

# A house of cards: banking, leverage, and macrofinancial linkages

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Lehman – 10 Years After

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# Overview

1. Research
2. Differences
3. Similarities
4. Conclusion

# 1. Research

- Two groups of publications: before and after Euro crisis
  - Before: James (2009), Ritschl (2009), Bordo and Landon-Lane (2010), Allen and Moessner (2011), Bähr and Rudolph (2011)
  - After: Eichengreen (2015), Borio, James and Shin (2016)
- New research on macrofinancial linkages
  - Crowe et al. (IMF 2010)
  - Claessens and Kose (BIS 2018)
  - Asset prices and macroeconomic outcomes
  - Macroeconomic implications of financial imperfections

## 2. Differences

### **United States 1929-33**

- Stock market crash
- Severe recession, deflation
- High real interest rates
- Banking crises, further deflation
- «European shock» of 1931
- Further banking crises
- Depression

### **United States 2007-09**

- Fall of housing prices
- No recession until late 2007
- Low real interest rates
- «Bear Stearns shock» contained
- «Lehman shock» of 2008
- Bail-out of banks, public debt
- Recession

## 2. Differences

### **Continental Europe 1929-33**

- Severe recession, deflation
- High real interest rates
- Central European crisis of 1931
- Liquidity crisis, banking crises
- Depression
- End of gold standard, partial default, bail-out of banks

### **Continental Europe 2007-09 / 2010-12**

- Liquidity crisis
- Supply of liquidity
- «Lehman shock» of 2008
- Liquidity crisis, banking crises
- Recession
- Interest rate cuts, bail-out of banks, no default
- Euro crisis

