This Time is Different: Eight Centuries of Financial Folly

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Kenneth S. Rogoff, Harvard University and NBER
(Princeton University Press, forthcoming 2009)

This talk is based on the following references (in chronological order):


Recent examples of the “this time is different syndrome”

- **US in the run-up to the 2007 financial crisis:** This time was different because of globalization, the technology boom, our superior financial system, our better understanding of monetary policy, the phenomenon of securitized debt. Sure, housing prices doubled, equity prices soared, all fueled by record borrowing from abroad. But it is not like the United States can have an emerging market type financial crisis…

- **Asia following the Mexican 1994-1995 crisis:** Sure, Latin America may experience recurrent problems, but Asia has high savings rates and superior work ethic (not to mention Asian values). Record current account deficits owe to high investment rates—not consumption booms. Financial crises are other people’s problems.

And a not so recent example…

more to follow
(courtesy of Professor Peter Lindert)

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FAMOUS WRONG GUESSES IN HISTORY

*when all Europe guessed wrong*


Shrill cries of women. Hoarse shouts of men. Speculators all exchanging their gold and jewels for a lifetime’s merger savings for magic shares in John Law’s Mississippi Company. Shares that were to make them rich overnight.

Then the bubble burst. Down—down went the shares. Facing utter ruin, the frenzied populace tried to “sell”. Panic-stricken mobs stormed the Banque Royale. No use! The bank’s coffers were empty. John Law had fled. The great Mississippi Company and its promise of wealth had become but a wretched memory.
HISTORY sometimes repeats itself—but not invariably. In 1719 there was practically no way of finding out the facts about the Mississippi venture. How different the position of the investor in 1929?

Today, it is inexcusable to buy a "bubble"—inexcusable because unnecessary. For now every investor—whether his capital consists of a few dollars or mounts into the millions—has at his disposal facilities for obtaining the facts. Facts which—as far as is humanly possible—eliminate the hazards of speculation and substitute in their place sound principles of investment.

Saturday Evening Post, September 14th, 1929

Reinhart and Rogoff, 2009

Where are we at present in a historical global context?

Reinhart and Rogoff, 2009
Is the U.S. subprime meltdown a new kind of financial crisis?

A review of some of the antecedents of crises.

Quantitative parallels to post-war banking crises in industrialized countries

- Leading indicators:
- Large capital inflows
- Sharp housing and equity price run-ups
- Inverted V-shaped growth trajectory
- Marked rise in indebtedness
The “Big Five” post-war industrialized country financial crises

Country (Start date)

• Spain (1977)
• Norway (1987)
• Finland (1991)
• Sweden (1991)
• Japan (1992)

Milder industrialized country financial crises

• New Zealand (1987),
• United States (1984).
A year ago we (RR, 2008a) compared the US 2007 crisis

- To the milder post-WWII crises
- and to the really severe ones (Big Five)

On housing and equity price run-ups on the eve of crises

- This is what real housing prices looked like then...
This is what it looks like now…

![Real Housing Prices and Banking Crises](image)

For real equity prices, this is what it looked like then…

![Real Equity Prices and Banking Crises](image)
This is what real equity prices look like now...

As to real per capita GDP, this was then...

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Reinhart and Rogoff, 2009

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Reinhart and Rogoff, 2009
Using consensus estimates for 2009, this is what real per capita GDP looks like **now**.

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**Real GDP Growth per Capita and Banking Crises**

(PPP basis)

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To sum up on the question: Is the US subprime meltdown a new kind of crisis?

- We conclude that while each crisis has idiosyncratic features (the subprime episode being no exception), the runup and unfolding of the current crisis bears many similarities to past episodes of severe financial crises.

- This time (once again) is not entirely different …
Here, we document the duration and depth of the post-crisis crash for selected indicators.

