this time is different
eight centuries of financial folly

By Carmen Reinhart & Kenneth Rogoff
Princeton University Press,
Princeton and Oxford, 463 pages

review rating

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As we now grind through the aftermath of the Global Financial Crisis, this book, published mid 2009, has attracted great attention and comment. It has assumed the mantle of a first reference point for understanding what we have been through and why – and putting this into a historical context.

The co-authors, professors Reinhart (University of Maryland) and Rogoff (Harvard) have laboured at this work for years, and the data assembled and analysed is, it would appear, without precedent. Thus, the Data Appendixes start at page 293 (macroeconomic time series, public debt, banking crises) and end at 392, followed by 41 pages of notes and references – before one reaches the index. The scope and detail of their work is stunning: sixty-six countries (emerging and developed), eight centuries, all manner and varieties of public/sovereign default, banking crises, currency crashes and the ravages of inflation – the latter being effectively a form of default. The central thesis is that: memories are short, we never seem to learn much from harsh lessons, and of course, this time is never really that different from the misfortunes that have visited us before. Central and fundamental tenets of valuation and macroeconomics prevail in the end, and bring everyone back into line. Or, as they precisely put it: "again and again, in the history of financial crises, is that when an accident is waiting to happen, it eventually does."

That said, this is a curious work in some ways, as it does not debate or hold out any answers for the prior ills. Thus, it is surprising to find no mention of Keynes or Keynesian theories – even in the index you will find no mention of Keynes or, eg, Krugman (who does appear in the text at p 211). The book is incredibly thorough and scholarly in what it purports to address, and yet strangely non-theoretical with few answers for future avoidance of calamity. And so, Robert Shiller (author of Irrational Exuberance and co-author of Animal Spirits) is quoted on the dustcover as saying that this book as terrific, "for it gives just the perspective we need on the current world economic crisis. People can't expect to understand the current crisis without some in-depth look at past crises. That is exactly what this excellent and timely book provides"; and then, in an Opinion article in the Australian Financial Review, on 16 March 2010 (p 63), Professor Shiller observes that this book is "essentially a summary of lessons learned from virtually every financial crisis in recorded history. But the book is almost entirely non-theoretical. It merely documents recurrent patters. Unfortunately, in 800 years of financial history, there is only one example of really massive worldwide contraction – the Great Depression. So it is hard to know exactly what to expect in the current contraction based on the Reinhart-Rogoff analysis."

Agreed, and perhaps the true benefit of this book is to caution the wary investor, that indeed death really does catcheth all men unawares – and, indeed, perhaps William Shakespeare knew as much about international finance in his day as anyone does today? Please see below re the quality of IMF foresight. Being more serious, the book does reinforce the view that Australia has done very well historically, and it appears soundly positioned for the future – given our ratio of public debt to GDP, fiscal position, etc. Australia is one of their "default virgins", as it has never outright failed to meet external debt repayment obligations – and we are conspicuous for our grouping with the other Anglophone nations: Canada, NZ and the US, but not the UK which has defaulted.

This book uses the approach of referring to the GFC as the "Second Great
Contraction" (thereby reinforcing Shiller's point), and primarily looks at most data-sets back to 1800. It invites the reader to read text in parts and chapters, and in any order, and thus the reader can use these as water tight compartments. However, the text is so readable and revealing that most will treat the experience as best approached seriatim – as I did. The six parts cover: An Operational Primer on Financial Crises; Sovereign External Debt Crises; the Forgotten History of Domestic Debt and Default; Banking Crises, Inflation, and Currency Crashes; the US Sub-Prime Meltdown and the Second Great Contraction; and ends posing the question in Part Six: "What Have We learned?".

In the preface, the authors stress the point that the "life" of the book is contained in the tables and figures in which data are presented "rather than in narratives of personalities, politics and negotiations." This is exemplified in visually confronting long time periods of data with the occasional rare event – generally triggered by excessive debt, of countries and institutions. This approach is revealing as "one point that jumps from the analysis is that the fairly recent (2003-2008) quiet spell in which governments have generally honoured their debt obligations is far from the norm." The reader might be surprised to learn that banking crises have "long plagued rich and poor countries alike" and that "on average, government debt rises by 86% percent during the three years following a banking crisis."