# 3. Similarities

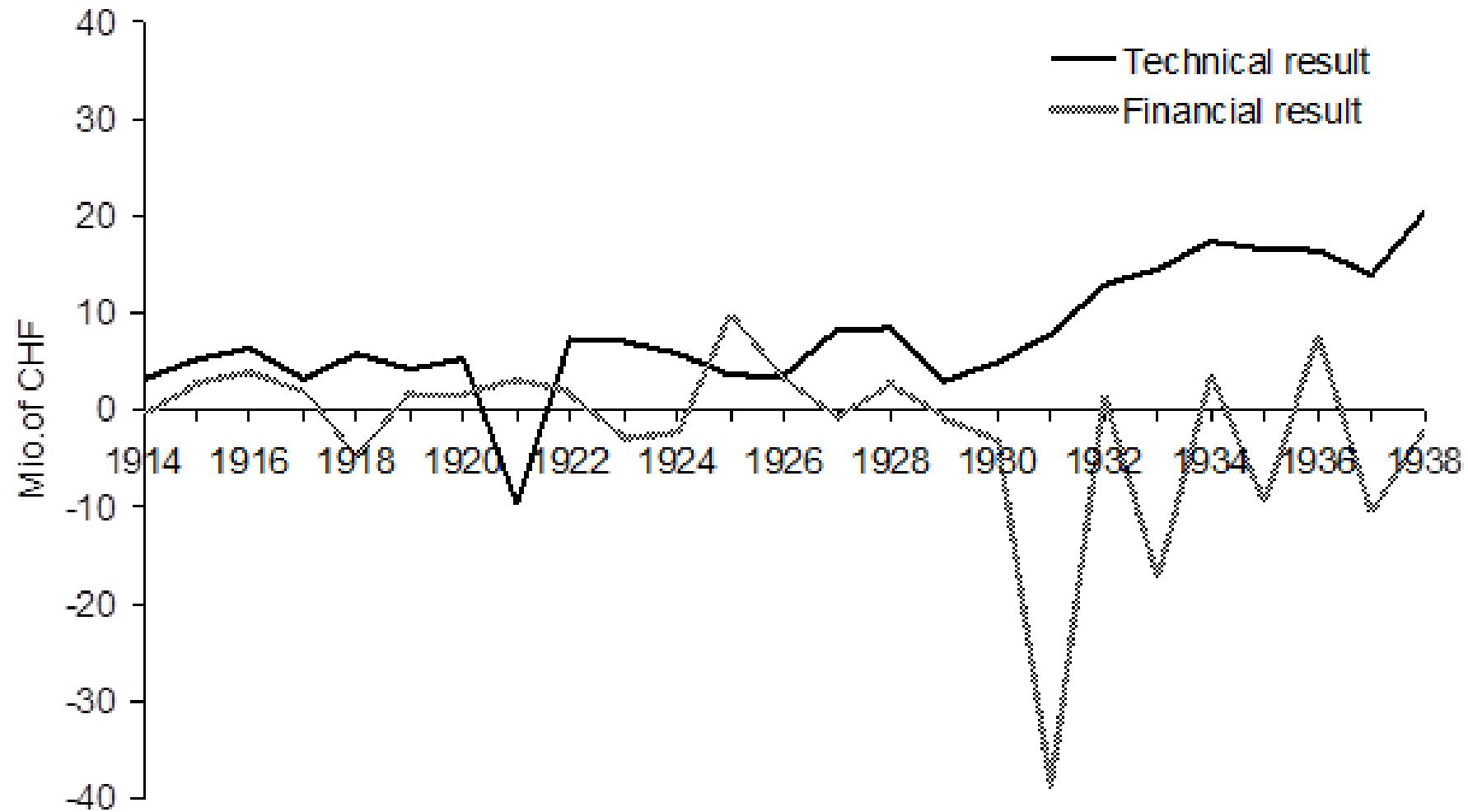
**United States**  
Banking crises



**Continental Europe**  
Twin and triplet crises

Macroeconomic linkages  
Macrofinancial linkages

Figure 1: Technical and financial results of Swiss Re



Source: SR Archives, Guggenbühl (1939).

## Composition of Swiss Re's assets

	Total	of which:	
	Assets	Bonds	Stocks
1922	208,699	59,268	4,374
1923	239,536	61,259	14,033
1924	263,625	67,984	22,802
1925	286,751	60,103	26,796
1926	325,178	71,514	34,026
1927	380,142	82,229	39,052
1928	435,368	83,316	71,911
1929	478,397	77,751	74,926
1930	499,812	78,306	74,568

