What History Has (or Hasn't) Taught Us

Carmen M. Reinhart,
University of Maryland, CEPR , and NBER

Based on This Time is Different:
Eight Centuries of Financial Folly
with Kenneth Rogoff

The Philadelphia Fed Policy Forum

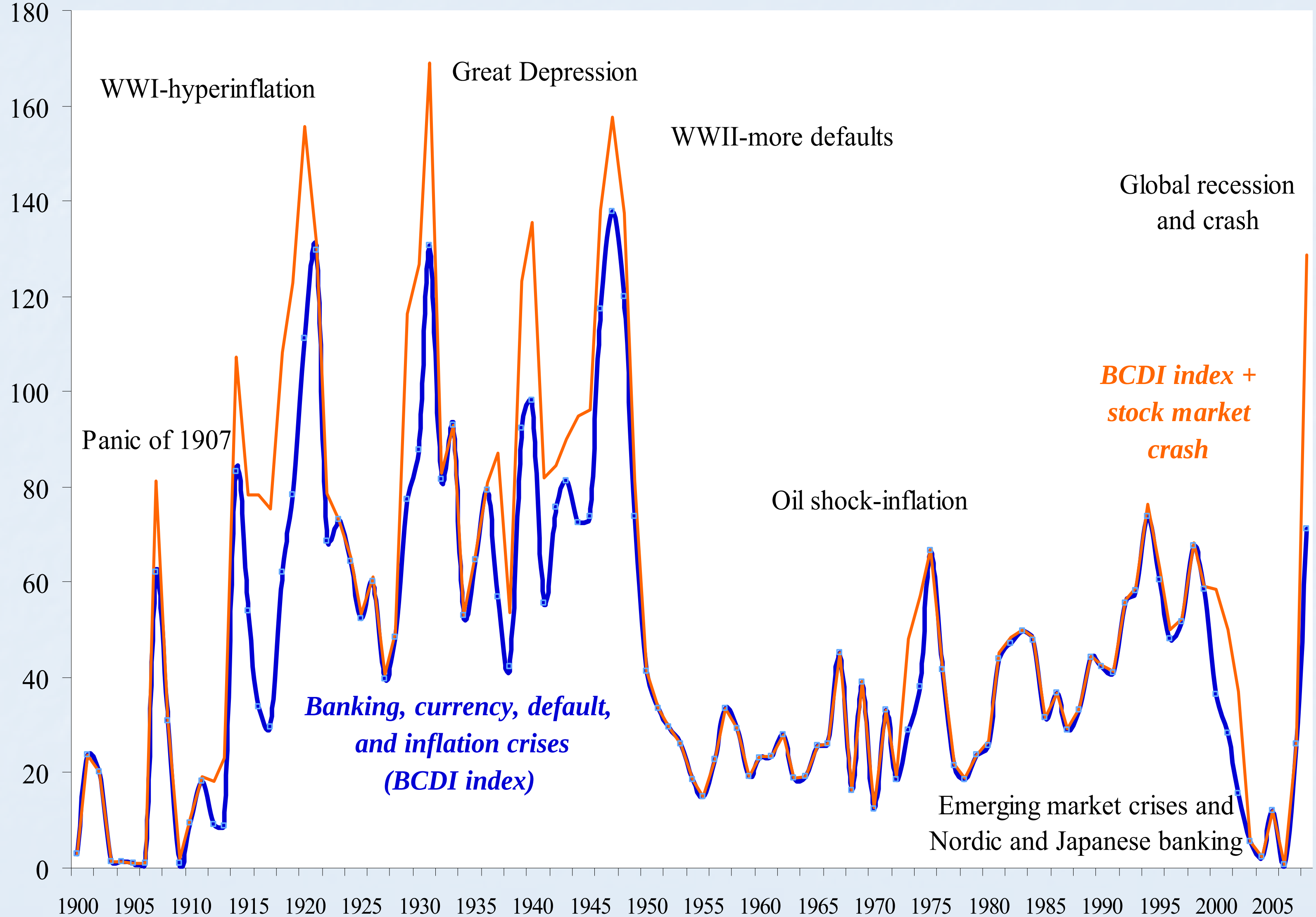
Policy Lessons from the Economic and Financial Crisis ,
December 4, 2009

Where are we at present in a historical global context?