Past and Ongoing Real House Price Cycles and Banking Crises:
Peak-to-trough Price Declines (left panel) and Years Duration of Downturn (right panel)

-5.5 percent
Past and Ongoing Real Equity Price Cycles and Banking Crises:
Peak-to-trough Price Declines (left panel) and Years Duration of Downturn (right panel)

Past Unemployment Cycles and Banking Crises: Trough-to-peak
Percent Increase in the Unemployment Rate (left panel) and Years Duration of Downturn (right panel)
Past Real Per Capita GDP Cycles and Banking Crises: Peak-to-trough
Percent Decline in Real GDP (left panel) and Years Duration of Downturn (right panel)

Severe financial crisis summary:
Peak-to-trough changes, all countries

<table>
<thead>
<tr>
<th>Averages</th>
<th>Cumulative % change</th>
<th>Duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real housing prices</td>
<td>-36</td>
<td>5 years</td>
</tr>
<tr>
<td>Real equity prices</td>
<td>-56</td>
<td>3.4 years</td>
</tr>
<tr>
<td>Unemployment, trough-to-peak</td>
<td>7</td>
<td>4.8 years</td>
</tr>
<tr>
<td>Real per capita GDP</td>
<td>-9.3</td>
<td>1.9 years</td>
</tr>
</tbody>
</table>
Across severe crises in emerging and advanced economies, we find:

- Depth and duration of housing price cycle (peak to trough) is similar.

- Broad similarity also in equity prices, a v-shaped recovery more common than in housing.

- There are similarities in the GDP trajectory—although contractions are more severe in emerging markets.

- Unemployment rises, if anything, **LESS** in emerging markets (perhaps due to sticky wages and high benefits in advanced countries)

As to the fiscal aftermath of banking crises, we find:

- That the nearly universal focus on calculations of **bailout costs** as the centerpiece of the fiscal consequences of banking crises is misguided and incomplete.

- Banking crises weaken fiscal positions beyond the costs of bailouts, as **government revenues contract** and **stimulus plans** find favor.
On the first point, the discrepancies across estimates of bail-out costs are large and in, some cases, staggering

<table>
<thead>
<tr>
<th>Country/beginning year</th>
<th>Estimated bailout cost as a percent of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Upper bound</td>
</tr>
<tr>
<td>Argentina, 1981</td>
<td>55.3</td>
</tr>
<tr>
<td>Chile, 1981</td>
<td>41.2</td>
</tr>
<tr>
<td>Ghana, 1982</td>
<td>6.0</td>
</tr>
<tr>
<td>Japan, 1992</td>
<td>24.0</td>
</tr>
<tr>
<td>Norway, 1987</td>
<td>4.0</td>
</tr>
<tr>
<td>Philippines</td>
<td>13.2</td>
</tr>
<tr>
<td>Spain, 1977</td>
<td>16.8</td>
</tr>
<tr>
<td>Sweden, 1991</td>
<td>6.4</td>
</tr>
<tr>
<td>US (S&amp;L), 1984</td>
<td>3.2</td>
</tr>
</tbody>
</table>

On the second point, government revenues suffer as the crisis lingers (more details to follow)

Bail-out costs are only part of the story why public debt surges after the crisis
Stimulus packages add to the bill of the crisis

- Also, governments engage in stimulus packages involving sometimes wasteful expenditure programs.

- At the height of Japan’s banking crisis in the 1990s, repaving the streets in Tokyo became a routine exercise. As a result, Japan’s gross debt-to-GDP ratio is now nearly 200 percent and a drag on what once was a vibrant economy.

Thus, the true legacy of financial crises is more government debt...

**Cumulative increase in public debt in the three years following the banking crisis**

- Average is 186.3
- Index=100 in year of crisis

<table>
<thead>
<tr>
<th>Country</th>
<th>Cumulative Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Malasia</td>
<td>100</td>
</tr>
<tr>
<td>Mexico</td>
<td>150</td>
</tr>
<tr>
<td>Japan</td>
<td>200</td>
</tr>
<tr>
<td>Norway</td>
<td>250</td>
</tr>
<tr>
<td>Philippines</td>
<td>300</td>
</tr>
<tr>
<td>Korea</td>
<td>100</td>
</tr>
<tr>
<td>Sweden</td>
<td>150</td>
</tr>
<tr>
<td>Thailand</td>
<td>200</td>
</tr>
<tr>
<td>Average</td>
<td>250</td>
</tr>
<tr>
<td>Spain</td>
<td>300</td>
</tr>
<tr>
<td>Indonesia</td>
<td>100</td>
</tr>
<tr>
<td>Chile</td>
<td>150</td>
</tr>
<tr>
<td>Finland</td>
<td>200</td>
</tr>
<tr>
<td>Colombia</td>
<td>250</td>
</tr>
</tbody>
</table>
Banking crises and default cycles on external debt

- This lull may also be temporary.
- A high incidence of global banking crises (such as at present) has historically been associated with a high incidence of sovereign defaults on external debt…
Perhaps Ecuador’s latest default (December 2008) on its external debt is a sign of things to come...