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Don’t Buy the Chirpy Forecasts

The history of banking crises indicates this one may be far from over.

Carmen Reinhart and Kenneth Rogoff
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The good news from our historical study of eight centuries of international financial crises is that, so far, they have all ended. And we confidently predict this one will end, too. We are just not quite so sure it will be nearly as soon as the chirpy forecasts coming from policymakers around the globe. The U.S. administration, for example, is now predicting that growth will renew in the latter part of this year and continue at a brisk pace of 4 percent for several years thereafter. Is this a fact-based forecast or wishful thinking?

A careful look at the international evidence on severe banking crises suggests a far more cautious assessment. The recessions that follow in the wake of big financial crises tend to last far longer than normal downturns, and to cause considerably more damage. If the United States follows the norm of recent crises, as it has until now, output may take four years to return to its pre-crisis level. Unemployment will continue to rise for three more years, reaching 11–12 percent in 2011.

The news on housing prices and the stock market is arguably a little better, mainly because there has been so much damage already. The typical fall in inflation-adjusted stock prices is 55 percent, a benchmark the U.S. has more or less achieved. The typical decline in housing prices is 36 percent. According to some indicators, inflation-adjusted housing prices have already fallen roughly 30 percent. The bad news is that these down price cycles typically last for several years. So, even if the big hit on stocks and house prices has come already, the bottom might not be reached until the end of 2010.

These forecasts may seem somber, but so far the U.S. experience has mirrored past deep banking crises around the world to a remarkable extent. In our forthcoming book, "This Time Is Different: Eight Centuries of Financial Folly," we compare the U.S. crisis with earlier banking-crisis episodes in Spain, Norway, Finland, Sweden, Japan, Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Thailand, Colombia and Argentina over the past three decades. It may seem like hyperbole to compare the United States with emerging markets, but hard evidence suggests it is not. True, rich countries are far less likely to face the prospect of sovereign default. (Why bother? Since rich countries can generally issue public debt in their own currency, they always have the option of reducing its value through inflation.) But, contrary to popular belief, banking crises tend to be far more of an equal opportunity menace. Indeed, a failure to recognize the historical vulnerability of rich countries to financial crises lies behind the incredible conceit of Anglo-American policymakers that their gold-plated financial systems were invulnerable.

British and U.S. financial regulatory frameworks did, in fact, have many strengths. But even a person who can handle a lot of stress will have a heart attack if she takes on too much. And that is exactly what happened under the weight of massive external borrowing. It is too bad, because had policymakers looked at standard warning signs of past financial crises, including the episodes we listed above, they would have realized the extent to which their economies were likely headed for a calamity.

Assuming the U.S. continues going down the tracks of past financial crises, perhaps the scariest prospect is the likely evolution of public debt, which tends to soar in the aftermath of a crisis. A base-line forecast, using the benchmark of recent past crises, suggests that U.S. national debt will rise by $8.5 trillion over the next three years. Debt rises for a variety of reasons, including bailout costs and fiscal stimulus. But the No. 1 factor is the collapse in tax revenues that inevitably accompanies a deep recession. Eight and a half trillion dollars may sound like a lot. It is more than

50 percent of U.S. national income. But if one looks at the Obama administration's stunning budget-deficit projections, with exceedingly optimistic projections on growth and bank-bailout costs, we think the U.S. is right on track.

We have focused on the United States, because it is the epicenter of the crisis, and because the quantitative comparisons are so striking. But one could just as well have been looking at a host of other countries around the globe, most of which are swept up in the maelstrom.

Might things be better than our historical benchmark? Should we, like the group of 20 finance ministers meeting in London last weekend, keep believing in the possibility of sustained strong growth by the end of the year? Today's fiscal and monetary policies are certainly a lot better than what the world saw in the Great Depression of the 1930s. On the other hand, the current crisis is far more global than any seen since the '30s, when most countries took a decade to grow back to where they had started.

Financial crises don't last forever. But this one could last a lot longer if policymakers don't start basing their actions on more realistic assessments of where we are and what is likely still to come.

Reinhart is a professor of economics at the School of Public Policy at the University of Maryland. Rogoff is the Thomas D. Cabot professor of public policy and professor of economics at Harvard University.

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