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On fat cats and sub-prime mortgages

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Trillions of dollars of paper values are disappearing as markets write down house prices and sub-prime mortgage based assets. It goes to show that modern asset markets can still make big mistakes. When it's all over, however, the British and U.S. economies will still have highly profitable financial sectors.

What does it all mean? Sometimes, it helps to take a long view.

A little appreciated fact about England in the Industrial Revolution is that the people who made most money were not the industrialists that fabricated the goods and pioneered the new production and management technologies that made England the workshop of the world. Money was made in manufacturing, to be sure, but competitive markets ensured that large profits were soon competed away. As supply increased and prices fell, the main

beneficiaries were the consumers, not the producers.

In *Men of Property: The Very Wealthy in Britain Since the Industrial Revolution* (second edition, 2006), William Rubinstein has shown that the big fortunes made at that time accrued to the bankers and brokers that traded in goods and financed and insured their production and distribution.

At a time of rapid economic change, their most important capital was trustworthy information: knowing what to trust, and knowing whom to trust. Because reliable knowledge was scarce, and what they did was valuable, they made a lot of money. They also made a lot of mistakes. Speculative bubbles, bank runs, credit crunches, and bankruptcies were common.

Notably, neither the money these "fat cats" made, nor the mistakes they made, prevented the Industrial Revolution from happening.

Debt defaults: the role of political institutions

If a nation defaults on its debt, then as well as hurting private creditors, it may find it hard to access credit markets in the future. **Emanuel Kohlscheen** examines the impact of parliaments and other political institutions on the likelihood that governments will default on their official obligations.

Debt crises are a relatively common phenomenon in emerging markets. Within the past decade, the governments of Russia (in 1998) and Argentina (in 2001) have made the headlines for having defaulted on massive amounts of public debt. But sovereign default is anything but new: it is reported that the Spanish government defaulted on its official obligations no less than 13 times between the fifteenth and eighteenth century; and France too defaulted several times, the last time in 1788.

So what circumstances make a country more likely to default? My research suggests that defaults on debt repayments are a problem of governance just as much as they are a problem of economics. I show that in the last quarter of the twentieth century, the likelihood of default was almost five times higher in countries with presidential political systems than in parliamentary democracies.

What's more, nine out of eleven presidential countries that reduced their external indebtedness swiftly over the period (by more than 25% of GDP in three years or less) did it via a default. This compares with only one in five parliamentary democracies.

acts as a powerful incentive to avoid an economic crisis. All else being equal, this institution alone reduces the likelihood of default from 3.9% a year to between 1.8% and 2.7% a year.

Of course, the form of government in a country is not chosen at random. It may be that certain characteristics mean that a country is more likely both to have a presidential system and to default. If so, an association between the two would not be surprising. Most Latin American countries, for example, have adopted presidential forms of government, whereas almost all developed countries have parliamentary constitutions.

My response is twofold. First, I show that the striking difference between presidential and parliamentary systems remains when either the Latin American countries or the developed countries are excluded from the sample. Moreover, the fact that most countries that have reached a high level of economic development are parliamentary democracies might not be a mere coincidence.

Parliamentary democracies are far less likely to default than countries with presidential systems

Defaults on debt repayments are a problem of governance just as much as they are a problem of economics

The key difference seems to be the fact that in a presidential system, the head of government does not need the continuous consent of the legislature to remain in power. Under a parliamentary constitution, the possibility of a vote of confidence in the government

I also use a technique known as "propensity score matching," which pairs very similar countries in terms of their cultural, historical and geographical characteristics at the time of independence. The difference in the default rates of these otherwise identical countries supports the idea that it is the parliamentary system of government that is crucial in reducing the likelihood of default.

Economic historians Peter Lindert and Peter Morton

have noted that "In either worldwide lending crises (the 1930s and 1980-86), the problem debtors tended to be those that had problems earlier." My study makes clear that it is constitutional forms of government that make history so relevant for the development of credit markets. The economic problems of Latin American countries are not so different from those faced by presidential countries elsewhere in the world, including Russia and the Philippines.