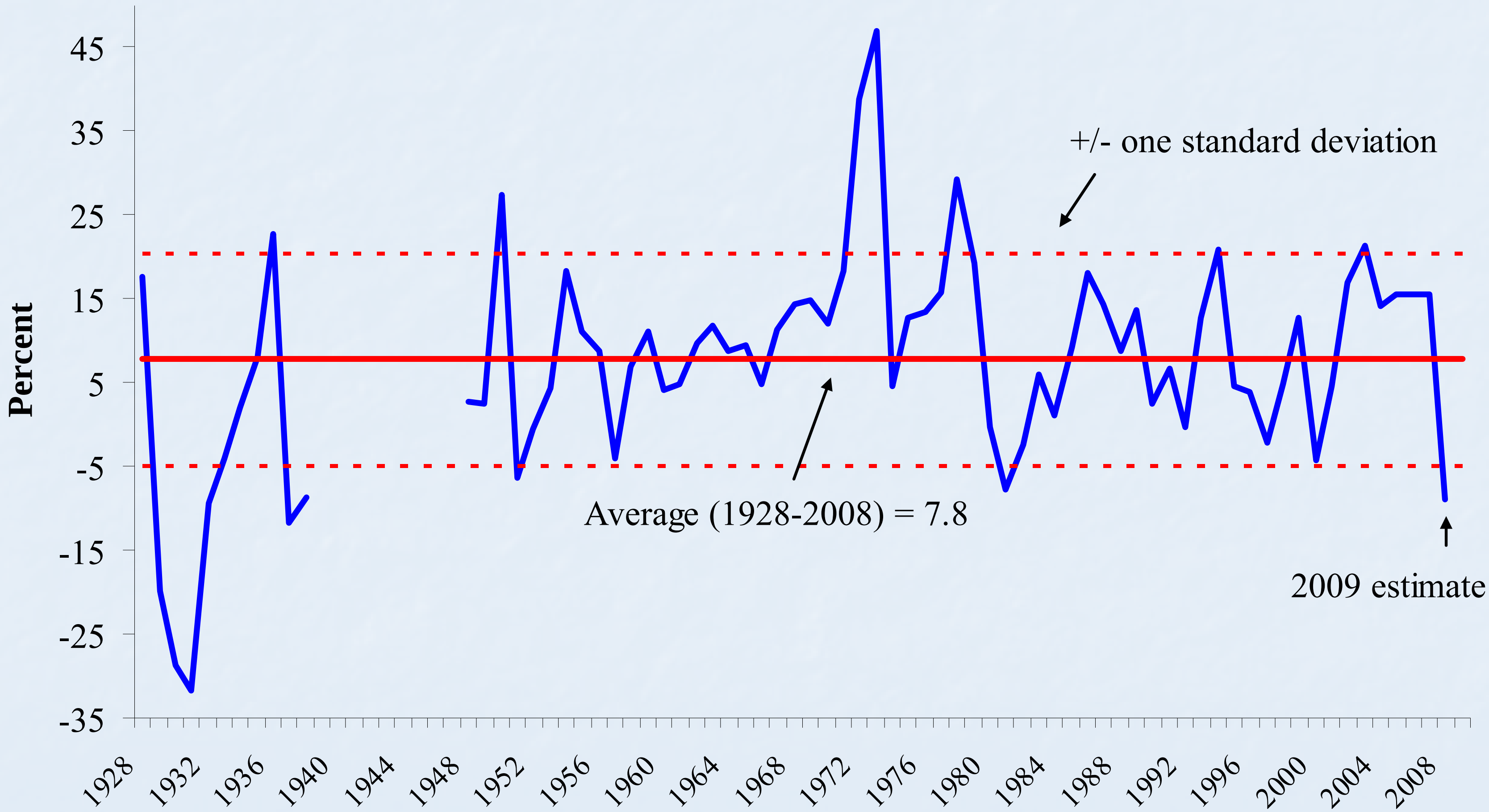
Taking stock…

Varieties of crises: World aggregate, 1900-2008

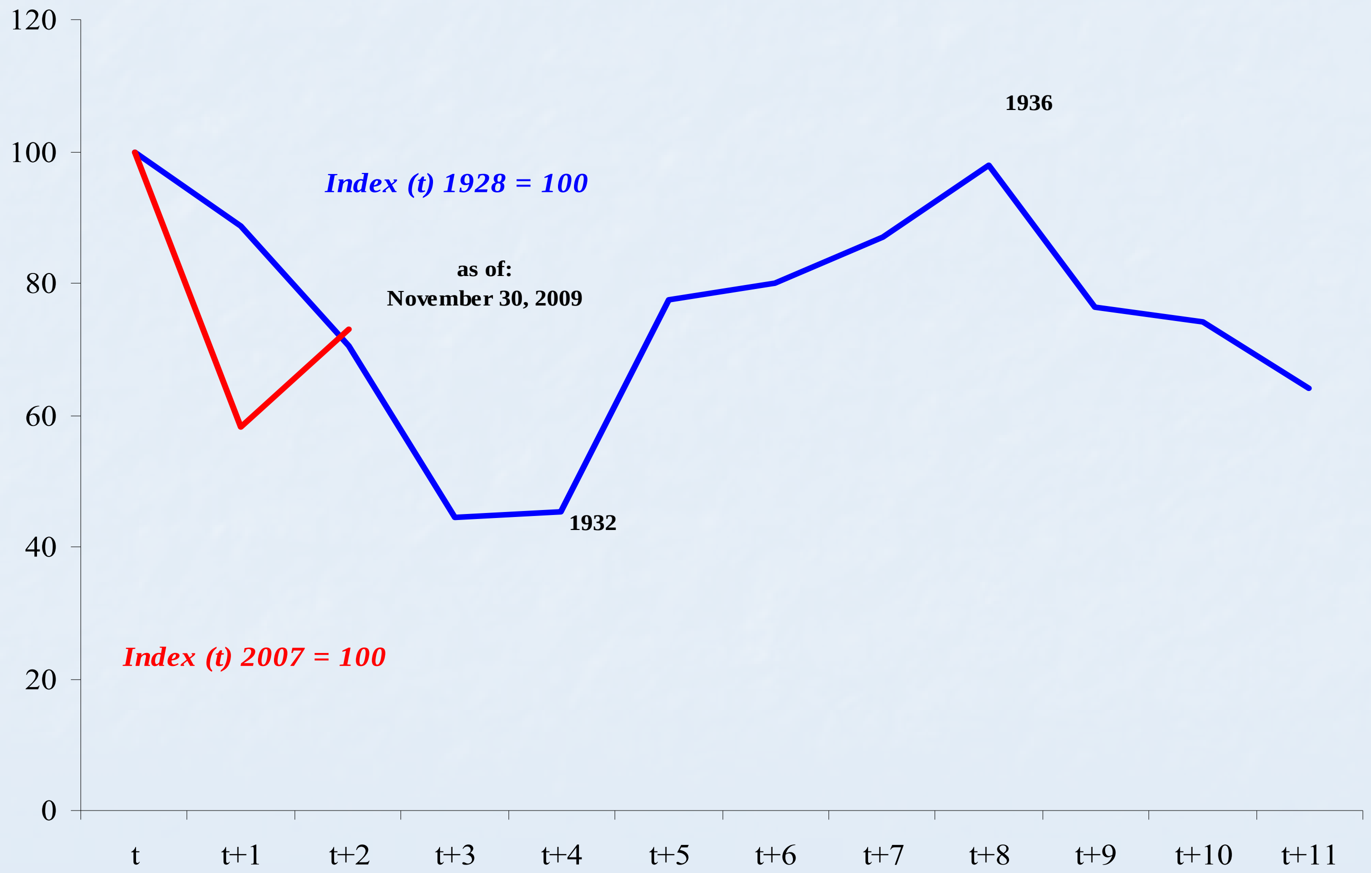
A composite index of banking, currency, sovereign default and, inflation crises, and stock market crashes (weighted by their share of world income)



World export growth, 1928-2009 (annual percent change)



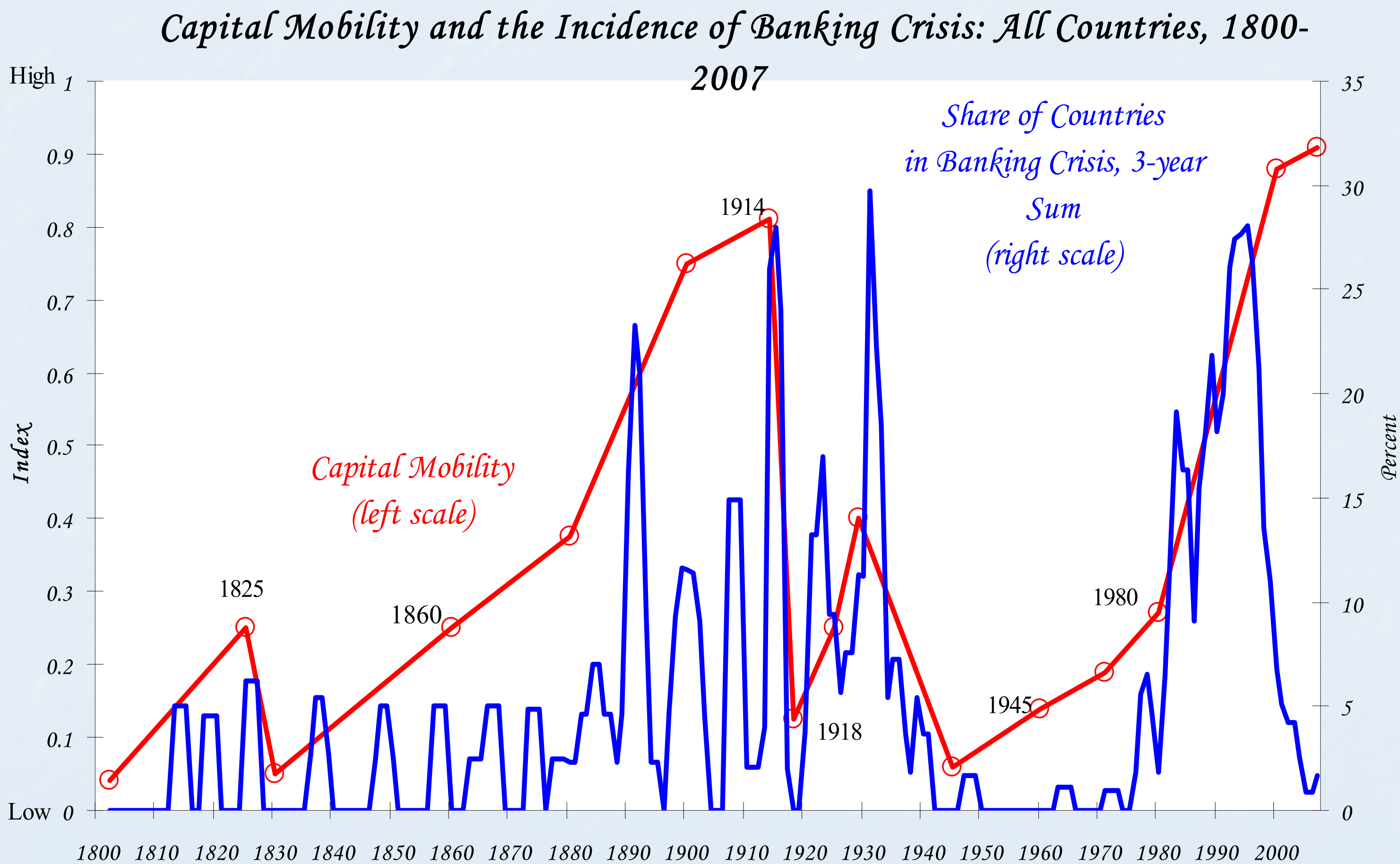
Global stock markets during global crises: Composite real stock price index *(end-of- period)*



Causes, antecedents, and amplifiers of banking crises

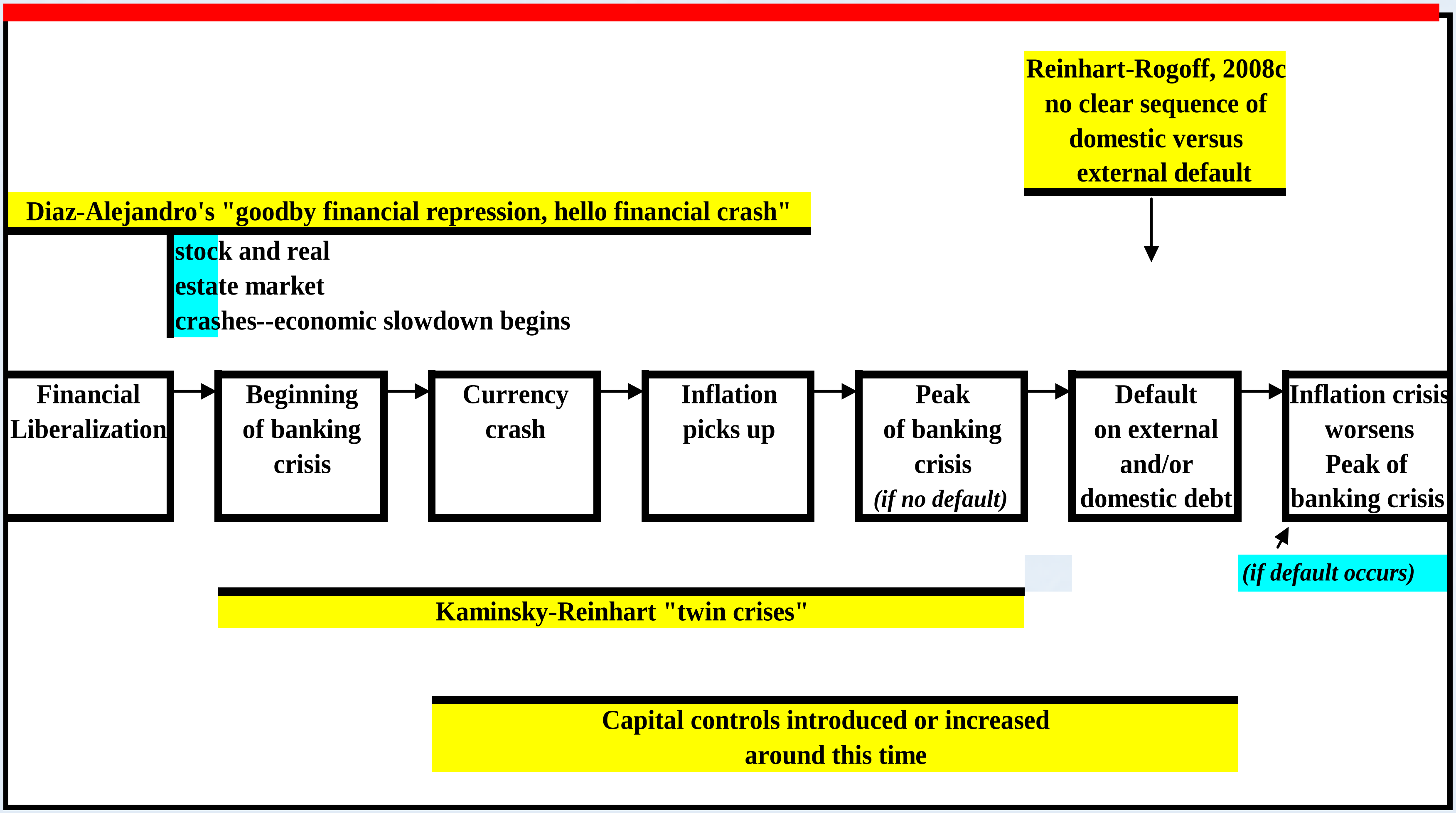
Periods of high international capital mobility have repeatedly produced international banking crises, not only famously as they did in the 1990s to the present, but historically.

