

# Financial Crises and International Financial Crisis Transmission in Eastern Europe during the European Financial Crisis of 1931

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# Motivation

- European Financial Crisis of 1931 crucial event in financial history; most often associated with Austria, Germany and UK [Eichengreen, 1992, Kindleberger, 1986]; recently, revived interest in international consequences e.g. [Accominotti, 2012], [Ritschl & Sarferaz, 2014]

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- Literature lacks a study documenting the occurrence and exploring causes of financial crises in Eastern Europe in 1931.
- Highlighted by Eichengreen [2011, pp. 36-37] - 'main victims' of the 1931 Central European emerging markets rather than advanced countries.

# Context

## *Time-line: European Financial Crisis of 1931 in Austria, Germany and Britain*

Date	Event
8-May	Creditanstalt's losses revealed to the public
14-May	Initial bailout of the Creditanstalt
6-Jun	German government states it could no longer pay reparations
6-Jun	Run on German currency
20-Jun	US president Hoover announced one year moratorium on war debts
1-Jul	Extent of Nordwolle losses revealed to the public
13-Jul	German Danat Bank fails
14 and 15 July	Banking holiday in Germany
15 Jul-1 Aug	Series of exchange control decrees in Germany
15 Jul-1 Aug	Run on British currency
21-Sep	Britain officially suspends gold standard and devalues its currency

Sources: See text.

## Research questions

Q.1 Did CESEE countries experience financial crises during 1931?

Q.2 If so, what factors contributed to these financial crises?

## Sample of countries

- All Central-Eastern and South-Eastern European (CESEE) countries,
- with population over two m. (as of 1931, Maddison [2010]),
- relatively well documented,
- had a market economy.
- Sample: Bulgaria, Czechoslovakia, Greece, Hungary, Poland, Romania and Yugoslavia - 'CESEE-7'
- Austria, Germany and UK treated as exogenous [Eichengreen, 1992, Kindleberger, 1986].

# Road map

## Q.1 Did CESEE countries experience financial crises during 1931?

- Look at indicators of currency, banking and sovereign risk crises.

## Q.2 If so, what factors contributed to these financial crises?

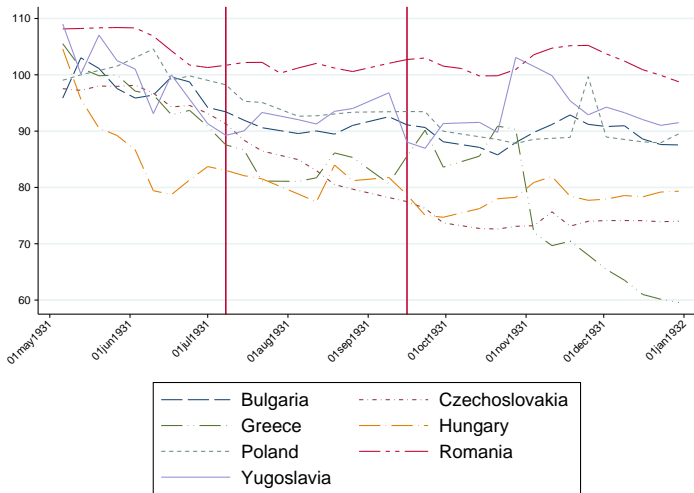
- Consider the role of global shocks, fundamentals, and international crisis transmission



## Data set

- Currency - Central bank foreign reserves (weekly data)
- Banking - Commercial bank deposits (monthly data)
- Sovereign default risk - Current yield on long-term sovereign bonds (weekly data)