So are countries with presidential political systems doomed? Not necessarily. There is nothing that precludes a president from being more trustworthy than a prime minister, even if the latter is constantly checked by parliament. But credit markets under presidential governments could get better insulation from the natural vagaries of the democratic process if debt policy were delegated to an independent committee, just as has happened with monetary policy.

Publication details

"Why are there Serial Defaulters? Evidence from Constitutions," by Emanuel Kohlscheen, is forthcoming in *The Journal of Law and Economics*, volume 50. The working paper version of the study is available as Warwick Economic Research Paper Series No. 755.

The author

Emanuel Kohlscheen is assistant professor of economics at the University of Warwick and an associate of the Centre for the Study of Globalisation and Regionalisation. He lectures on macroeconomics and international monetary economics.

Further reading

Lindert, Peter and Peter Morton. 1989. "How Sovereign Debt has Worked." in *Developing Country Debt and Economic Performance: the World Financial System*, pp. 39-106. Edited by Jeffrey Sachs. University of Chicago Press for NBER.

Economic growth in the very long run

How can we explain both the long period of stagnating living standards prior to the Industrial Revolution and the period of sustained economic growth since then? In a new survey, **Stephen Broadberry** considers how recent work by economic theorists and economic historians approaches this fundamental question about human development.

Why have some countries grown rich and others stayed poor? This question is so central to human development that, in the words of Nobel laureate Robert Lucas, "it becomes hard to think about anything else."

My study explores the latest research by economic theorists seeking to find a unified approach to growth across countries and over very long periods of time. It then compares this work with parallel efforts by economic historians to break away from specialisation by country and period and understand long-run developments. The two research programmes share the goal of moving beyond the traditional practice of using different methods to analyse the world before and after the Industrial Revolution.

Interactions between institutions, markets and technology play an important role in driving growth

There are common themes in the work of theorists and historians in three key areas. The first is growth itself, where "unified growth theory" has been developed to explain the transition from a pre-industrial, Malthusian setting, where real wages are negatively related to population, to a modern setting, where the relationship between real wages and population is positive. Within this framework, human capital is central in bringing about the Industrial Revolution.

Work on a related theme by economic historians finds that in addition to the Great Divergence between Europe and Asia, there was a "Little Divergence" within Europe. During the late medieval and early modern period, Britain and Holland accelerated ahead of the rest of the continent by maintaining the real wage gains of the post-Black Death period while limiting fertility and sustaining investment in human capital. Unified growth models need to be able to account for this divergence.

The second theme is the role of institutions, where the "new institutional economics" has identified the key role of institutions in solving the "fundamental problem of exchange" and creating an environment where economic growth is possible. Theorists have also developed a framework for modelling the link between institutions and technology via the patent system, which provides incentives for innovation.

Meanwhile, economic historians point to the important role that institutions played in the general economic development of late medieval and early modern Europe. For example, Britain and Holland were the only countries to succeed in overthrowing absolutist governments. These countries also played a leading role in the development of private institutions: growing commercialisation showed up in both a dramatic decline in the share of the labour force employed in agriculture and a sharp rise in urbanisation.

Interactions between institutions, markets and technology were also important in Britain's overtaking of Holland, which marked the final stages of the transition to sustained modern economic growth. Innovation flourished in an environment where a patent system protected intellectual property, there was a large market, and factor prices provided an incentive to use machine-intensive methods.

Human capital was crucial in allowing Britain and Holland to move ahead of the rest of Europe

The final theme is "general purpose technologies" (GPTs), an idea developed by theorists to help explain how technological progress and growth can be sustained. Although rare and sporadic, the effects of GPTs like electricity and information technology can be dramatic as they spread through the economy and spawn other innovations.