Banking crises and capital mobility, 1800-2008



Reinhart and Rogoff

Financial liberalization and the sequencing of crises



The "this time is different syndrome"

- Is rooted in the firmly- held beliefs that:
  - Financial crises are something that happen to other people in other countries at other times;
  - Crises do not happen here and now to us.
  - We are doing things better, we are smarter, we have learned from the past mistakes.
- As a consequence, old rules of valuation are not thought to apply any longer.

One plausible diagnosis of the crisis

"Overindebtedness simply means that debts are out-of-line, are too big relative to other economic factors. It may be started by many causes, of which the most common appears to be *new opportunities to invest at a big prospective profit*… such as through new industries… Easy money is the great cause of over-borrowing."

This diagnosis . . .

comes from Irving Fisher (1933).

There are quantitative parallels as well.

Quantitative parallels to post-war banking crises in industrialized countries

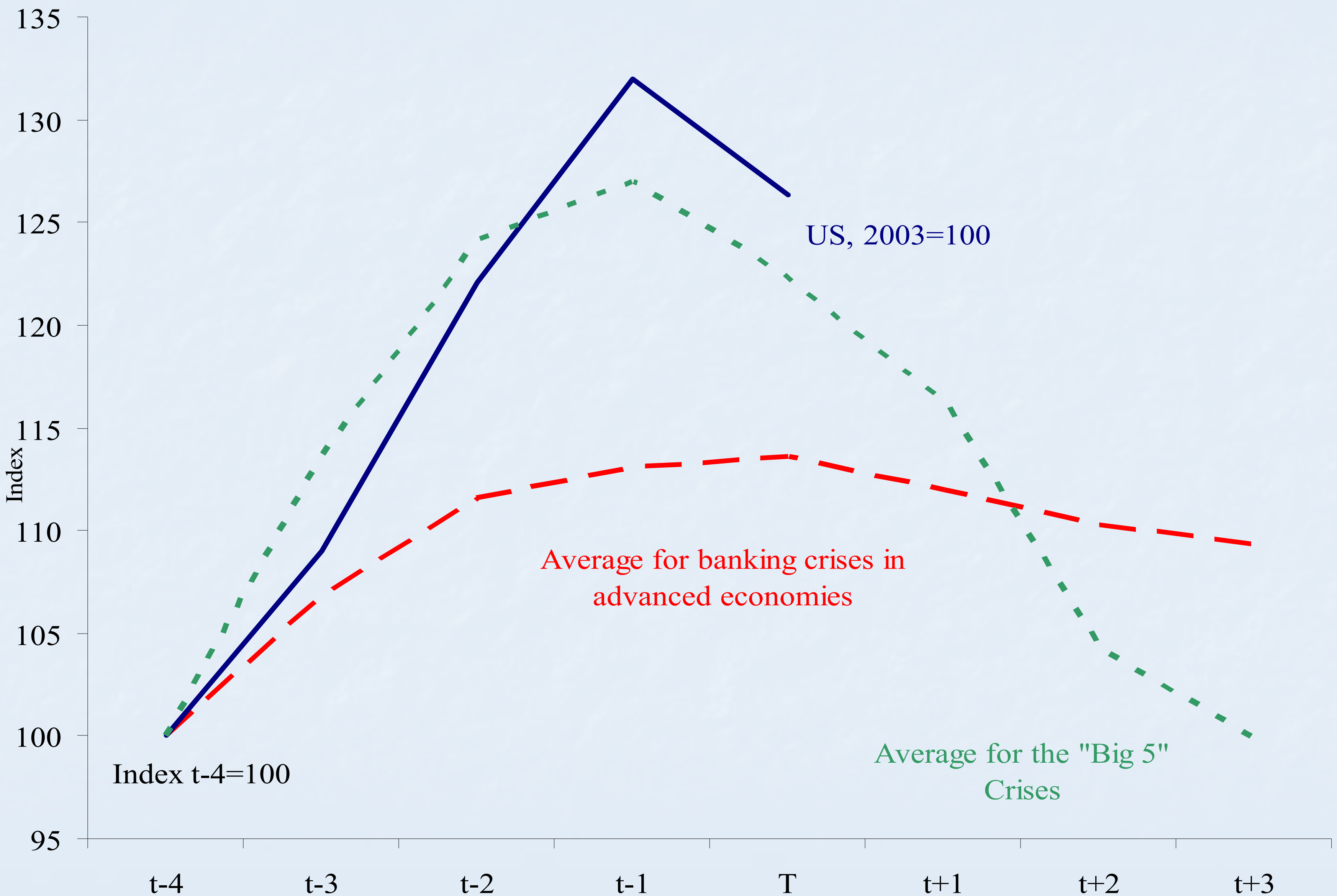
Leading indicators:

- Large capital inflows
- Sharp housing and equity price run-ups
- Inverted V-shaped growth trajectory
- Marked rise in indebtedness

As in earlier episodes, many of these capital inflow bonanza episodes have ended badly…

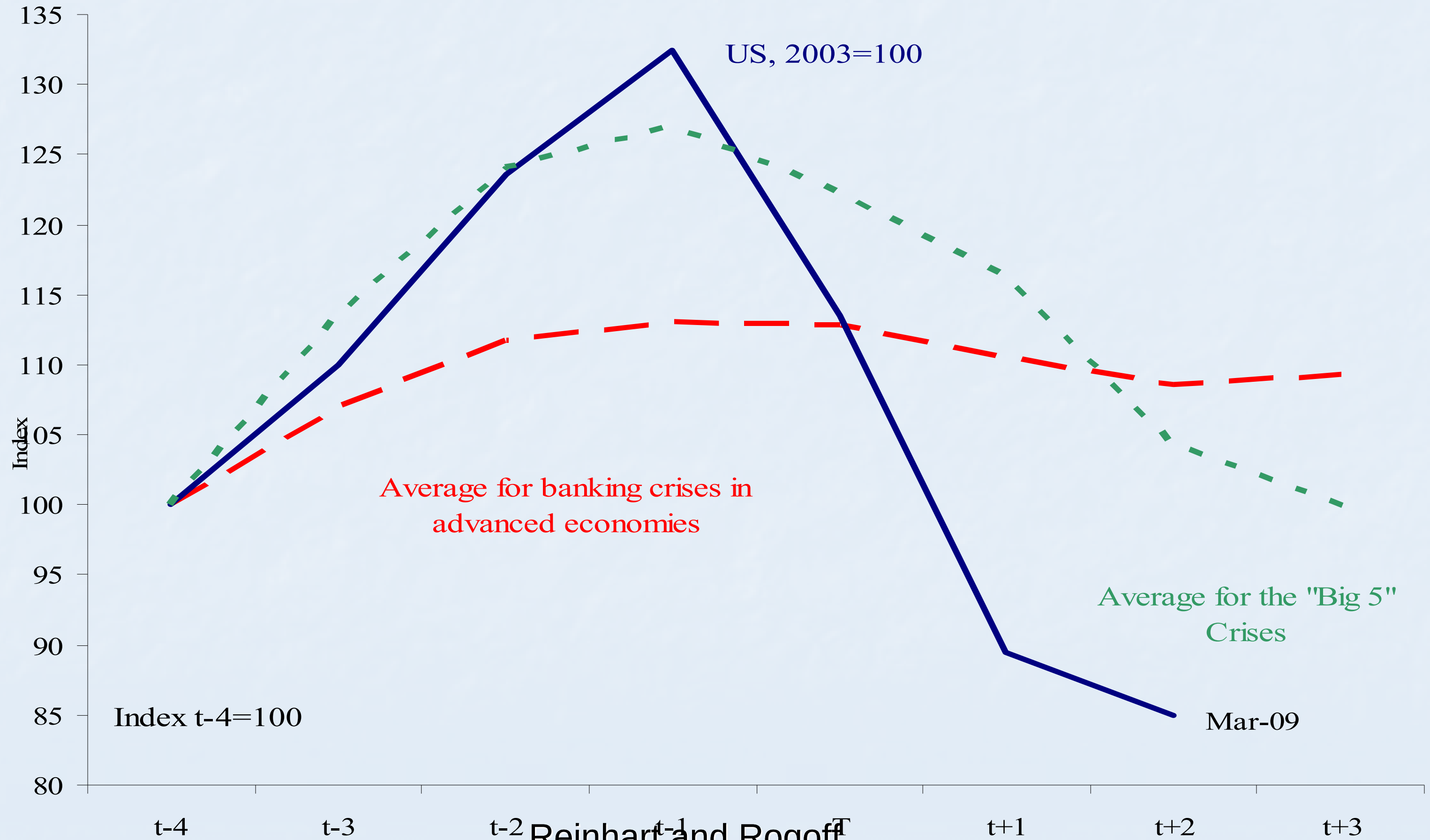
Countries with recent notable capital inflows	2006	2007	2008
Bulgaria	√	√	√
Iceland	√	√	√
Italy	√	√	√
Latvia	√	√	√
Pakistan	√	√	√
Romania	√	√	√
Slovenia	√	√	√
South Africa	√	√	√
Spain	√	√	√
Turkey	√	√	√
United Kingdom	√	√	√
United States	√	√	√

