standard era”
- But gold flows did not exhaust the golden *fetters*
 - Deflationary effect of cover ratios on ‘World money supply multiplier’ (Nurkse 1944, Bernanke 1993)
 - CBs targeting of ‘free gold’ reserves
 - ‘Ideology of gold’ (Eichengreen and Temin 2000, 2010)
- “the dynamics associated with the international supply of capital, the ‘global financial cycle’ (Rey, 2013). This paper confirms, that countries which are more exposed to these dynamics also suffer more from their consequences.”
 - “not being on gold is shown to partially shield countries from the effects of the global financial cycle.”
- Does this confirm the trilemma, despite the ‘global financial cycle’ (dilemma)?

DATA

Currency of denomination and revaluations

- Does it make sense to convert BoP flows in LCU into USD *at pre-1933 parities*?
 - Devaluation of the GBP in 1931 effectively cut down the GILPs of all its debtors by ~30%

$$\Delta_n GILP_{t+n} = \Delta_n GILP_{t+n} - GILP_t = \sum_{t=1}^n Capital_{C,t} + \sum_{t=1}^n R_{L,t}$$

- Ignore revaluations $R_{L,t}$ (not on LoN statistics and hard to estimate)
 - Still “When revaluations are cyclical, financial flows provide close approximations”
- True on a case-by-case basis but total returns varied a lot in interwar across countries
 - All the more since 1929
- Perhaps use Baron’s (2021) return series for equities plus benchmark indices for bonds to estimate the full GILPs and GIAPs as in Gourinchas and Rey (2005)

DATA

Gross Positions vs Gross Flows

$$\sum_{t=0}^n Capital_{C,t} = \Delta_n GILP_{t+n} - \sum_{t=0}^n R_{L,t}$$

- In fact, you do not compute Gross Positions (à la Lane-Milesi-Ferretti) , so maybe this discussion is redundant
 - The Gross Exposure (GED) and Gross Financial Assets (GFA) dummies are only indirectly related to the GILP and GIAP
- Although this decreases relevance for the Borio-James-Shin ‘capital account perspective’
 - More about balance sheet exposure than flows themselves
- Authors also recognize that tensions only partly reflected in exchange rate regime
 - FRA vs UK, CAN vs USA

ANALYSIS

Predictive regressions

- Your preferred results omit year effects:

$$\Delta_h y_{i,t+h} = \alpha_i + \beta_B^h \sum_{j=0}^2 \text{Balance}_{i,t-j} + \beta_C^h \sum_{j=0}^2 \text{Credit}_{i,t-j} + \beta_D^h \sum_{j=0}^2 \text{Debit}_{i,t-j} + \gamma^X X_{i,t} + u_{i,t+h}, \quad (5)$$

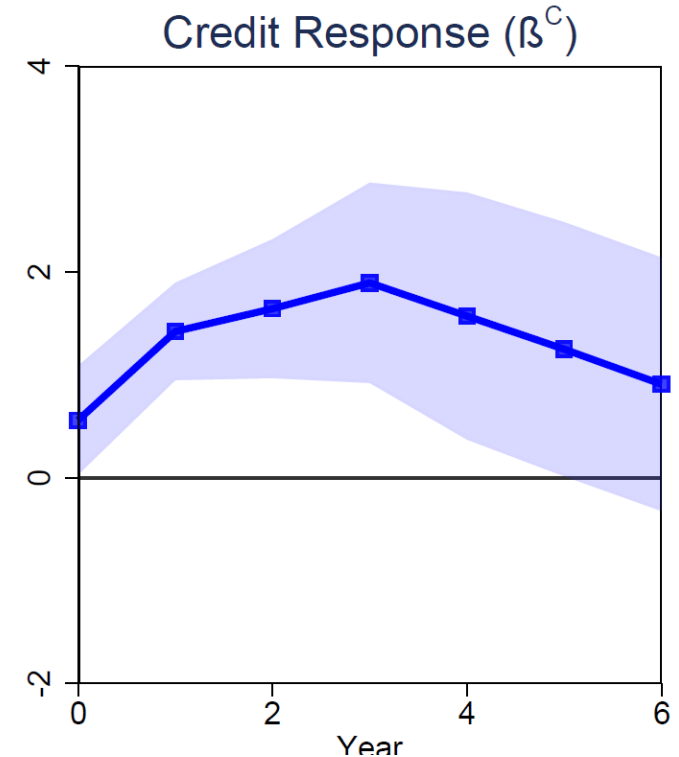
- In Mian et al (2017) they do so to introduce a global measure of credit growth (collinear). Why do it here?
- You note that coefficients on cumulative credit (5) are larger than coefficients on yearly flows (4)
 - “effect of repeated gross foreign borrowing is at least partially additive. When foreign credit accumulates, growth slowdowns become more severe.”
 - Yes, but could also be that GDP is serially correlated

ANALYSIS

Gold Standard Leads Capital Flows

Figure 6: *Cumulative Capital Flow responses to a Gold Standard Indicator*

- “Under the Gold Standard gross capital inflows increase and gross inflows precede periods of lower growth.”
- But you did not test for pretrends
 - Speculative capital inflows prior to return to gold: well-known in the cases of Britain (1924-5) and France (1927-8)
- GED vs GFA: “it is possible for a country to be adversely affected by exposure to inflows, but simultaneously benefit from its own foreign assets.”
- But how much overlap was there really between (gross) creditors and (net) debtors?



MINOR POINTS

- Why no data on Iberian nations?
 - In general, can't you use historical reconstructions of BoP?
- How often did you have to impute the capital account with the current account? This can introduce errors, as you know
- Fig 3: what we want to see is the scatterplot of net vs gross flows. Why disguise it with the 3 panels?
- Eqn (4): country fixed effects or country-specific time trends?
- “it is not the excess spending captured by net flows, but the payment streams attached to them that ultimately matter for economic outcomes.”
 - This sounds semantic or disingenuous: is all spending justified? Or think of 3rd generation balance sheet crises
- Fig A3.6 has some strange coeffs: what explains the insignificant UK or the positive and significant IRL and SWE?
- the interactions with GS status of Tab 3 effectively make controlling for gold flows in Table 2 a redundant exercise; better drop Tab 2

MINOR POINTS

- Strange that the interaction with GS has opposite results (and interpretations...) in Tabs 7 and A4.14
- Fig A5.11 has weird divergent paths – non-stationarity?
- Your interpretation for why IV estimates are larger make sense (downward bias of OLS)
- But could also simply come from IV results being LATE on the compliers, whereas countries unaffected by shocks to global credit are effectively excluded from the sample
 - Though when previously restricting sample to countries with at least one crisis (Tab 5) didn't change the results