Research by economic historians has explored the impact of steam power as a GPT because of its wide range of applications in a variety of industries. The

switch to fossil fuels was also important in sustaining growth by allowing industrial economies to escape from an energy constraint.

Both theory and history have made significant progress in understanding economic growth, but they are difficult to combine. As Joseph Schumpeter noted, "There are such things as historical and theoretical temperaments. That is to say, there are types of minds that take delight in all the colours of historical processes and of individual cultural patterns. There are other types that prefer a neat theorem to everything else. We have use for both. But they were not made to appreciate one another."

Schumpeter's words have particular force when

applied to very long-run growth, where historical narrative without theory can seem to lack direction, but where theory without attention to historical detail can all too easily result in over-simplistic generalisations.

Publication details

"Recent Developments in the Theory of Very Long Run Growth: A Historical Appraisal," by Stephen Broadberry, is available as Warwick Economic Research Paper No. 818.

The author

Stephen Broadberry is professor of economic history at the University of Warwick.

Class attendance: the impact on student performance

University teaching in the UK is typically based on large-group lectures supplemented by small-group classes. Since classes are costly, it is worth asking if they make a real difference to student performance. To explore this question, Wiji Arulampalam, Robin Naylor and Jeremy Smith have looked at a group of economics undergraduates.

Lectures are an efficient way to deliver a large quantity of complex information to university students. But classes, which are traditionally thought to be crucial for reinforcing this material and exploring it in greater depth, lack the returns to scale of lectures and are therefore relatively costly. Since some of their functions are also potential substitutes for private study, it is worth trying to assess their effectiveness.

To evaluate the benefits of small-group tuition, we conducted an experiment with second-year undergraduates in a leading UK economics department. The students were randomly assigned to classes for each of their three compulsory papers: microeconomics, macroeconomics and econometrics. With 444 students over three cohorts (students starting their second year in 2004, 2005 and 2006) in each module, we have data consisting of 1,332 observations.

We analyse these data to find out, first, what determines students' decisions about whether to attend class, and second, the effect of absence from class on their performance in each module. Addressing the second question requires correcting for the influence of factors such as ability and effort on both absence and performance.

Missing class has an adverse effect on performance only for more able students

Although attendance at lectures tends to be seen as optional, attendance at classes is regarded as compulsory – in part because it is more easily monitored. In practice, student absenteeism from classes is often a problem. It is this absenteeism that leads to variation in class attendance and allows us to establish the effect of classes on attainment. Tutors used an online class register to record attendance, which made it easier to compile the data accurately.

Our analysis reveals that students tend to conform to their stereotype: morning classes have higher rates of absenteeism than afternoon classes, with classes that start at 9 o'clock proving especially problematic. We also find that female students miss fewer classes than male students, and overseas students miss more classes

than home (European Union) students. And students who have performed well in their first year tend to have lower absenteeism rates in their second year.

Morning classes, notably 9 o'clock starts, have higher rates of absenteeism than afternoon classes

What about the effect of absence on student performance? We find that missing class has an adverse effect, but only for 'high ability' students: missing 10% of classes is associated with a 1-2 percentage point lower mark for this group of students. There seems to be no effect of missing class for lower ability students.

Our results suggest that class attendance is a productive activity: the effect of missing class on performance is negative, at least for the more able students. This suggests that there is no over-provision of classes and that compulsory attendance is worthwhile.

The fact that missing class is costly for more able students suggests that classes are more productive for these students. In view of this, it might be appropriate to reflect on how the effectiveness of class teaching and learning can be enhanced for weaker students. Alternatively, additional voluntary classes might be organised for more able students given that, for them, absence is low and the returns are relatively high.

Publication details

"Am I Missing Something? The Effects of Absence from Class on Student Performance," by Wiji Arulampalam, Robin Naylor, and Jeremy Smith, is published as Warwick Economic Research Paper No. 820.

The authors

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