Real Housing Prices and Banking Crises



This is what it looks like now…

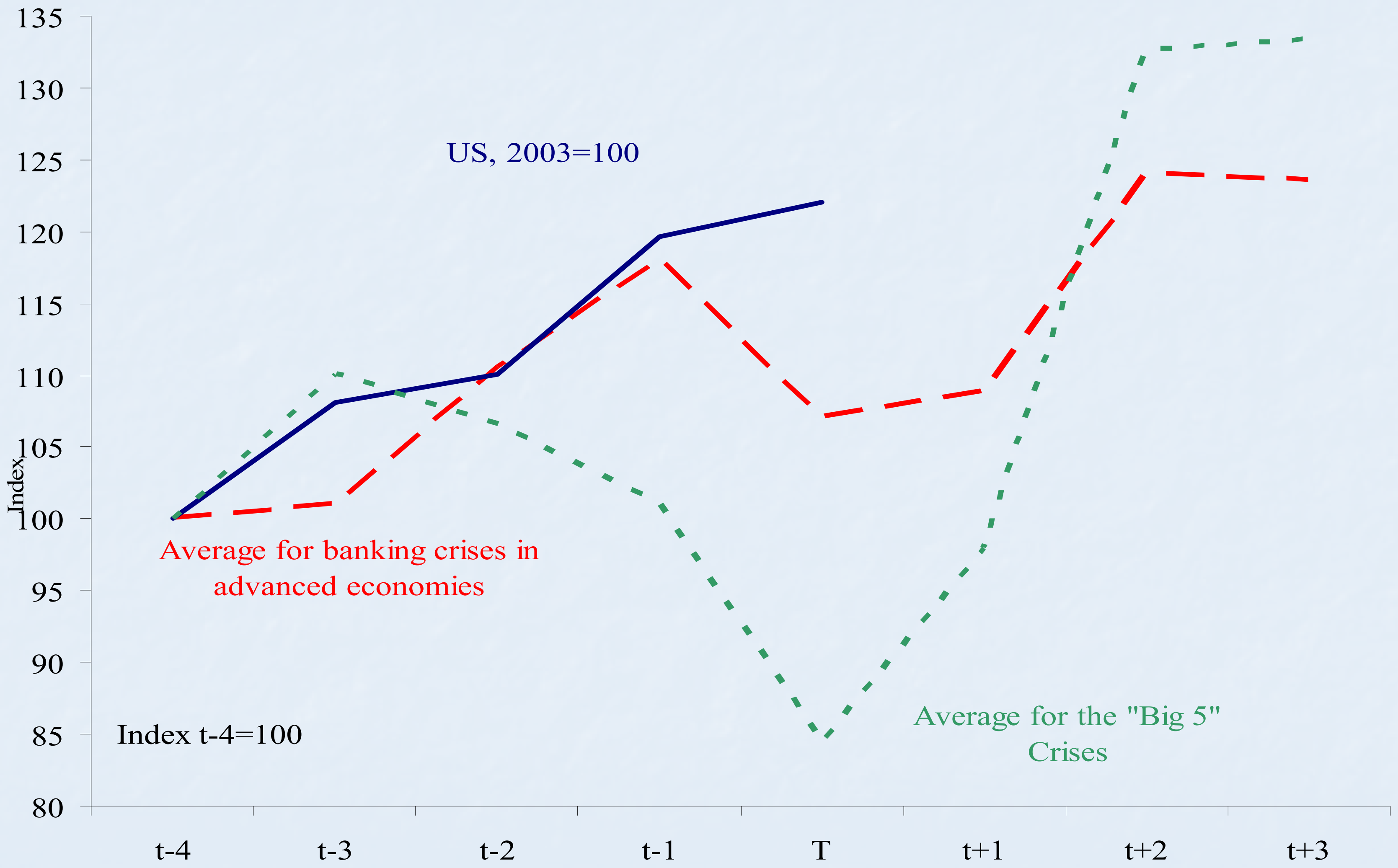
Real Housing Prices and Banking Crises



Reinhart and Rogoff

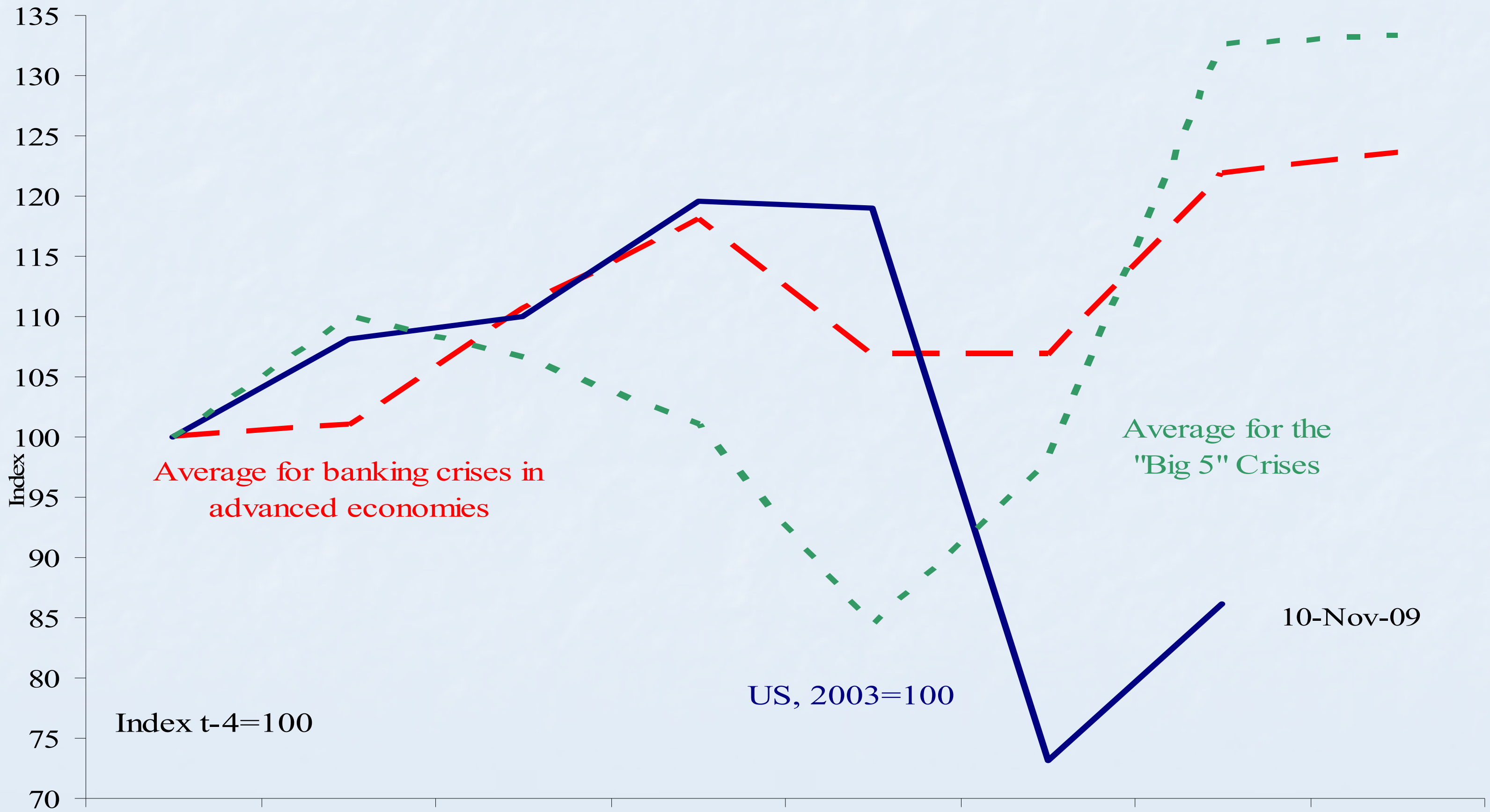
For real equity prices, this is what it looked like then…