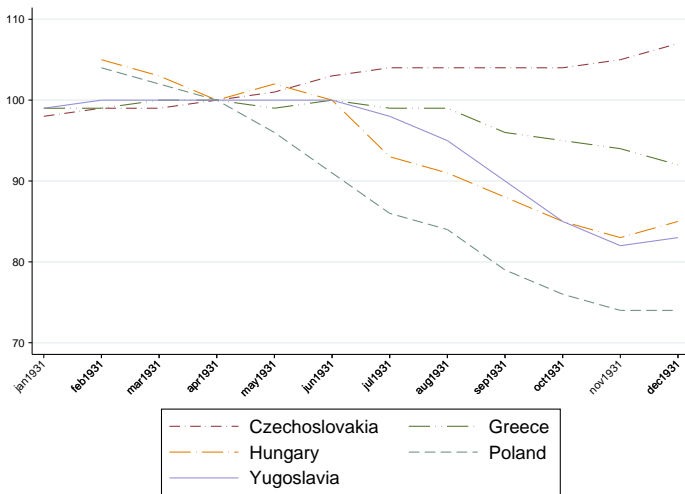
**Figure 1:** Central bank (gold and foreign exchange) reserves of CESEE-7 (7 May to 31 Dec 1931, weekly, April value = 100)



Notes: Vertical lines - 2nd week of July (German crisis) and 2nd week of Sep. (week before Britain leaves gold)

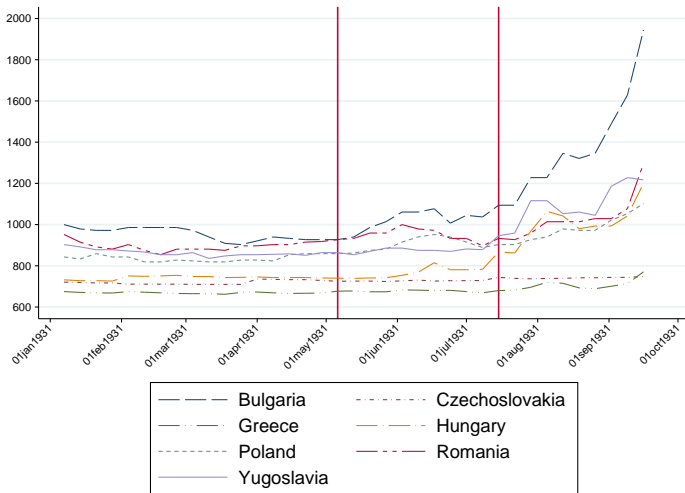
Sources: Own calculations based on data from The Economist [1931].

Figure 2: Commercial bank deposits of five CESEE countries (Jan to December 1931, monthly frequency, April value = 100)



Sources: Own calculations based on data from [League of Nations, 1932a,b], [Statistisches Reichsamt, 1936].

Figure 3: Long-term sovereign bond yields of CESEE-7 (7 January to 16 September 1931, weekly, basis points)



Notes: Vertical lines - 1st week of May (Austrian crisis) and 2nd week of July (German crisis)

Sources: Own calculations based on data from The Financial Times [1931].

## Overview

*Summary of Financial Crises in CESEE-7 during 1931, as well as the dates of the introduction of exchange controls, official devaluation of currency, and default on foreign sovereign debt*

Country	Financial Crisis in 1931 <sup>1</sup>	Introduction of exchange controls	Official devaluation of currency	Default on foreign sovereign debt
Bulgaria	C, B, D	15 Oct 1931	n.a.	1 Apr 1932
Czechoslovakia	C	2 Oct 1931	Feb 1934; Oct 1936	n.a.
Greece	C, B, D	28 Sep 1931	Apr 1932	1 May 1932
Hungary	C, B, D	17 Jul 1931	n.a.	Dec 1931
Poland	C, B, D	26 Apr 1936	n.a.	n.a.
Romania	C, B, D	18 Dec 1931	Nov 1936	15 Aug 1933
Yugoslavia	C, B, D	7 Oct 1931	Jul 1932	Oct 1932

Notes: <sup>1</sup>C, B and D stand for currency, banking and sovereign default risk crises, respectively.

Sources: See text.