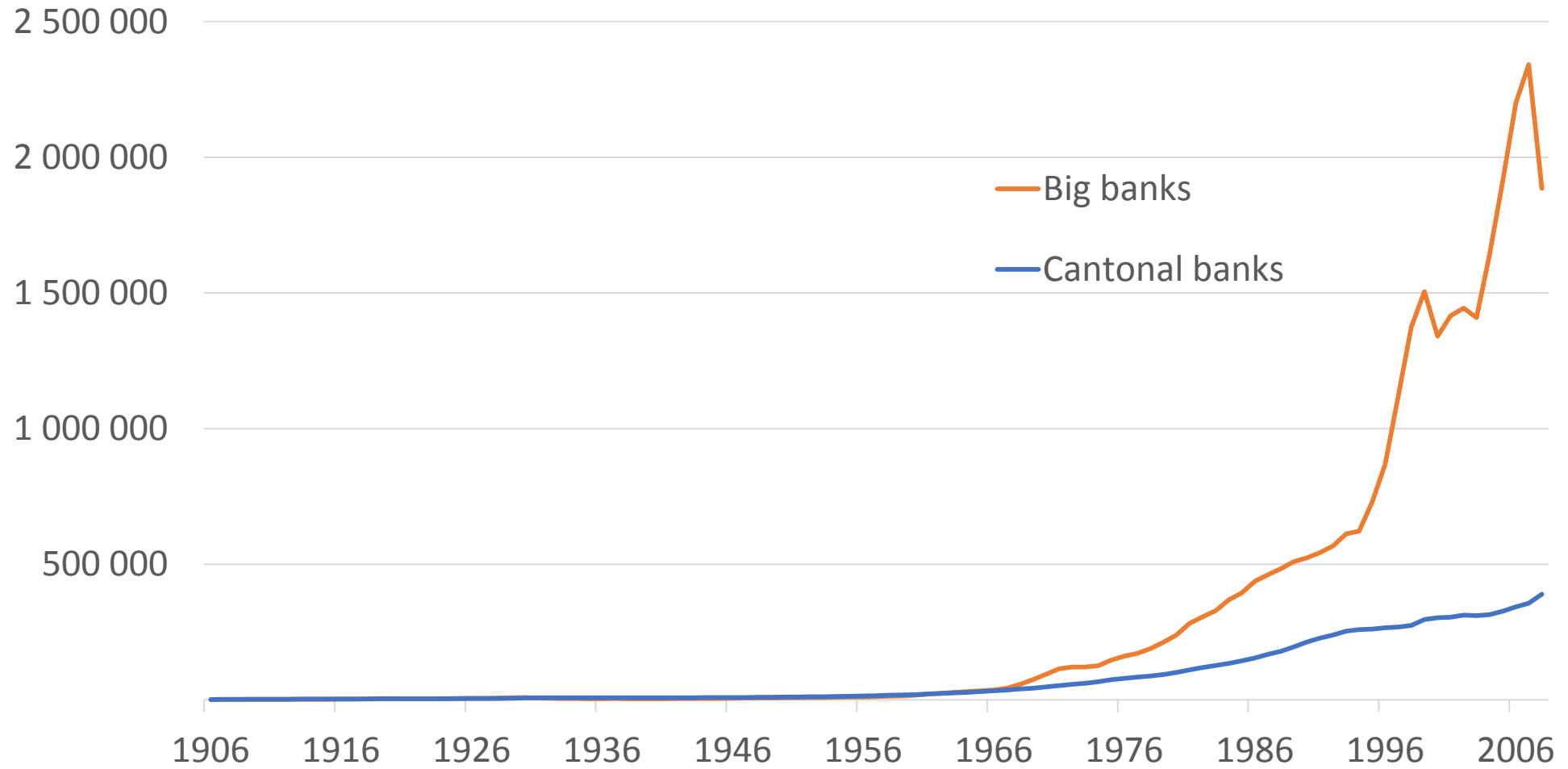


## Swiss Re: Real gain, reported gain, hidden reserves, and dividends (in Tsd. of CHF)

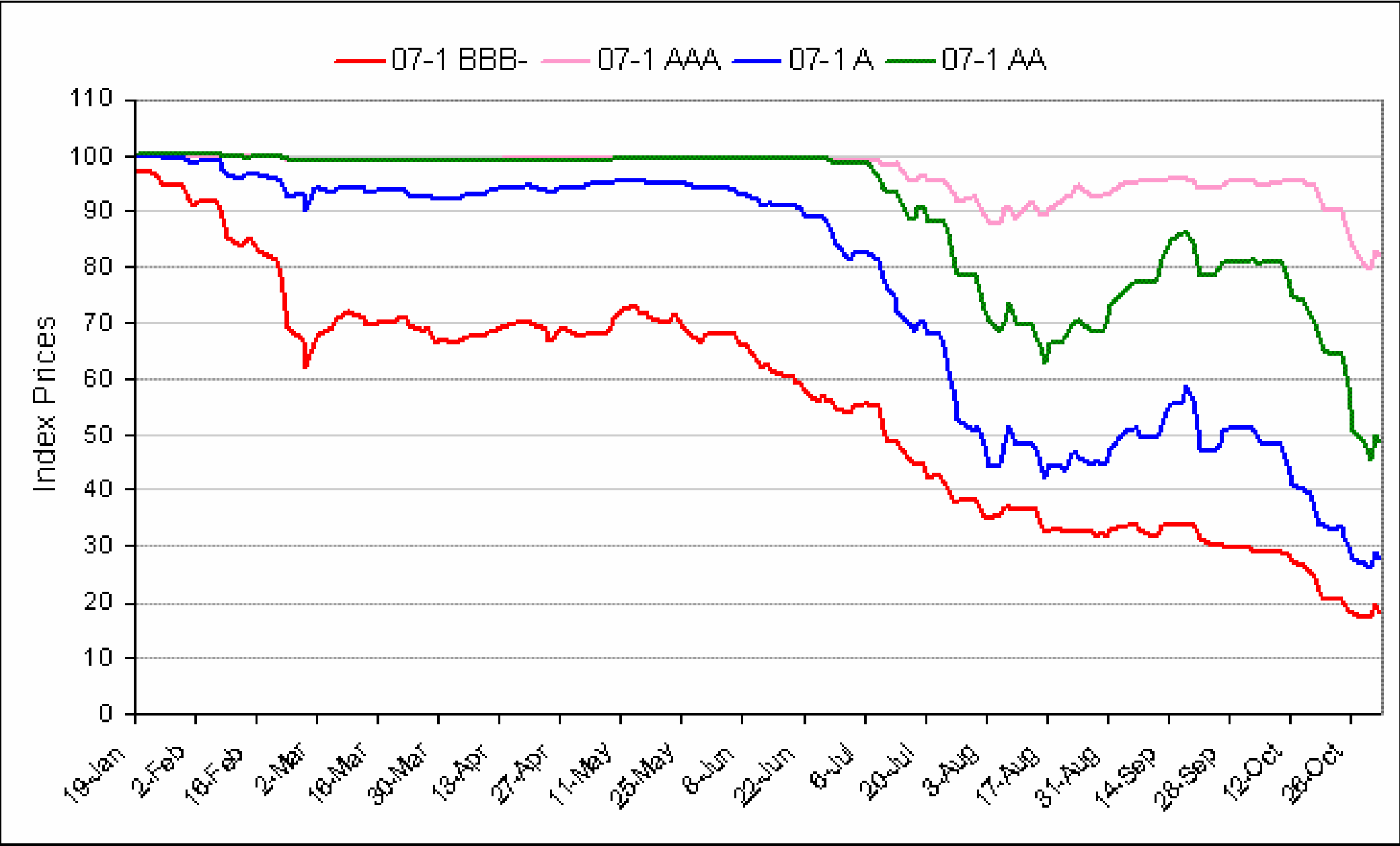
	Real gain/loss	Reported gain/loss	Hidden reserves	Dividends
1928	11,168	6,167	43,828	2,321
1929	2,203	6,755	39,876	4,330
1930	1,697	7,873	33,700	6,186
1931	-30,865	8,435	4,400	6,186
1932	14,112	8,112	10,400	6,186
1933	-2,503	5,297	2,600	6,283