Real Equity Prices and Banking Crises



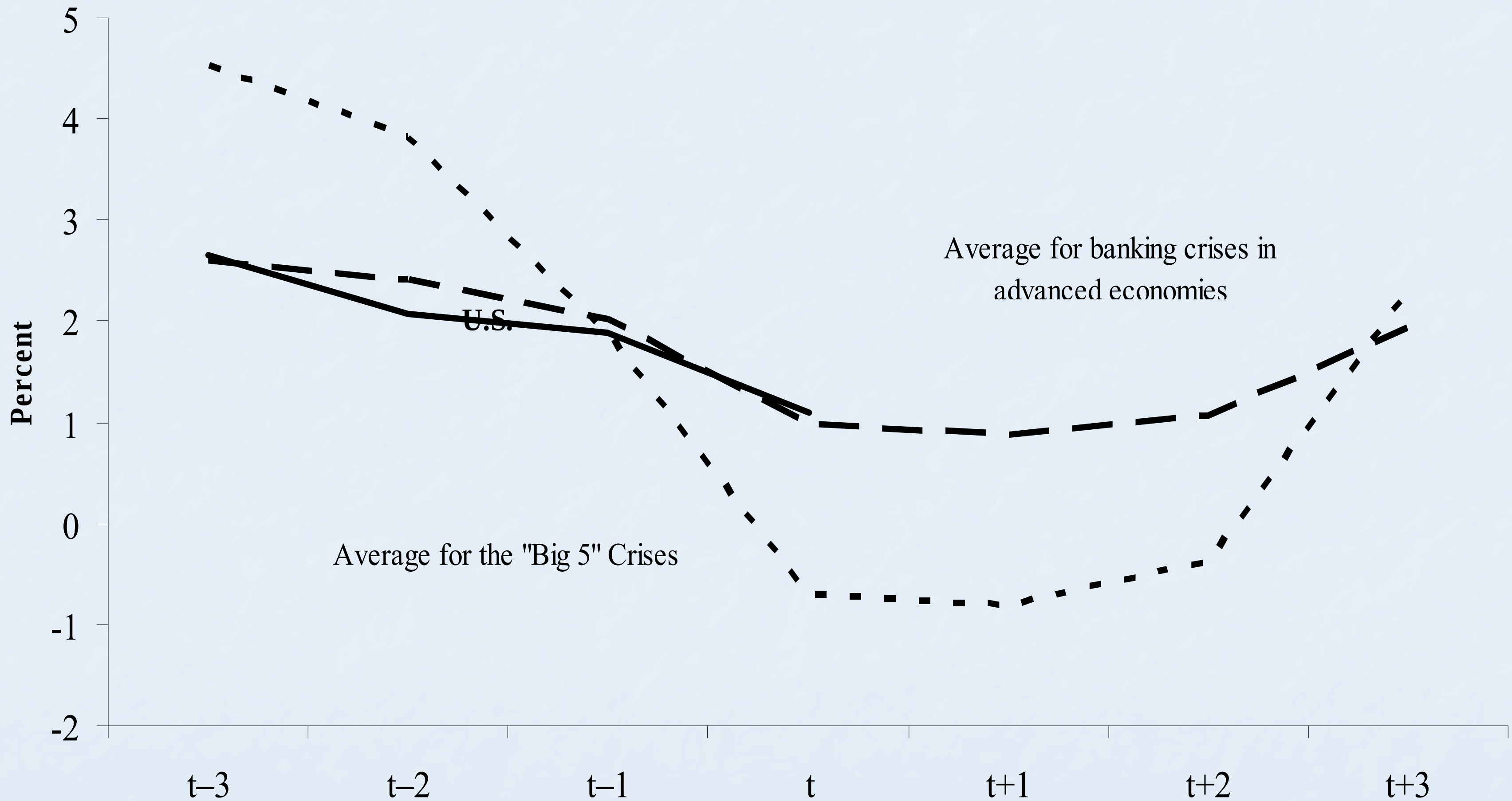
This is what real equity prices look like **now…**

Real equity prices and banking crises



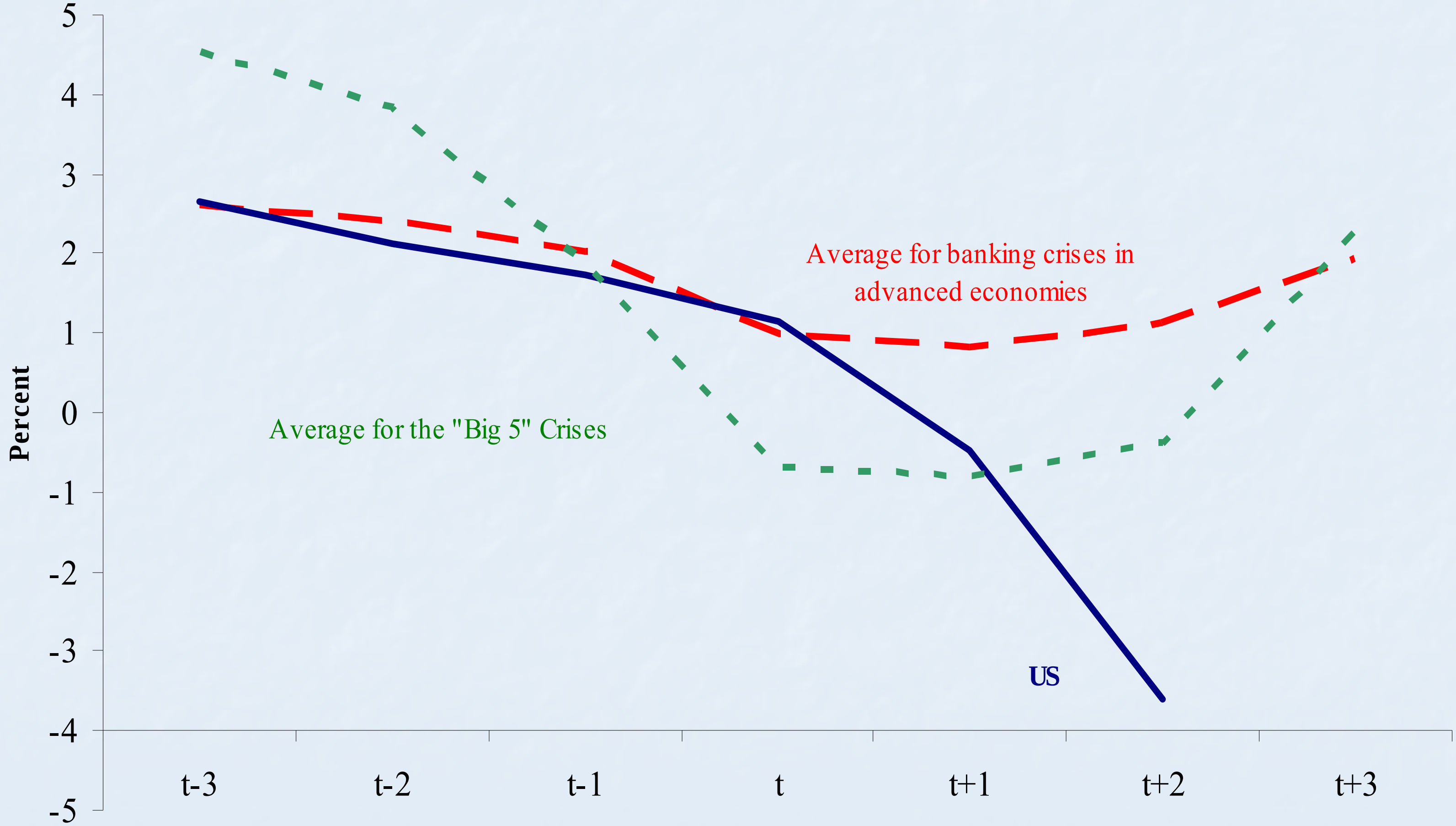
As to real per capita GDP, this was **then…**

Real GDP Growth per Capita and Banking Crises (PPP basis)



Based on the October IMF *World Economic Outlook* estimates for 2009, this is what real per capita GDP looks like now.

