Our Giant Banking Crisis—What to Expect
Paul Krugman and Robin Wells

This Time Is Different: Eight Centuries of Financial Folly by Carmen M. Reinhart and Kenneth S. Rogoff. Princeton University Press, 463 pp., $35.00

World Economic Outlook, April 2009: Crisis and Recovery by the International Monetary Fund. 226 pp., available at www.imf.org

World Economic Outlook, October 2008: The Great Contraction by the International Monetary Fund. 208 pp., available at www.imf.org

Lately, the big concern rolling financial markets has been fear of Greek debt crisis. Early signs that Greek government debt is at levels that have historically signaled deep trouble for middle-income nations, and debt is still rising rapidly thanks to a large deficit. Meanwhile, Greece is suffering a severe recession in large part because costs have gotten far out of line with the rest of Europe. And one more thing: Greece has long history of default—in fact, the nation has been in arrears on its debt for half its modern history.

Yet as recently as last September, nobody seemed worried. Credit default swap spreads for Greek debt were still a buy—a surefire deal. Either Greece would pay its debt—or its finance minister would find some way to make the debt cheaper. That was why investors were so confident. The answer was that almost everyone believed that historical precedents were irrelevant. Greece was now part of Europe, and even more important, since 2001 part of the eurozone—sharing a currency with its most affluent neighbors. And that changed everything. Except that it didn’t.

The Greek crisis came after the publication of This Time Is Different: Eight Centuries of Financial Folly, by Harvard’s Kenneth Rogoff and the University of Maryland’s Carmen Reinhart, but it was a dramatic illustration of the point they make with their sarcastic title: the more things change in the financial world, the more they stay the same. The current crisis of 2010 bears a strong resemblance to the Mexican debt crisis of 1827; inflation in 1920s Yugoslavia; and the latest crisis in a history of currency devaluation that goes back to ancient Greek city-states, and last but not least, the US subprime crisis of 2008 followed the script of scores of banking crises past, going back as far as eighteen-century Scotland.

1. From an economist’s point of view, there are two striking aspects of This Time Is Different. The first is the sheer range of evidence brought to bear. Reading Reinhart and Rogoff is a reminder of how many economists take the easy road—how much they tend to focus their efforts on times and places for which numbers are readily available, which basically means the recent history of the United States and a few other wealthy nations. When it comes to crises, that means acting like the proverbial drunk who searches for his keys under the lamppost, even though that’s not where he dropped them, because the light is better there: the quarter-century or so preceding the current crisis was an era of relative calm, at least among advanced economies, so to understand what’s happening to us one must reach further back and farther afield. This Time Is Different was focused on millennia of economic data, accepting im-

perfect or fragmentary numbers as the price of looking at a wide range of experience.

The second distinguishing feature is the absence of a single theory. It’s not that the authors have anything against elaborate mathematical modeling. Professor Rogoff’s influential 1996 book, Foundations of International Macroeconomics, coauthored with Maurice Obstfeld, contains literally hundreds of fairly abstruse equations. But This Time Is Different takes a Sergeant Friday, just-the-facts-m’am approach: before we start theorizing, let’s take a hard look at what history tells us. One side benefit of this approach is that the current book manages to be both extremely useful to professional economists and accessible to the intelligent lay reader.

The Reinhart-Rogoff approach has already paid off handsomely in making sense of current events. In 2007, at a time when the wise men of both Wall Street and Washington were still proclaiming the problems of subprime “contained,” Reinhart and Rogoff circulated a working paper—now largely subsumed into Chapter 13 of This Time Is Different—that compared the US housing bubble with previous episodes in other countries, and concluded that America’s profile resembled those of countries that had suffered severe financial crises. And sure enough, we had one too. Later, when many business forecasters were arguing that the deep recession would be followed by a rapid, “V-shaped” recovery, they circulated another working paper, largely subsumed into Chapter 14, describing the historical aftermath of financial crises, which suggested that we would face a prolonged period of high unemployment—and so we have.

What is the message of This Time Is Different? In a nutshell, it is that too much debt is always dangerous. It’s dangerous when a government borrows heavily from foreigners—but it’s equally dangerous when a government borrows heavily from its own citizen. It’s dangerous, too, when the private sector borrows heavily, whether from foreigners or from itself—for banks are basically institutions that borrow from their depositors, then make loans to others, and banking crises are among the most devastating shocks an economy can face.

Yet people—both investors and policymakers—tend to rationalize away these dangers. After any prolonged period of financial calm, they either forget history or invent reasons to believe that historical experience is irrelevant. Encouraged by these rationalizations, people run up ever more debt—and in so doing set the stage for eventual crisis. (One odd omission by Reinhart and Rogoff, by the way, is their failure to mention the late Hyman Minsky, a heterodox economic thinker who made a similar argument and is now experiencing a renaissance in influence.)

Debt-driven crises can take a variety of forms. There are sovereign debt crises, in which investors lose faith in the ability and/or willingness of governments to fulfill their financial obligations. There are inflationary crises, which happen when governments turn to the printing press either to pay their bills or to inflate away the real value of their debts. There are banking crises, in which people lose trust in private-sector promises that is essential to a fully functioning market economy. And all of these afflictions are often associated with currency crises, in which speculation leads to a sharp fall in a currency’s value in terms of other currencies.