Source: SR Archives Zurich (Switzerland): P. Guggenbühl, Hausstatistik der Schweizer Rück (Zurich, 1939).

## Total assets of Swiss cantonal banks and big banks (in mio. of CHF), 1906-2008



Source: SNB.



The ChO was updated on funding and liquidity issues in April 2007, at which time the ChO expressed concerns as to these issues. The then-Group CEO advised that he wanted to see how effective short term measures were before considering a general freeze in June / July. The ChO confirmed that it wished to be updated again in July / August, at which time they said it would consider illiquid asset caps in the IB.

(UBS, Shareholder Report, April 2008)

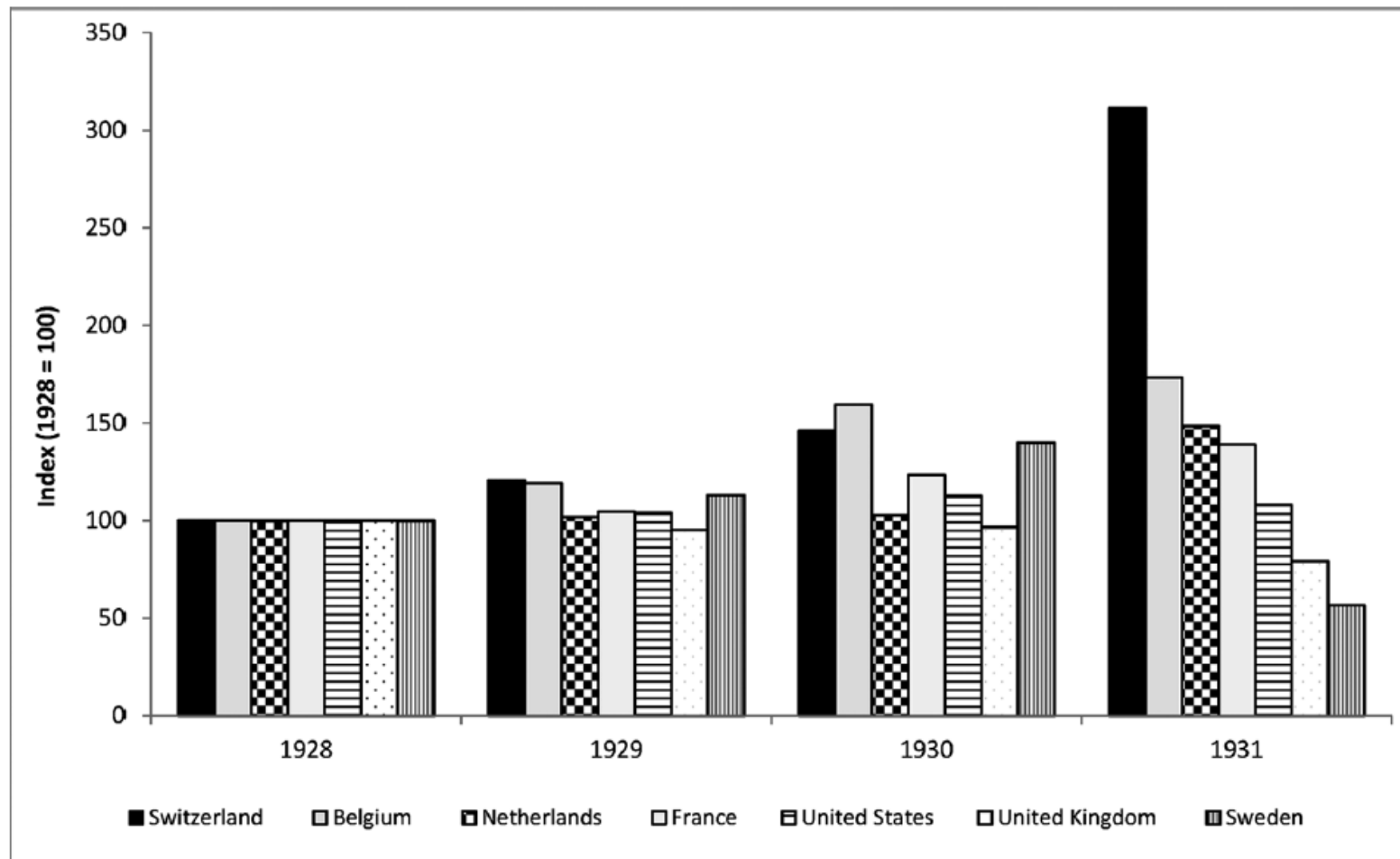


Figure 1. *Central bank reserves of creditor countries (end of 1928 = 100)*

*Source: Federal Reserve Bulletin (1928–31).*

Source: Straumann, Kugler and Weber (2017).

Table 4. *Foreign short-term balances of Svenska Handelsbanken und Skandinaviska Kredit AB in 1931 (in millions of SEK)*

		<i>Svenska Handelsbanken</i>			<i>Skandinaviska Kredit AB</i>		
		<i>Foreign short-term assets</i>	<i>Foreign short-term liabilities</i>	<i>Foreign short-term balances</i>	<i>Foreign short-term assets</i>	<i>Foreign short-term liabilities</i>	<i>Foreign short-term balances</i>
1931	Jan.	55	44	11	62	117	-55
	Feb.	53	48	5	74	103	-29
	March	55	66	-11	68	107	-39
	April	36	70	-34	73	115	-42
	May	46	95	-49	90	146	-56
	June	47	72	-25	77	122	-45
	July	48	51	-3	74	94	-20
	Aug.	44	34	10	53	50	3
	Sept.	51	22	29	45	31	14
	Oct.	41	18	23	43	22	21
	Nov.	42	18	24	49	19	30
	Dec.	35	17	18	50	17	33

Source: *Ekonomisk Tidskrift* (1931-2); and own calculations.

Source: Straumann, Kugler and Weber (2017).

# 3. Similarities

## United States

- Complacency
- Poor banking regulation
- Monetary policy «mistakes»
- Political gridlock
- Boomerang syndrome

## Continental Europe

- «Schadenfreude»
- Dysfunctional institutions
- Monetary policy «mistakes»
- Rise of nationalism
- Boomerang syndrome

# Felix Somary (Heidelberg, January 1930)

The danger that the chain holding together the national and international economy will rip apart is nearer than one would think. Perhaps reparations and international political debts will eventually disappear in the vortex of the crisis, but it is highly probable that the international private debts will also be hit by the crisis on a scale unseen in generations. (...)