Real GDP growth per capita



Amplifiers of the boom-bust cycle include:

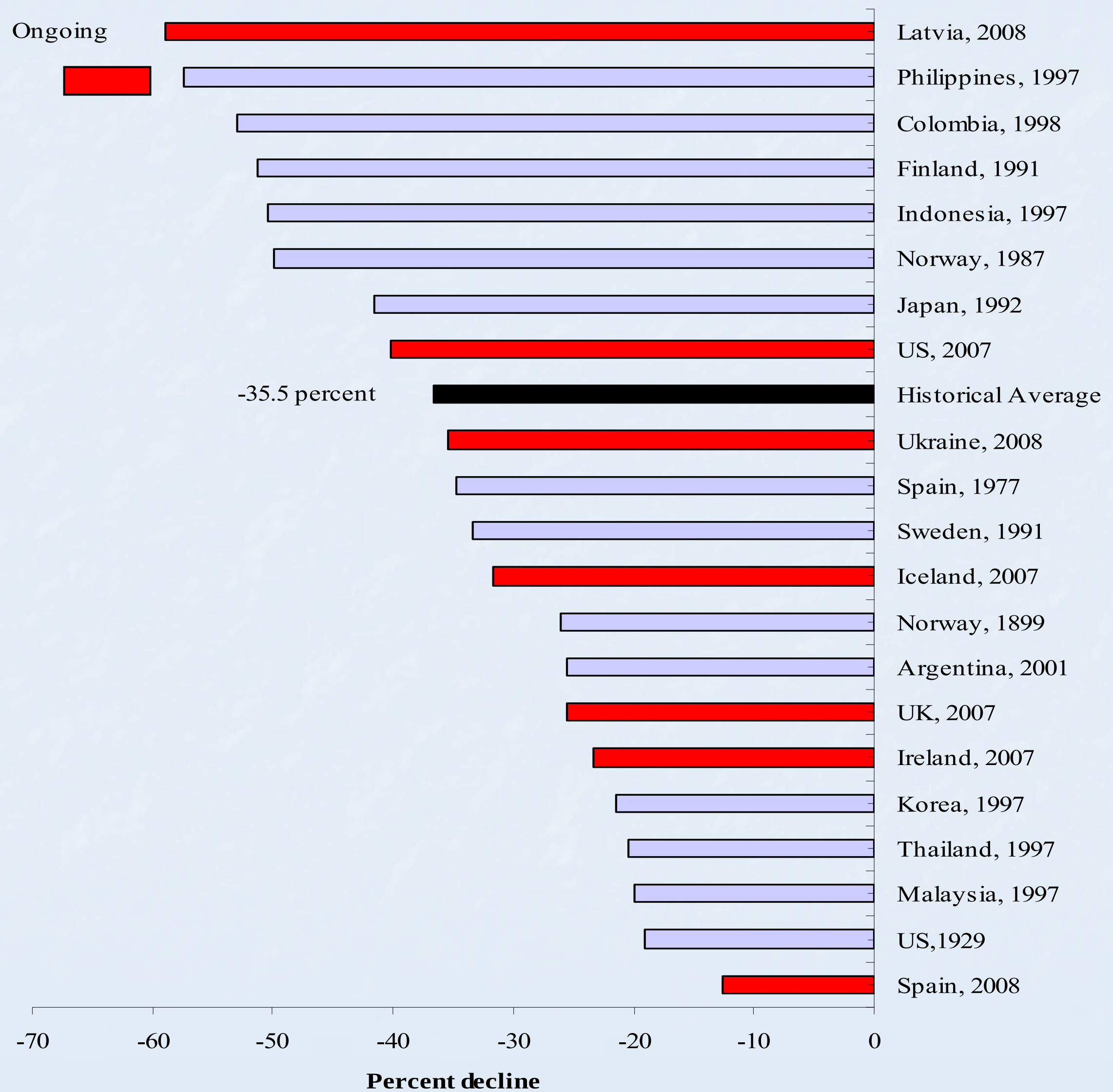
- **Procyclical macroeconomic policies**
- **Hidden debts (implicit guarantees)**
- **Overvalued currencies**
- **Poor regulation**
- **Even worse supervision**
- **Outright fraud**
- **Myopic rating agencies**

The aftermath of financial crises

Past and Ongoing Real House Price Cycles and Banking Crises:

Peak-to-trough Price Declines (left panel) and Years Duration of Downturn (right panel)

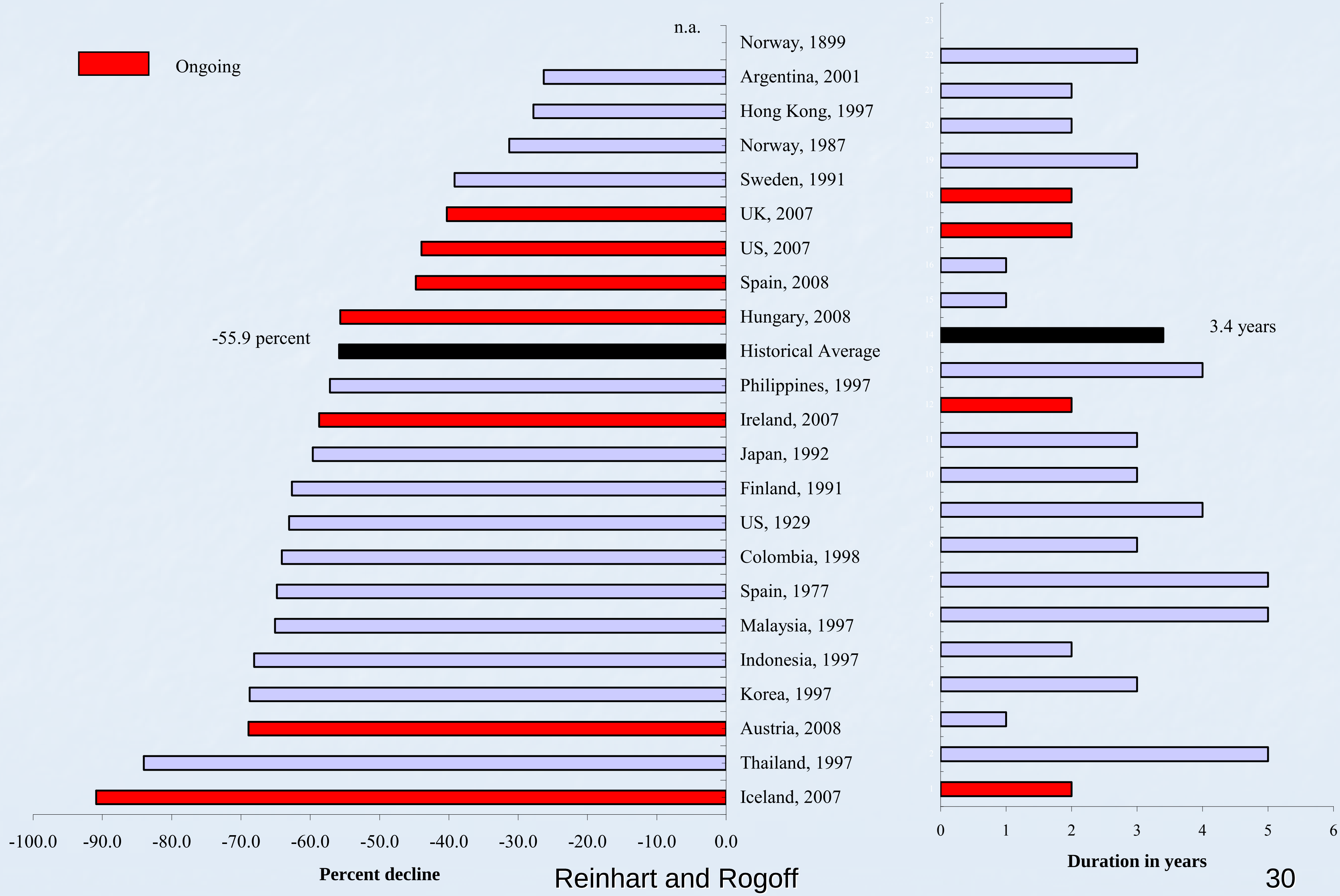
Housing price declines through September 2009



