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Top Culprit in the Financial Crisis: Human Nature

By LAWRENCE C. STRAUSS

Kenneth Rogoff and Carmen Reinhart, who wrote This Time Is Different, say coming up with regulations to ward off financial disasters is a lot easier than getting people to keep them in place as years pass.

Carmen Reinhart and Kenneth Rogoff have spent countless hours studying financial crises and debt bubbles. And unfortunately for those with an upbeat economic forecast, their news is not good. For one thing, they expect growth to remain challenged for a long time, thanks in part to the aftermath of the debt binge of the 2000s. "In the advanced economies, think of trend growth being a percentage point lower for a decade more, possibly even two decades more," says Rogoff, a Harvard economics professor who in 2009 co-authored This Time Is Different, with Reinhart, who teaches about the international financial system at Harvard's John F. Kennedy School of Government. The two recently came to Manhattan, where they had a lively discussion with a Barron's editor. They agree that the proper regulatory framework to prevent another severe crisis is achievable. "But can we stay there?" Reinhart asks. For the answer to that question and many others, read on.

Barron's: How does the recent financial crisis compare with others throughout history?

Reinhart: The advanced economies, the United States included, really have not seen a crisis of this depth and breadth since the 1930s. In terms of its onset, it harks back to a lot of the liberalization of the financial systems in the advanced economies that enables a lot more risk-taking. And part of that risk-taking gets reflected in significant private-debt buildup. When we talk about having a debt overhang, it is not just about public debt, but also significant private debt, household debt, bank debt, domestic debt, and external debt. So this buildup began to show itself as an asset-price bubble, importantly in real estate—though that is not unique to this crisis. This is something that culminates with a lot of poor lending decisions, which became a banking crisis.

Rogoff: We circulated a paper in 2007 that plotted some of these key macroeconomic indicators, and we said, "Here are the worst financial crises since World War II." We said it was clear that the U.S. would be lucky, given all of the indicators, to escape having a deep financial crisis. So, compared with other post-World War II financial crises around the world, this one is very typical, regardless of whether you compare it with the very small number of advanced-country crises or to the broader number of emerging-market crises. When it comes to this kind of a financial crisis, we as a country are not so different [than other countries]. That was a shock to us, because we are used to seeing emerging-market data be wildly more volatile than advanced-country data.

Gary Spector for Barron's

While doing their research, Rogoff and Reinhart were shocked to discover how similar financial crises were, regardless of where in the world they had erupted.

What are some common themes you saw?

Reinhart: No two crises are identical. Policies differ, and political systems differ. But the common thread is this sustained buildup in a period of really bold optimism, often predicated on the expectation that if asset prices have gone up today, they are going to go up tomorrow and, therefore, we can borrow fairly indiscriminately without a problem. What was also very illuminating was that the U.S. wasn't alone. You saw Ireland, Spain, Portugal, Greece, and the U.K. with a very similar pattern of debt buildup. In all these cases, the U.S. included, they were fueled not just by borrowing domestically, but by borrowing from the rest of the world. All these countries have been running current-account deficits.

What are some of the key lessons from the financial crisis and the recovery?

Reinhart: The U.S. recovery very much fits the mold of those following any severe financial crisis. The U.S. did not have as sharp an initial decline in output as what you have seen in emerging markets or, in effect, as what you saw in prior crises in U.S. history.—not just the Great Depression, but in the crises of 1907 and 1893, as well. In all of these, there were years where you had massive initial declines in GDP [gross domestic product] of 10% or 12%. In the Depression, it was 30%. We did not have that this time. But all the other developments were the same, including the failure to regain what was lost in income and employment, and how long it has lasted.

Post-war recessions, on average, barely last a year. And here we are having these conversations five years after the onset of the subprime crisis. It attests to the long duration of this type of systemic crisis. In the historical context, the U.S. has had, overall, a pretty good track record in the latest crisis. In terms of income per person and in comparison with other countries that are having similarly severe crises, we are doing pretty well–but not so hot in terms of unemployment.

