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This time will never be different

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This Time Is Different: Eight Centuries of Financial Folly
By Carmen Reinhart and Kenneth Rogoff
Princeton, $35; £19.95

The four most dangerous words in finance are “this time is different”. Thanks to this masterpiece by Carmen Reinhart of the university of Maryland and Kenneth Rogoff of Harvard, no one can doubt this again.

As the authors note, “If there is one common theme to the vast range of crises we consider in this book, it is that excessive debt accumulation, whether it be by government, banks, corporations or consumers, often poses greater systemic risks than it seems [to do] during a boom”.

The authors have put an immense amount of work into collecting the data financial institutions needed if they were to have any chance of making quantitative risk management work. Needless to say, they failed to put even a tiny proportion of their revenues into this essential task. As a result, stress the authors, “a large fraction of the academic and policy literature on debt and default draws conclusions based on data collected since 1980, in no small part because such data are the most readily accessible”. This was simply ludicrous.

Happily, that excuse will never hold again. The authors have put together a remarkable database on the external and domestic debt, trade, national income, inflation, exchange rates, interest rates and commodity prices of 66 countries from all over the world. The data go back more than 800 years in some cases, to the date of independence for most countries and into the colonial period for several.

What, then, do these data tell us?

The biggest lesson, alas, is that we have been here before. The details may change, but the story does not. Cycles of confidence and panic are inevitable in our world of debt, be that debt public or private, domestic or foreign. Credit is extended freely and then withdrawn brutally.

A second lesson is the recurrence of public sector debt crises. One of the salient features of the book is the light it sheds on the role of domestic public debt, on which data have hitherto been poor. This database shows how often high levels of domestic public debt have explained simultaneous outbursts of inflation and default on foreign debt, even though the latter appears to be at low levels. Crises on foreign debt also recur throughout the ages, from the default to Florentine bankers by Edward III of England, in the 14th century to the default of Argentina to its foreign creditors in 2001. In all, sovereign default turns out to be almost, though not quite, universal, with serial default on domestic, foreign or domestic and foreign debt quite common. No less universal, again particularly for emerging countries, are periods of currency debasement or, today, inflation.

A third lesson is that, while advanced countries appear to leave their days of sovereign default behind them (possibly, famous last words), this does not apply to banking crises. These are “an equal-opportunity menace”. As the authors note, “the incidence of banking crises proves to be remarkably similar in the high- and the middle- to low-income countries”. Out of the 66 countries in their sample, only Austria, Belgium, Portugal and the Netherlands managed to escape banking crises between 1945 and 2007. Financial systems are accidents waiting to happen.

Banking crises are also devastatingly expensive, in terms of lost national income and public debt. On average, note the authors, government debt rises by 86 per cent during the three years following a banking crisis. The red ink drowning the fiscal accounts of the crisis-hit US and UK are exactly what past experience would have led us to expect.

A fourth lesson is that bad things go together. In a boom, property prices jump, current account deficits explode, fiscal receipts soar and governments borrow easily; then, in the slump, property prices tumble, the financial system implodes, capital flows out, the currency falls, the fiscal deficit soars and inflation jumps.

The final lesson is that financial liberalisation and financial crises go together like a horse and carriage. It is no surprise, therefore, that the last 30 years have seen waves of financial crises, of which the latest one is merely the biggest. The current crisis is the worst since the Great Depression. Yet, argue the authors, no one should have been surprised by this outcome. The US showed all the classic symptoms of a country heading for crisis: a huge current account deficit; soaring house prices; headlong credit growth; and, let us not forget, excessively complacent regulators.

If governments want to help financial stability, they will pay to extend this pioneering effort. But the data collected and analysed here should already change the way we all look at the financial world. Crises will always be with us. But maybe, this very realisation will reduce their frequency. Alas, nothing else has done so.

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