Reinhart and Rogoff

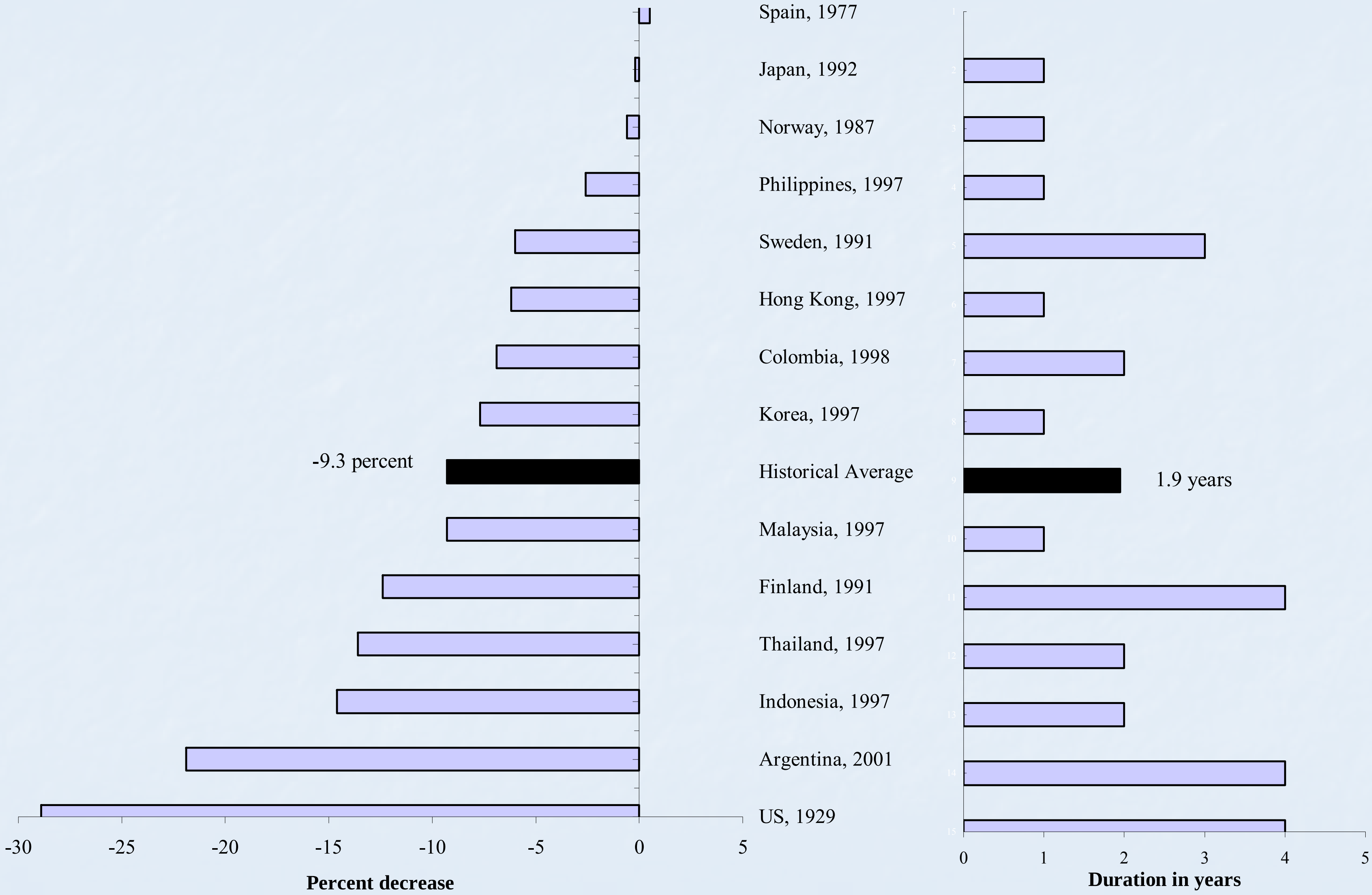
Past and ongoing real equity price cycles and banking crises:

Peak-to-trough price declines (left panel) and years duration of downturn (right panel)

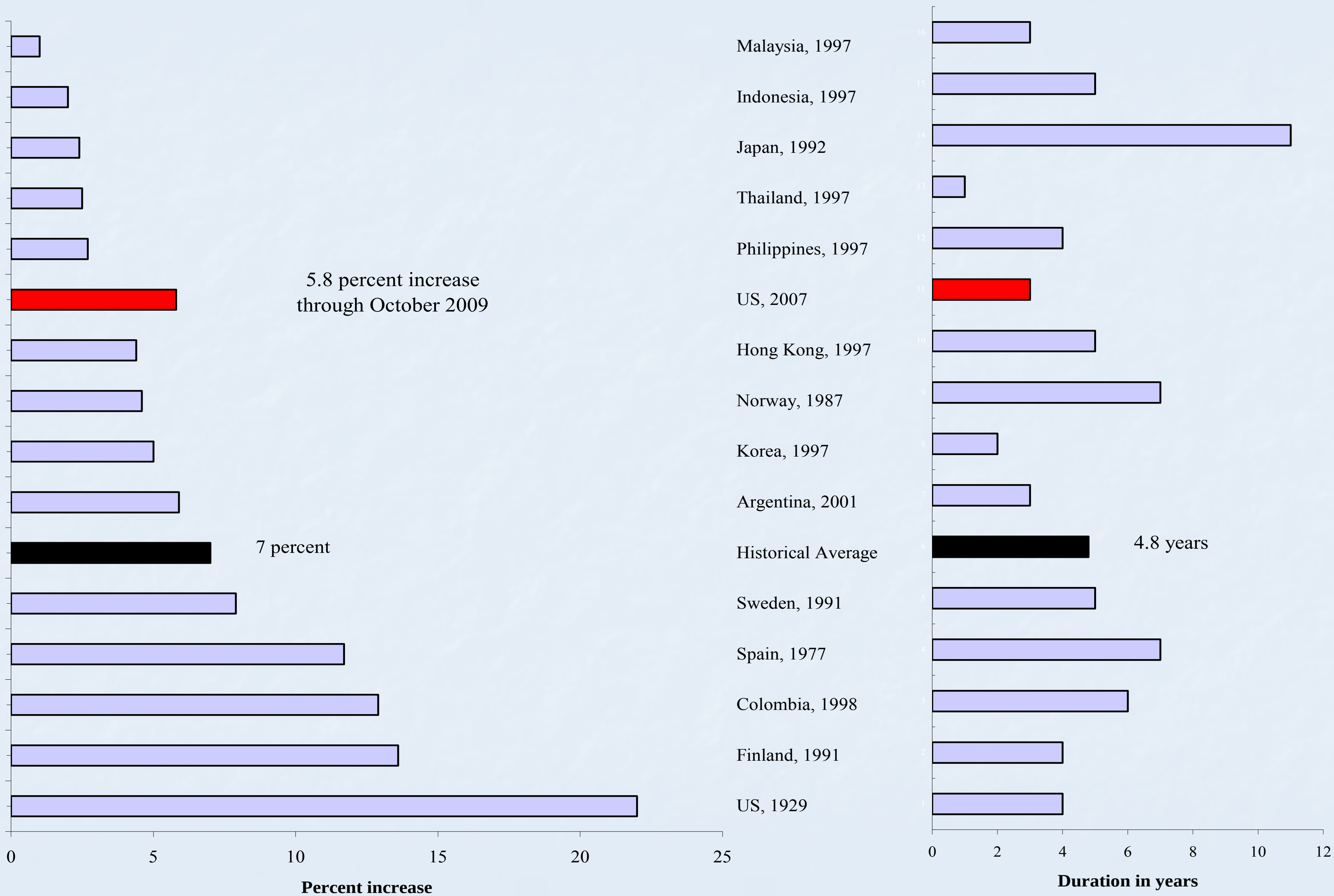


Past Real Per Capita GDP Cycles and Banking Crises: Peak-to-trough

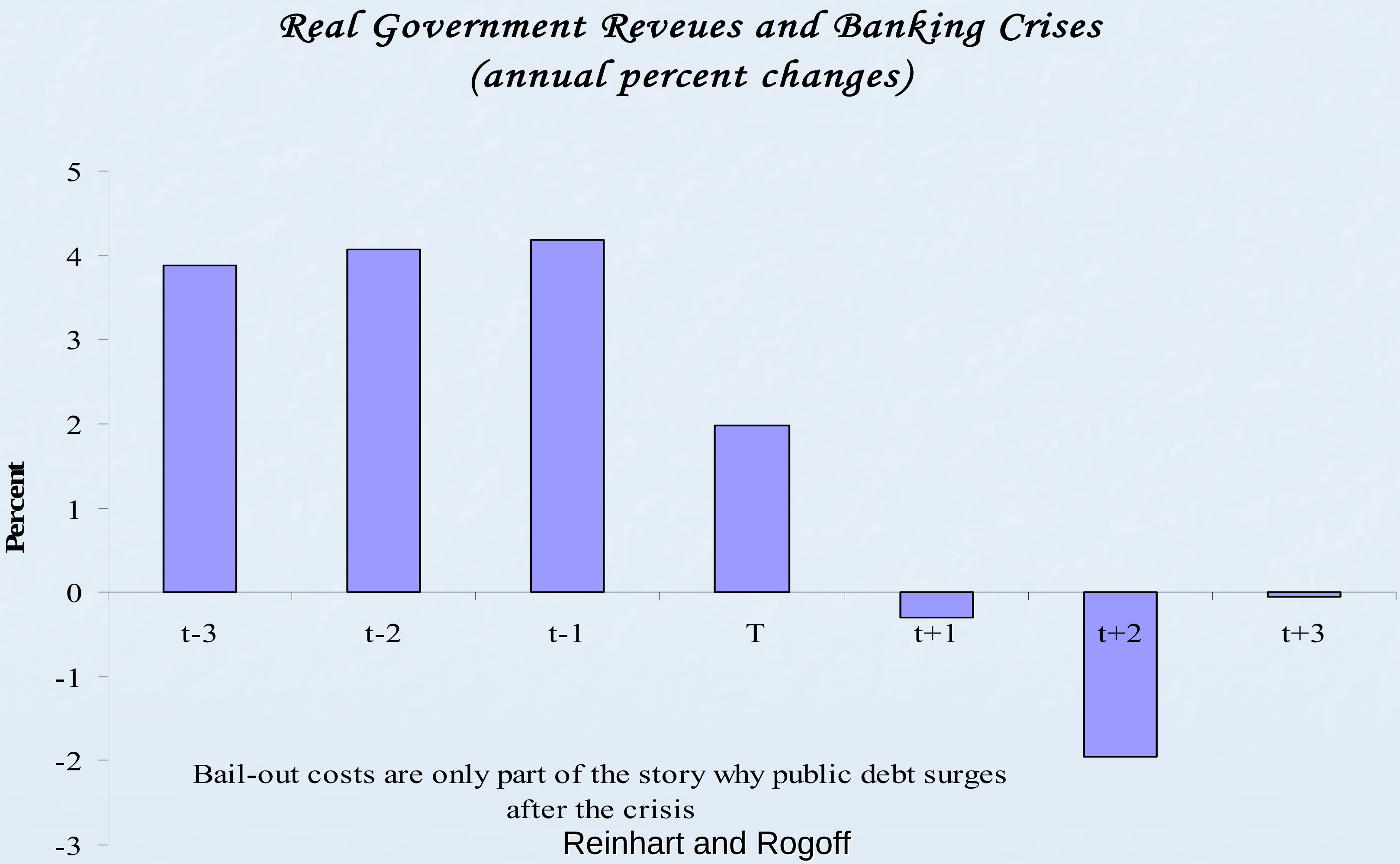
Percent Decline in Real GDP (left panel) and Years Duration of Downturn (right panel)