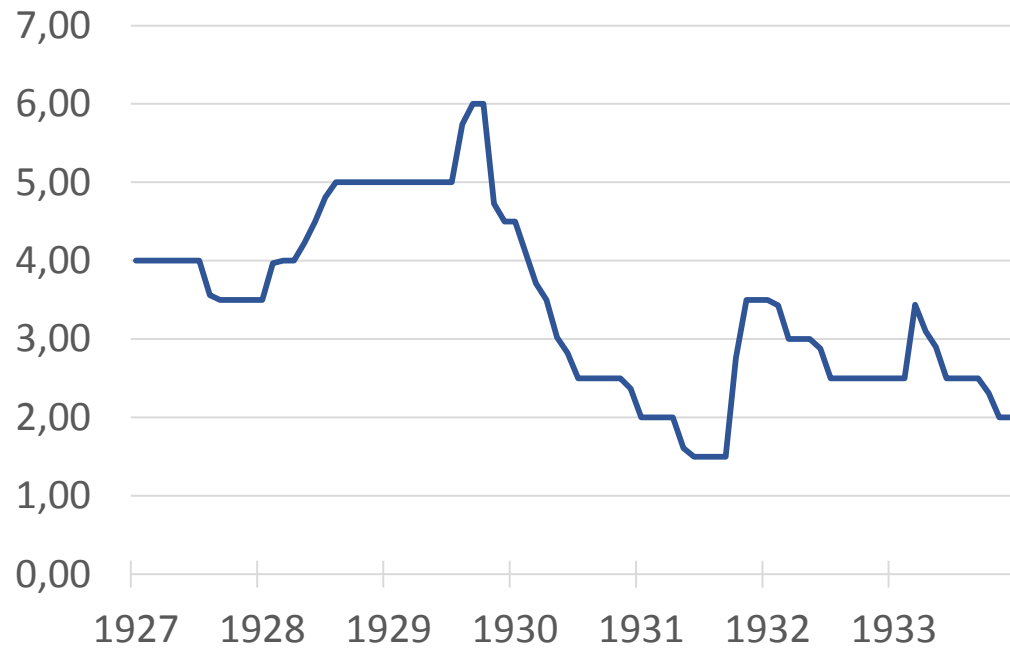
Only France is strong enough to consolidate Germany's foreign short-term debts. If this plan does not succeed, we will witness the whole apparatus of foreign exchange control, import and export bans, and at the end maybe not again inflation, but something that tears the fabric of the economy even more apart: the collapse of the banks and of public finances.