Rogoff: We have always argued that the right metric for thinking about deep financial crises is to compare the current conditions to where you started. It is a much more robust method, particularly because there are false starts, and you don't know when the recovery starts. It is really getting into semantics to say, "Well, we are not racing ahead that fast." But the flip side of that is that a lot of effort was made to have the economy not fall that fast. There is basically fiscal stimulus being taken out of the economy, for example, as we are consolidating from the initial $800 billion stimulus in 2009. And if we hadn't done that, there would be more room to make the economy grow faster now. But that doesn't mean we would be ahead.

So where is the economy now, compared with when the financial crisis started in 2007?

Reinhart: We are almost caught up.

What are your thoughts about the steps taken to foster fiscal and monetary policy?

Reinhart: We can always go back and figure out a way in which the fiscal and monetary policy could have been made sharper, to do more. But the thrust in a deep financial crisis, when you throw in both monetary and fiscal stimulus, is to come up with something that helps raise the floor. That's why the decline wasn't 10% or 12%. However, one area where policy really has left a bit to be desired is that both in the U.S. and in Europe, we have embraced forbearance. Delaying debt write-downs and delaying marking to market is not particularly conducive to speeding up deleveraging and recovery. Write-downs are not easy. On the whole, write-offs have been very sluggish.

Rogoff: Again and again, policy makers, Wall Street economists, and world leaders have all been overly optimistic about how fast things are going to go. If you think that we are about to get a V-shaped recovery, then you talk yourself into forbearance. If you think, "My gosh, this is going to last 10 years, but how can we make it last seven years?" you say, "This is really painful, but we've got to do it." But they've been very slow coming around to the view that this downturn isn't ending soon, and they can't just hold their breath and have it go away.

Look at Europe. A lot of policies are directed at keeping European banks afloat, and it is crippling the credit system. You could have said the same about the U.S., where a lot of policies are about recapitalizing the financial system. The policy makers were very, very cautious about breaking eggs. The thinking was, "We just have got to hold out for a year, and it is going to be fine."

What kind of policy makes sense in the U.S.?

Reinhart: On the monetary side, which for me is the least ambiguous right now, this is not the time to be an inflation hawk. I would rather see the margin of error favor easing too much, rather than too little, for many reasons. The frailty of the recovery is still an issue. The amount of debt that is still out there for households, the financial industry, and the government is still large.

The fiscal side is more complicated, because the idea of withdrawing stimulus in what is still a frail environment is not an easy one to tackle. However, over the longer haul, a comprehensive, credible fiscal consolidation is very much needed, because as much as we allude to the level of public debt, the level of private debt, external debt, and so on are even higher. And we also have a lot of unfunded liabilities in our pension scheme, a long-term issue that needs addressing.

But getting back to the earlier point about helping the deleveraging process, we have a credit system that is still working very poorly. It is very difficult for households to refinance. So we are not actually talking about taking on new debt, but re-contracting to get the benefits of lower interest rates. The whole approach of Fannie Mae and Freddie Mac right now is to have caution, which was thrown out the door during the boom.

Rogoff: There is overshooting now in the other direction, through regulation.

Reinhart: Right, and so getting the refinancing process under way would actually help a great deal.

But you do see reports in the press about a lot of refinancing going on, don't you?

Reinhart: You do, but there could be a lot more of it. For example, if you look at the prerequisites for refinancing, the credit scores basically shut out a huge chunk of the population.

In the 1982 recession, there was high inflation that lingered from the late 1970s, and a lot of the mortgage debt was variable-rate. So, as soon as the Fed eased, the benefits were transmitted to households in the form of a lower mortgage payment. That helped enormously. Now what we have inherited is basically a lot of fixed 30-year mortgages, so anything that can be done to loosen up the clogged credit wheels merits quite a bit of attention.

Rogoff:It is important to have an independent central bank that can resist, when necessary, short-sighted political pressures for lower interest rates, even if that's at the cost of higher inflation. At the onset of this crisis, informed by my work with Carmen, I started writing that this is a once-in-a-100-year event. And, yes, there are a lot of clever ways to try to clean things up, but I'm pretty cynical that we will be able to do it. But having some temporarily elevated inflation would not be such a bad idea for many, many reasons. Of course, it means there will be a transfer of wealth from creditors to debtors. But some of this is inevitable anyway, since not all of the debt is going to get paid. Even then, we will need more restructuring [of debt]. Second, on fiscal policy we have struck a middle ground because we are running a 7% deficit [as a percentage of GDP], and the situation is comparable in the U.K. And there are voices that say, "Well, the deficit should be much higher." Our work suggests caution on that front. There can be very-long-term costs, in terms of growth, to having such elevated debt.