Past Unemployment Cycles and Banking Crises: Trough-to-peak Percent Increase in the Unemployment Rate (left panel) and Years Duration of Downturn (right panel)



Government revenues suffer as the crisis lingers

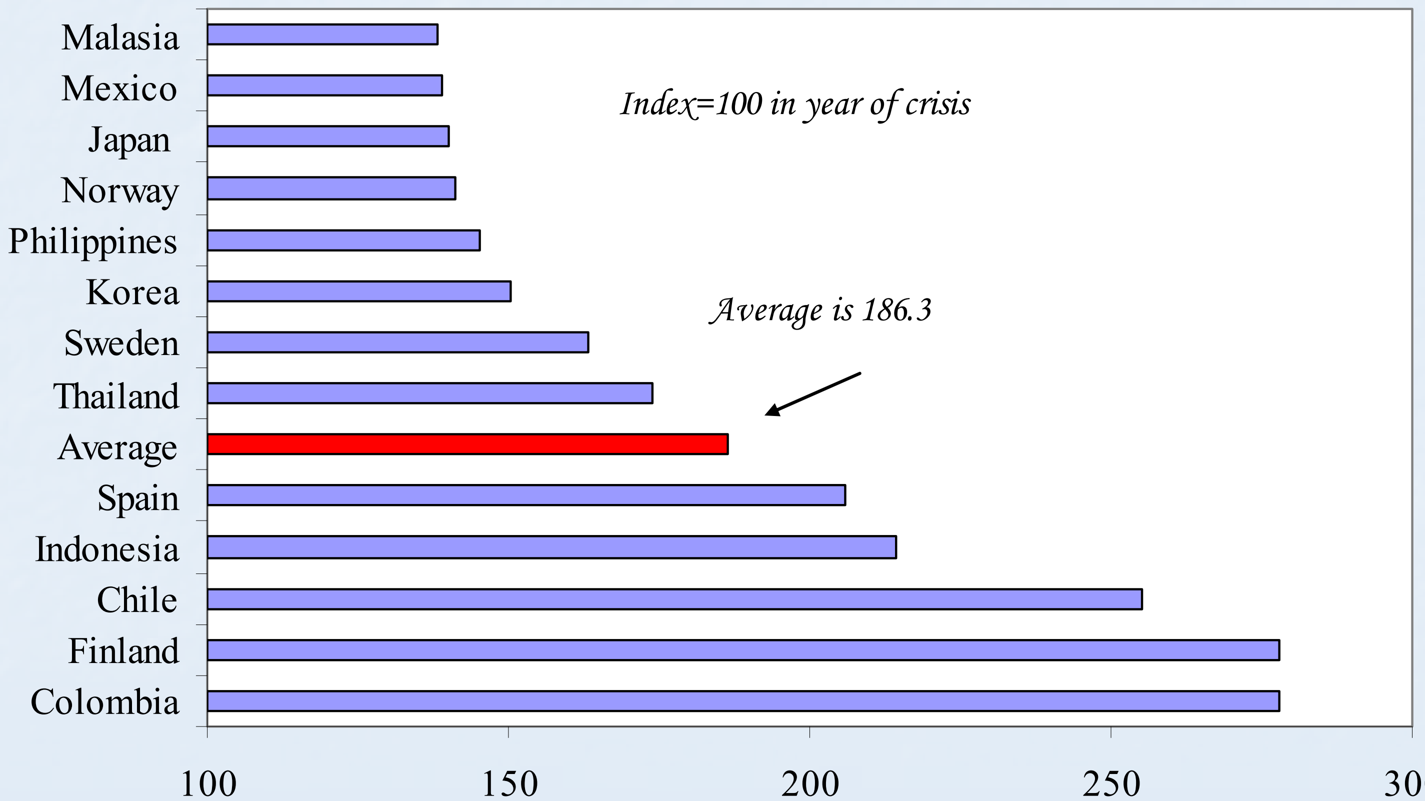


Bail-out costs are only part of the story why public debt surges after the crisis

Reinhart and Rogoff

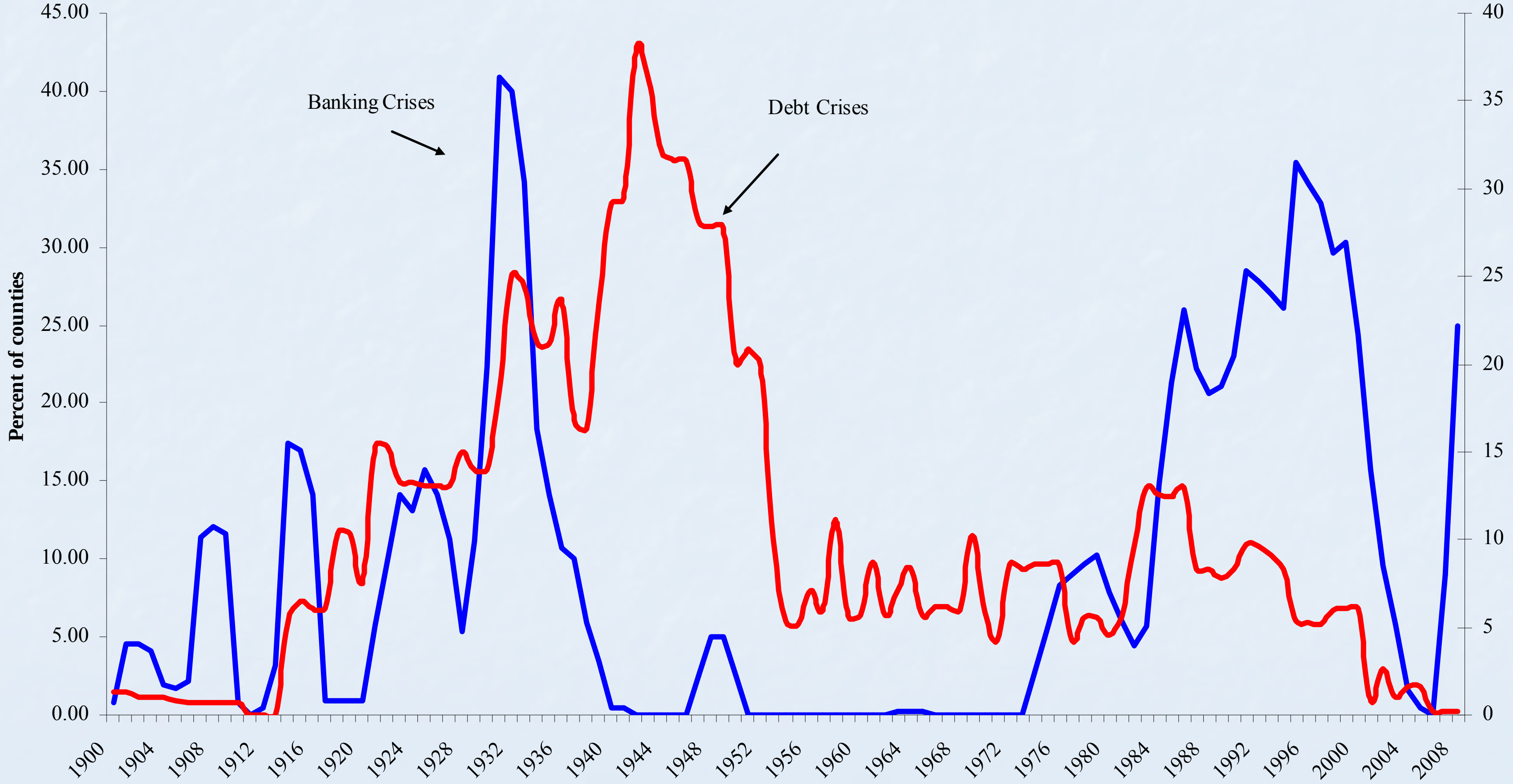
Thus, the true legacy of financial crises is **more government debt…**

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



Reinhart and Rogoff

Debt crises followed in the wake of banking crises



What has history taught us?

- Severe financial crises are protracted affairs. There is view that we have weathered the global crisis, such celebration may be premature.
- Seldom do countries (advanced or emerging) simply “grow” their way out of debts. High levels of debt are associated with sub-par growth.
- Governments that in the past inflated away or outright defaulted on their debts may do so again.
- This problem is not a likely imminent scenario for most countries—it is a concern for the medium term.