

Reinhart & Rogoff on Financial Crises

By Allan H. Meltzer

This Time Is Different is a splendid book. One has to go back a long time to find another book that develops new data and that illuminates old problems in new ways. Burns and Mitchell's work at the National Bureau comes to mind. My compliments to the authors for pausing to present the data and the comparisons of more than 60 countries over more than two centuries. Efforts to develop better models of crises will come next, but I applaud the authors for publishing and interpreting the data now.

The massive, new data series raise many issues. They show that banking crises in the 20th century are not very different from 19th century banking crises. Did abandoning the gold standard and developing rigorous models and greatly improved policy procedures not affect banking crises?

From 1800 to the present, the authors find 250 defaults on externally held sovereign debt and 68 defaults on domestic debt. The authors recognize the absence of a legal framework for enforcing international debt contracts. And they ask: Why do creditors continue to lend to foreign governments? In the 19th century some debtors, especially Britain, could send gunboats and occupy the customs house. After World War II, the International Monetary Fund often lent to the debtor country so that they could hold the exchange rate from falling while many lenders could keep their risk premia and escape. As the authors note, however, there is no rule or mechanism to protect lenders; that gives borrowing governments the opportunity to expropriate foreigners. Figure 9.5 suggests that in the 20th century domestic and external defaults are highly correlated. Borrowers expropriate domestic lenders, not just foreigners.

One of the overriding themes is that mistakes are neither rare nor fully anticipated. The title, "This Time Is Different", could have been "We Have the Problem Under Control" or "We Will Not Devalue or Default". But, the repeated history is that large, continuing budget deficits, fast money growth, and a depreciating currency end in a crisis unless policy changes. I hope the authors send copies of their book to Larry Summers, Tim Geithner, and Ben Bernanke. A reader of this book has to expect that the United States is headed for a crisis.

Other themes are that countries do not report their total liabilities, that excessive debt accumulation poses greater risks than borrowers and lenders foresee during the boom that the

debt finances, and that there is a “clear inflationary bias throughout history” (p. xxxiii), but 20th century inflations are much higher. Early in the text, the authors recognize the roles of institutions, corruption and governance as important for understanding the historical record. But the authors do not follow this statement with discussion of how institutional dependence influenced outcomes. That’s a big task for more than 60 countries and many crises. Apparently the reader will have to wait for a later volume.

I believe it is impossible to understand why crises occur without knowing about the institutions under which they occur. Two examples come from recent history. The savings and loan failures in the 1980s resulted from inflation that bankrupted institutions limited to lending long and borrowing short. The current crisis would not have occurred if Congress and several administrations had not insisted upon subsidies for housing that took the form of zero down payments to borrowers and ignoring their lack of good credit history. Earlier, the financial collapse during the Great Depression was abetted, even exacerbated, by adherence to the real bills doctrine. And in our own time, too big to fail policy encouraged bankers to believe that they kept the profits and the taxpayers took the losses. Why be surprised that some took excessive risks?

Alexander Hamilton famously repaid all the Revolutionary War debt of both states and the federal government. He wanted to establish the credit of the new country. How many other countries avoided crises in a similar way? Comparison of crises and crises avoided would be a valuable contribution especially if it explained the difference.

One of the author’s most striking results (Figure 5.4) is the very close relation between high inflation and external defaults especially in the past 60 years. The authors point to heightened willingness by governments to expropriate foreigners. I would add policies of the International Monetary Fund that hold exchange rates fixed and allowed creditors to leave. In Mexico creditors received 15 or more percent interest rates but were able to avoid many losses. The domestic public bore the costs. During the Latin American debt crisis of the 1980s, the IMF and the Federal Reserve worked to protect the lending banks at the expense of the local populations. Almost a decade passed before the debt was written down as part of the Brady plans.

The authors are modest about their claims. They recognize many problems and imperfections in their data. One problem that they do not mention I think is important. They

consider only inflation of 20 percent or more. I think the harm done by inflation is much higher in countries with a relatively large stock of capital, unless depreciation is indexed. In an agricultural country, land prices rise but the value of non-indexed capital stocks falls. I recognize that the precise choice of a lower inflation rate for a heavily capitalized country is arbitrary but no less than the use of a 20 percent rate.

One strength of *This Time Is Different* is the broad range of countries. The authors compiled data on African debt probably for the first time. African indebtedness differs greatly from the debt of emerging countries like Australia, Canada and the United States in the 19th century. Much of Africa's debt comes from international organizations such as the World Bank. Interest rates are below market rates and term to maturity often extends far beyond the expected life of the borrowing government. When the debt comes due for repayment after 30 or 40 years, much of it is forgiven. At one point, the authors mention short horizons of politicians and governments, so I do not think they will object to this reason for indebtedness and default in Africa.

On pp. 145 and 146 the authors begin to sketch a plausible model in which economic adversity leads first to a fall in output, then to banking, debt and exchange rate crises. I would add the type of uncertainty discussed by J.M. Keynes and Frank Knight. Each separately argued that there are risks that can be described by a probability distribution and true uncertainty for which there is no useful distribution. Of course, one can play at being a Bayesian and assume some prior distribution, but that bypasses the problem without changing it.

Many of the crises followed unforeseen events. The size and scope of World War II was such an event, but there are others including the collapse of the Soviet Union in the recent past. After the event, one may find some forecast of these uncertain events, but they are not the forecasts that dominated market behavior or outcomes.

In the recent housing and financial crisis, a widely-held belief that housing prices could not fall changed quickly after housing prices began a steep decline. Belief that the Federal Reserve would prevent banks from losing during financial crises strengthened when Bear Stearns failed. Confidence in the policy of preventing failures received a blow when Lehman Brothers failed. Who believed that the Federal Reserve would change a policy that it had followed for thirty years and would make the change during a recession? That's an uncertain event that had serious consequences all over the world.

Policymakers, members of Congress and their staff should read *This Time Is Different*. While the administration and the Federal Reserve look for scapegoats, United States policy is on a path that seems likely to produce a serious crisis. Countries with unsustainable deficits, an unprecedented stock of excess reserves capable of being used to create massive money growth and inflation, and an expected, continued decline in its exchange rate end in crisis unless policy changes.

Perhaps the Chinese will continue to invest in U.S. Treasury debt, perhaps the Federal Reserve will stop promising and start acting to reduce reserves. Past history suggests that it will wait too long, move aggressively, increase unemployment, and retreat.

We can do better.

The authors deserve great praise for their diligence and persistence in searching out and developing data series. Two omissions from their bibliography are worth noting. One is Anna Schwartz's work on crises including her essay "Real and Pseudo Financial Crises." The other is Peter Bernholz's extensive work on past inflation, especially, Chinese inflation.