And then if you didn't just raise taxes or cut taxes but actually fixed the tax system, that would be very important. There are very good ideas out there on how to accomplish that. The baseline is a flat consumption tax of some form with a high deduction. The Simpson-Bowles plan takes the political middle road in trying to reach that. It's a great idea. You can have more revenue and keep incentives and maintain growth. And, lastly, other things, like infrastructure and education spending, are important. This isn't all about austerity versus no austerity. Countries that are successful in dealing with these crises, such as Sweden, sometimes take them as an opportunity to change. We haven't.

Reinhart: You go through history and, in good times, the tendency is to liberalize. Then a crisis happens, and you retrench. But the retrenchment lasts only as long as your memory does, and memory is not that great. Not the memory of the policy makers and not the memory of the markets. So as you start putting time in between where you are now and your last crisis, complacency sets in, and you begin to be more cavalier about what your indicators or warning signals are showing. That's the essence of the this-time-is-different syndrome. The debt ratios are X, but we really don't have to worry about that; the price-earnings ratios are Y, but that's not a concern.

And so, given that this is so grounded in human nature, I'm extremely skeptical that we will overcome financial crises in any definitive way. We may have longer stretches [without a major crisis], as we did after World War II during the era of financial repression, which grew out of the crisis of the early 1930s. Back then, you had a lot more regulation and clamps on risk-taking, both domestically and cross-border. But then we outgrew it. It was passé. Who needed Glass-Steagall?

So you're not optimistic that financial crises can be avoided?

Reinhart: No, no.

Rogoff: When we started writing our book, we thought we would find that there were financial crises in Asia, Europe, the U. S. and elsewhere. What we hadn't quite anticipated was how similar these crises would be. It just shocked us, because these areas have different legal systems and different institutions. Carmen mentioned human nature. It is almost as if these institutions and these legal systems were forms of clothing and makeup, but inside the person is the same.

Is there a regulatory framework that would prevent severe financial crises?

Reinhart: Of course there is. But can we get there?

Rogoff: And stay there?

Reinhart: That's the question. Getting there is one thing, staying there is a different matter. And that's where the memory, or the dissolution of memory, kicks in. This comes out very clearly in our chapter in the book about banking crises. Devastated by what happened in the 1930s, the architects of the Bretton Woods System at the end of World War II, including John Maynard Keynes, were very leery of financial markets. This was an era of financial repression. Trade boomed. Not trade in finance, but trade in goods and services. And this very tight system, with all its distortions and problems, still delivered decade after decade of no systemic crisis. Between 1945 and 1980, it was an unusually quiet period. But then, by the late-1990s, the regulations seemed passé. The financial system found ways of circumventing regulation. It was outmoded. It was discarded, and we started anew.

Rogoff: It's important to channel some financing into safer instruments. If banks were to finance themselves like normal firms by raising a significant share of their lendable capital through issuing equity or retained earnings, we would have much, much safer financial system. So that's a very simple change.

In closing, what's your assessment of the financial crisis in Europe?

Reinhart: The short answer is that it is a lot worse there than it is in the U.S. in terms of the financial crisis morphing into an immediate sovereign crisis with a very deep, double-dip recession. But [European Central Bank President] Mario Draghi has tried to be much more accommodative with regard to purchasing the debt of periphery countries. That's a very big step in the right direction.

But it's very clear that the euro zone needs higher inflation. The orders of magnitude are such that fiscal austerity, together with the ECB easing, won't be sufficient to deal with the extreme debt overhangs in places like Spain and Ireland. And so, bottom line, we expect to see more credit events, including the writing off of senior bank debt. Credit events don't end with Greece. This is not a Greek problem. This is a European problem. So be prepared for a lot of volatility surrounding future credit events.

Thanks very much.