The Operational Primer in Part One has direct relevance to current troubles, as it records that the "honour" of the record currency crash goes to Greece in 1944, and that Greece's "default of 1826 shut it out of the international capital markets for fifty-three years," This was said in July 2009 (publication) before the Greek debt crisis surfaced, and of course, is yet another example of déjà vu. Crisis prone countries and "serial defaulters", they say, tend to over-borrow in good times, leaving themselves vulnerable to the inevitable downturn.

In Chapter 3 they explain just how difficult it was to find data on public domestic and external debt: more akin to archaeology than economics. All their many sources are disclosed. They address the ways that governments, after concealing debt (? Greece again) then find creative ways of avoiding their obligations, - eg, after the introduction of "fait"

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(paper) currencies, the use of inflation to expropriate value and thus cause currency debasement (a modern Greek problem, as they cannot do this within the Euro). They explain how sovereign bankruptcy is different from corporate bankruptcy, as for countries, creditors have to accept that repayment turns on a country's willingness to repay, not simply its ability to repay. Which takes us to the political implications of debt generally, and so in Chapter 4 they say that "the fact that the US Sub-Prime crisis became much worse in the run-up to the country's 2008 election is quite typical." And whilst in this area, they note that financial repression can be used as a tool to expand domestic debt markets, with China being the best current example.

In Chapter 10 they fully explore the incidence of banking crises, and contend that "for the advanced economies over the full span, the picture that emerges is one of serial banking crisis." – and even Australia records black marks on this score. Whether one looks pre (back to 1800) or post the Second WW (from 1945), and whether into advanced or emerging countries, banking crises plague the scene with incredible regularity. They provide numerous examples and relate these to booms in housing prices – always a prime culprit for a banking crisis, and food for thought for Australians who believe in the one-way housing bet: "banking crisis are protracted affairs with lingering consequences in asset markets – notably real estate prices and the real economy."

In dealing with default through debasement, in Chapter 11, we unfortunately get another example of Greek misdemeanours, through an excellent explanation of 100% inflation created overnight by Dionysius of Syracuse in Greece of the fourth century B.C. This leads to an excellent explanation of how currency crises are linked to inflation, and the fact that "no emerging country in history, including the US (whose inflation rate in 1779 approached 200 percent) has managed to escape bouts of high inflation."

Coverage of the US Sub-Prime crisis is the best I have read, and any non-economist will understand it – they draw all the threads together, including political aspects. However, the truly depressing point to note here, is that the International Monetary Fund concluded in April 2007, in its twice-annual World Economic Outlook, that "the risks to the global economy has become extremely low and that, for the moment, there were no great worries." As the authors say, with some irony and feeling, "When the international agency charged with being the global watch-dog declares that there are no risks, there is no sure sign that this time is different." So much for active asset allocation.

Chapter 14 provides a painful exposition of the aftermath of financial crises, and the general characteristics that evolve: declines in real housing prices averaging 35% over six years; falls in equity prices of 56% over three years; quantified declines in output and employment; exploding government debt – exacerbated by falling tax revenues. Again, as throughout the book, this information is based on illustrated tables/figures and data, including a comparative analysis of the "Second Great Contraction" with the Great Depression.

The final Chapter 17 examines reflections on early warnings, "graduation", policy responses, and the foibles of human nature. The observations located here duplicate those made in earlier Chapters, but this text serves as a useful overlay of the indicia of crises generally. They revisit a theme on the problems encountered by countries trying to graduate from serial default and high inflation, to prime credit standing. Their conclusion: "graduation is a very slow process and graduations are all too often premature." (Greece again ?)

They believe that the greatest barrier to success in foretelling crises through observing signals, is "the well-entrenched tendency of policy makers and market participants to treat the signals as irrelevant archaic residuals of an outdated framework assuming that old rules of valuation no longer apply." But then, after their Herculean labour, and applying their undoubted expertise and knowledge, they are still driven to confess that their analysis of the history of various types of financial crises "raises many important questions (and provides considerably fewer answers)." And there it should rest.

This book, as Shiller says, is terrific for the historical perspective it conveys. But the future remains as uncertain as ever. One risk for investors, after reading this book, is to become partially informed of risks through sighting potential triggers of misfortune, and then to adopt a bearish disposition. That might seem comforting at the outset, but then progressively disconcerting as growth assets march on. Finally, it can be even more costly, when the bear capitulates to join the marching bulls … in mid 2007! If the IMF cannot announce arrival of the storm, what chance of private investors in Australia?

Martin Earp
Berry, April 2010