## Contributing factors to financial crises in CESEE-7

- Global shocks, fundamentals and international crisis transmission

## Global shocks

- 'The most severe contraction of demand' the international economy had ever known [Feinstein *et al.* , 2008, pp. 93-97]

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- Contraction of international long-term credit - sudden stop and capital flow reversal from major international financial centers [Accominotti & Eichengreen, 2015].
- i.e. there was a fall in the global demand for commodities and a reduction in the availability of international long-term credit.

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- Net capital importers affected more (than net capital exporters) by curtailment of international credit
  - Czechoslovakia consistently net capital *exporter*; rest of CESEE-7 net capital *importers* [United Nations, 1949].
- Therefore, Czechoslovakia less affected by the changes in the global economy - partly explains why it was less susceptible to financial crises than rest of CESEE-7 during 1931.

# Fundamentals

*GDP per capita (1990 GK USD), value of exports (in current USD) per capita, occupational shares in agriculture (percentage of working population in agriculture in total working population) and openness ratio (exports plus imports as share of GDP) of seven CESEE countries circa 1930*

Country	GDP per capita	exports per capita	% working in agriculture	openness ratio
Bulgaria	1284	7.40	81.9	26.2
Czechoslovakia	2926	37.04	37.5	55.2
Greece	2258	11.87	61.1	62.5
Hungary	2404	18.45	54.8	32.7
Poland	1994	9.66	67.3	22.8
Romania	1219	12.10	80.7	21.8
Yugoslavia	1318	8.33	79.7	25.9

*Notes and Sources:* see text.

# Changes in economic activity

*Dates of pre-crisis peaks and changes in economic activity (in per cent) of eight CESEE countries*

Country	Date of pre-crisis peak	Change from pre-crisis peak to April 1931
Bulgaria	May 1930	-11.28
Czechoslovakia	Jul 1929	-6.49
Hungary	Aug 1929	-10.45
Poland	May 1929	-10.80
Romania	Dec 1929	-1.96
Yugoslavia	Dec 1929	-2.00
Austria	Jun 1929	-11.86
Germany	Apr 1929	-16.41

*Notes and Sources:* Dates of pre-crisis peaks and underlying data kindly communicated by Thilo Albers. Changes in economic activity are own calculations based on economic activity series (all indicators) shown in Albers & Uebele [2015].



# International financial crisis transmission

- Economies are linked internationally through various economic fundamentals such as finance or trade, the term 'spillovers' [Masson, 1999] was proposed to signify the spread of financial crises through these linkages.
- Finance spillovers: *inter-connected FI effect* [Allen & Gale, 2000] or *common lender effect* [Kaminsky & Reinhart, 2000]
- Trade spillovers: *income effect* [Forbes, 2002] and *competitiveness effect*

## Finance spillovers

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- The presence of a number of European banks suggests this could have been due to both a common bank lender and interconnected financial institutions effects.

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- Income effect contributed to currency crises and increased sovereign risk in these countries as reduced exports mean *less foreign exchange earnings*
  - pressure on exchange rates leads central banks to sell foreign exchange in order to defend fixed exchange rates
  - increase sovereign risk as foreign exchange is crucial for the servicing of foreign currency denominated sovereign debt.

## Summary and Conclusion

- Financial crises in Austria, Germany and Britain during 1931 researched extensively, experience of Eastern Europe largely unknown.

Q.1 Did CESEE countries experience financial crises during 1931?

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## Summary and Conclusion

- A.1 No CESEE country managed to go through 1931 without experiencing at least one type of financial crisis.
- A.2 Worsening of domestic fundamentals, falling global demand and drying up of international credit, as well as finance and trade spillovers all played a contributing role.
  - In conclusion, completely avoiding financial crises during the European Financial Crisis of 1931 was elusive for Eastern Europe. However, as the case of Czechoslovakia shows strong economic fundamentals helped downsize the extent of financial crises.



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