What we’re in the middle of right now is what Reinhart and Rogoff call the “second great contraction”—a giant banking crisis afflicting both sides of the Atlantic, with effects that have spilled over to the entire world. The first great contraction was, of course, the Great Depression. In the past, banking crises

have often led to sovereign debt crises as well; the inability to service debt depressed the economy, reducing government revenue, at the same time that they often required deep cuts, creating a recession in the financial system. Greece may be only the first of many stories of troubled governments, most obviously, Spain, Portugal, and Italy are all in some danger.

It’s worth noting, as an aside, that the Reinhart-Rogoff interpretation of the Great Depression is, implicitly, a critique of other interpretations—most notably, Milton Friedman’s famous claim that the Depression was fundamentally a failure of monetary policy, when it was really a failure of fiscal policy. And the reason why the Great Depression is so relevant is that a lot of these stories look very much like the prologue to other severe financial crises: irrational exuberance in the housing market, defaults in household debt, and an ever more overextended banking system. There was even a real estate bubble in Florida, memorialized by the Marx Brothers in The Cocoanuts. “You can have any two you like. You can even get stucco. Oh, how you can get stucco.” That’s not to deny that today’s problems are more complicated than that question we’ll return to later: But the Depression looks much more like the product of excessive private-sector debt than like the government failure of monetarist legend.

2. So now we’ve experienced a severe financial crisis, and we’re basically in the same boat as those of the past. What does history tell us to expect next? That’s the subject of Reinhart and Rogoff’s Chapter 14, “The Aftermath of Financial Crises.” This chapter can useful be read in connection with two studies by the International Monetary Fund that take a similar approach, published as chapters in the April 2009 and October 2009 editions of the semiannual World Economic Outlook. All three studies offer a clear forecast of the aftermath of financial crises tends to be nasty, brutish, and long. That is, financial crises are typically followed by a long string of recessions, and these recessions are followed by slow, disappointing recoveries.

Consider, for example, the case of Sweden, which experienced a severe banking crisis in 1991, following a major housing bubble. Sweden’s government has been widely praised for its response to the crisis: it stabilized markets by guaranteeing bank debt, and restored faith in the system by temporarily nationalizing and then recapitalizing the largest banks. Despite these measures, however, Swedish unemployment soared from 3 percent to almost 10 percent; it didn’t start coming down until 1995, and progress was slow and fitful for several more years.

But as Krugman and Wells point out, it’s true that there have been some “phoenix-like” recoveries from financial crises, to use a term introduced by Columbia University economist John Paul Turner in 1999.
to promote employment in the crisis, but take measures to curb spending and raise revenue once the crisis has passed. Others will see it differently. The main thing to notice, perhaps, is that there is no safe path: debt has long-term risks, but it also fails to engineer a solid recovery. The IMF’s research suggests that the long-term cost of financial crisis is not evident, when compared with the strong stimulus policies, which means that failing to do so risks damage not just this year but for years to come.

Why didn’t more people see this coming? One answer, of course, lies in Reinhart and Rogoff’s title. There were superfluous differences between debt now and debt three generations ago: more elaborate financial instruments, new techniques of assessment, an apparent wider spreading of risks (which turned out to have been an illusion). So financial executives, policymakers, and many economists convinced themselves that the old rules didn’t apply. We should not forget, too, that some people were making a lot of money from the explosive growth of both debt and of the financial industry, and money talks. The world’s two great financial centers, in New York and London, wielded vast influence over their respective governments, regardless of party. The Clinton administration in the US, and the Labour government in Britain succumbed alike to the siren song of financial innovation in part by the competition between the two great centers, because politicians were all too easily convinced by the larger financial industry in a wonderful thing. Only when the crisis struck did it become clear that Wall Street and the City actually exposed their home nations to special risks, and that nations that missed out on the plunder of high finance, like Canada, also missed out on the worst of the crisis.

Now that the once-beleaguered bubbles have burst, there’s obviously a strong case for a return to much stricter regulation. It’s no longer clear, however, whether this will actually happen. For one thing, the ideology used to justify the dismantling of regulation has proved remarkably resilient. It’s now an article of faith on the right, impervious to contrary evidence, that the crisis was caused not by private-sector excesses but by liberal politicians who forced banks to make loans to the undeserving poor. Less partisan ideologists nonetheless are powerfully in favor of the proposition that the US might crimp financial innovation, even though it’s very hard to find examples of such innovation that were clearly beneficial (ATMs don’t cut).

Equally important, the financial industry’s political clout has not decayed away. Banks have waged a fierce campaign against what many expected to be an easily passed reform bill, the creation of a new agency to protect financial consumers. Despite the steady drumbeat of scandal and revelations—most recently, the discovery that Goldman Sachs helped Greece cook its books, while Lehman cooked its own books—top financial executives continue to have ready access to the corridors of power. And as many have noted, President Obama’s chief economic and financial officials are men closely associated with Clinton-era deregulation and financial triumphalism; they may have revived their views but the continuity remains striking.

In that sense, this time really is different: while the first great financial crisis was followed by major reforms, it’s not clear that anything comparable will happen after the second. And history tells us what will happen if those reforms don’t take place. There will be a resurgence of financial folly, which always flourishes given a chance. And the consequence of that folly will be more and quite possibly worse crises in the years to come.

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