# Boomerang syndrome

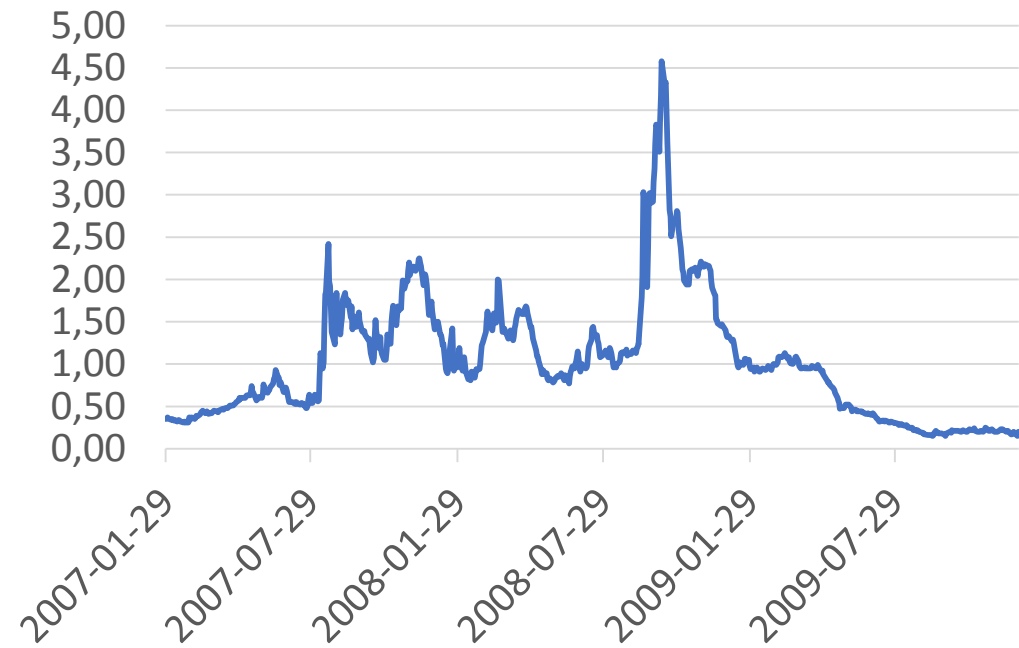
## United States 1929-33

### New York Fed discount rate



## United States 2007-09

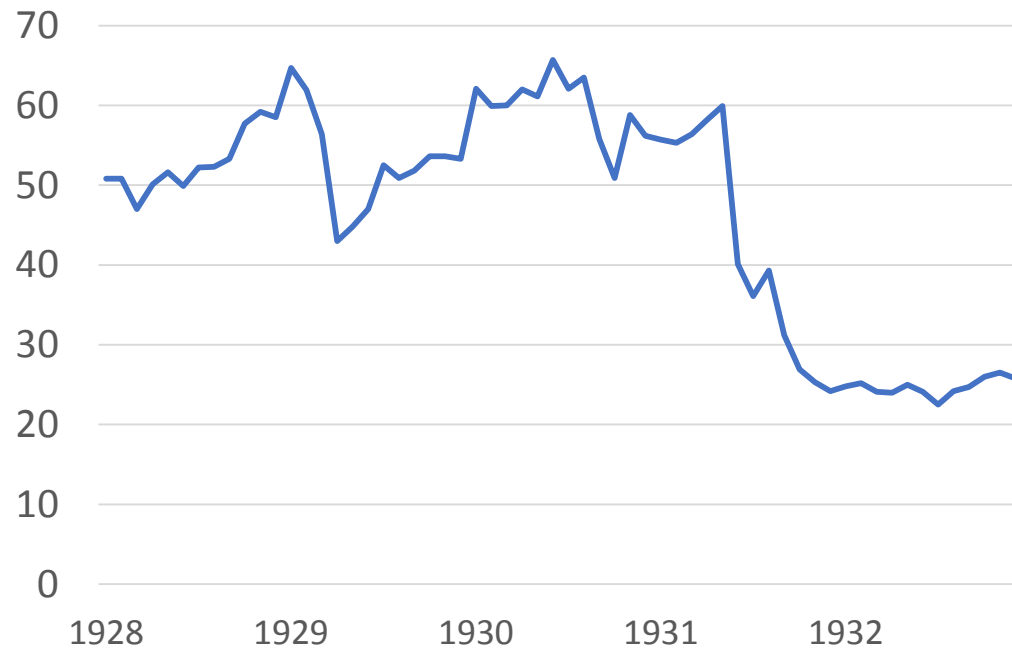
### TED Spread



# Boomerang syndrome

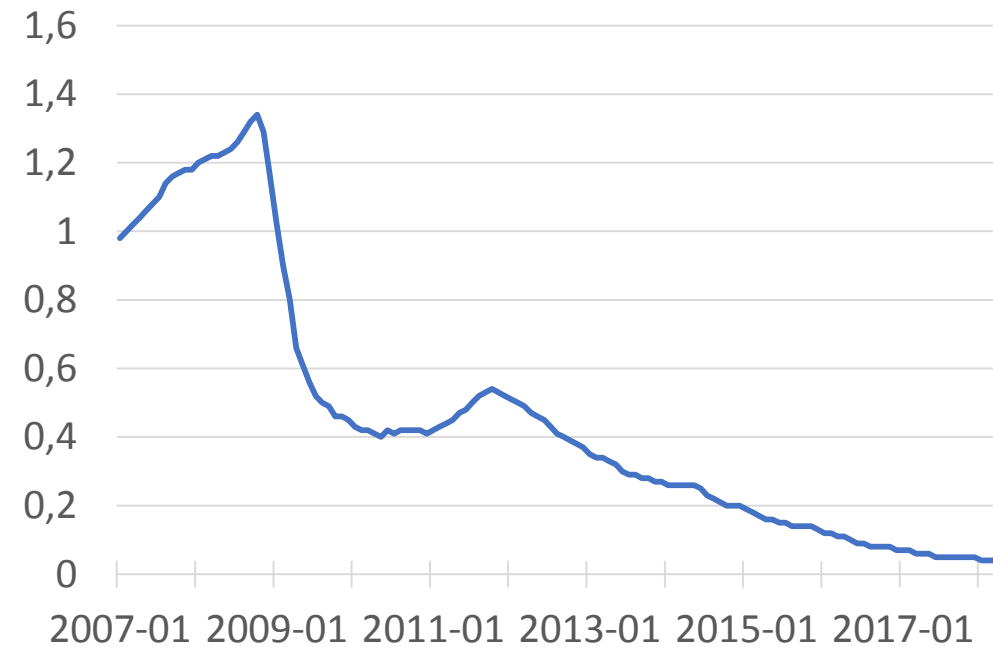
## Continental Europe 1929-33

### Reichsbank Cover ratio



## Continental Europe 2007-09 / 2010-12

### Euro area overnight interest rate in %



## 4. Conclusion

- Differences vs. similarities: depends on lens (worm vs. bird)
- Macrofinancial linkages: many channels
- Disturbing constants
  - United States: regulation of financial sector
  - Continental Europe: failure of cooperation
  - Failure to resolve the crisis in the first round (boomerang syndrome)