- THE WALL STREET JOURNAL. WSJ.com OPINION

- FEBRUARY 3, 2009

What Other Financial Crises Tell Us
The lesson of history is grim: Expect a prolonged slump.

By CARMEN M. REINHART and KENNETH S. ROGOFF

Perhaps the Obama administration will be able to bring a surprisingly early end to the ongoing U.S. financial crisis. We hope so, but it is not going to be easy. Until now, the U.S. economy has been driving straight down the tracks of past severe financial crises, at least according to a variety of standard macroeconomic indicators we evaluated in a study for the National Bureau of Economic Research (NBER) last December.

In particular, when one compares the U.S. crisis to serious financial crises in developed countries (e.g., Spain 1977, Norway 1987, Finland 1991, Sweden 1991, and Japan 1992), or even to banking crises in major emerging-market economies, the parallels are nothing short of stunning.

Let's start with the good news. Financial crises, even very deep ones, do not last forever. Really. In fact, negative growth episodes typically subside in just under two years. If one accepts the NBER's judgment that the recession began in December 2007, then the U.S. economy should stop contracting toward the end of 2009. Of course, if one dates the start of the real recession from September 2008, as many on Wall Street do, the case for an end in 2009 is less compelling.

On other fronts the news is similarly grim, although perhaps not out of bounds of market expectations. In the typical severe financial crisis, the real (inflation-adjusted) price of housing tends to decline 36%, with the duration of peak to trough lasting five to six years. Given that U.S. housing prices peaked at the end of 2005, this means that the bottom won't come before the end of 2010, with real housing prices falling perhaps another 8%-10% from current levels.

Equity prices tend to bottom out somewhat more quickly, taking only three and a half years from peak to trough -- dropping an average of 55% in real terms, a mark the S&P has already touched. However, given that most stock indices peaked only around mid-2007, equity prices could still take a couple more years for a sustained rebound, at least by historical benchmarks.

Turning to unemployment, where the new administration is concentrating its focus, pain seems likely to worsen for a minimum of two more years. Over past crises, the duration of the period of rising unemployment averaged nearly five years, with a mean increase in the unemployment rate of seven percentage points, which would bring the U.S. to double digits.

Interestingly, unemployment is a category where rich countries, with their high levels of wage insurance and stronger worker protections, tend to experience larger problems after financial crises than do emerging markets. Emerging market economies do have deeper output falls after their banking crises, but the parallels in other areas such as housing prices are quite strong.

Perhaps the most stunning message from crisis history is the simply staggering rise in government debt most countries experience. Central government debt tends to rise over 85% in real terms during the first three years after a banking crisis. This would mean another $8 trillion or $9 trillion in the case of the U.S.

Interestingly, the main reason why debt explodes is not the much ballyhooed cost of bailing out the financial system, painful as that may be. Instead, the real culprit is the inevitable collapse of tax revenues that comes as countries sink into deep and prolonged recession. Aggressive countercyclical fiscal policies also play a role, as we are about to witness in spades here in the U.S. with the passage of a more than $800 billion stimulus bill.

Needless to say, a near doubling of the U.S. national debt suggests that the endgame to this crisis is going to eventually bring much higher interest rates and a collapse in today's bond-market bubble. The legacy of high government debt is yet another reason why the current crisis could mean stunted U.S. growth for at least five to seven more years.

Yes, there are important differences between the current U.S. crisis and past deep financial crises, but they are not all to the good. True, for the moment the U.S. government is in the very fortunate position of being able to borrow at lower interest rates than before the crisis, and the dollar has actually strengthened. Still, deep financial crises in the past have mostly been country-specific or regional, allowing countries to export their way out.

The current crisis is decidedly global. The collapse in foreign equity and bond markets has inflicted massive losses on the U.S. external asset holdings. At the same time, weak global demand limits how much the U.S. can rely on exports to cushion the ongoing collapse in domestic consumption and investment.

Can the U.S. avoid continuing down the deep rut of past financial crises and recessions? At this point, effective policy prescriptions -- such as coming up with realistic costs of the size of the hole in bank balance sheets -- require a sober assessment of where the economy is going.

For far too long, official estimates of the likely trajectory of U.S. growth have been absurdly rosy and always behind the curve, leading to a distinctly underpowered response, particularly in terms of forcing the necessary restructuring of the financial system. Instead, authorities should be prepared to allow financial institutions to be restructured through accelerated bankruptcy, if necessary placing them under temporary receivership, and only then recapitalizing and reprivatizing them. This is not the time for the U.S. to avoid painful but necessary restructuring by telling ourselves we are different from everyone else.

Ms. Reinhart is professor of economics at the University of Maryland. Mr. Rogoff is professor of economics at Harvard and former chief economist at the International Monetary Fund.