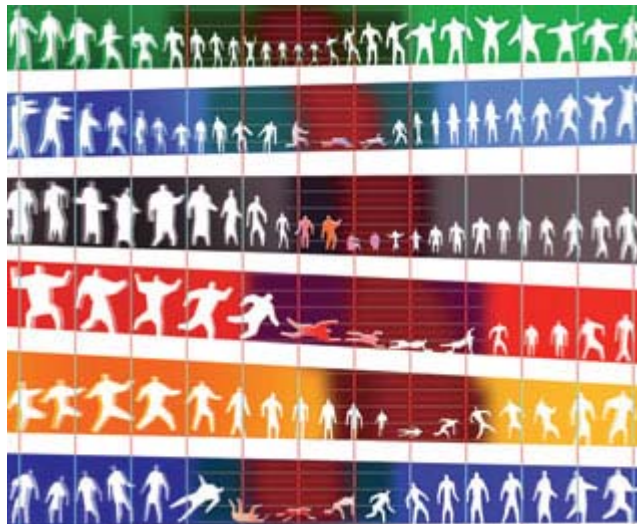

Economics focus**Same as it ever was**

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What do earlier banking crises reveal about America's travails today?

Illustration by Jac



A DASH of otherworldliness is part of the charm of academic conferences. But this year's annual meeting of the American Economic Association (AEA) in New Orleans afforded little shelter. Reality gatecrashed the very first morning of the three-day meeting, the world's largest convention of dismal scientists, with the release of a report on January 4th showing that America's unemployment rate had spiked from 4.7% to 5% in December. The bad news made a presentation by Kenneth Rogoff, a professor at Harvard University, on the final day all the more timely. His paper^{*}, written with Carmen Reinhart of the University of Maryland and part of a larger historical study, sets out some parallels between America's subprime mess and 18 previous banking crises in the rich world. For an audience recovering from a Saturday night on Bourbon Street, the conclusions were aptly sobering.

The authors show that, although details may vary, banking crises follow the same broad script. Each blow-up is preceded by rising home and equity prices; an acceleration in capital inflows driven by optimistic foreign investors; a rapid build-up of debt; and—immediately before the storm hits—an inverted V-shaped path for the economy, with growth first picking up and then faltering. The years just before the

start of the subprime meltdown fit the Reinhart-Rogoff template remarkably well. Indeed on most criteria, the portents of trouble were more marked than in past crises. House prices rose more sharply in real terms. Equity-market gains were more persistent. Capital inflows picked up too, though they were already running at an alarmingly high level. America's current-account deficit was much larger, relative to GDP, than in a typical crisis candidate.

Given such ominous indications, what of the aftermath? Mr Rogoff was careful to say that the malign effects of the subprime mess might not be as great as those of previous crises. A great deal of uncertainty remains, not least about the scale of lending losses. Yet the precedents are worrying. In the 18 earlier crises, the average drop in output growth was two percentage points and it took two years for growth to return to normal. For the five worst crises, growth rates tumbled by five percentage points from their peak and recovery took more than three years. If America avoids a material slowdown, say the authors, "it should either be considered very lucky or even more 'special' than most optimistic theories suggest."

Financial-market lore has it that uttering "this time is different" is the easiest way to get laughed off a trading floor. When recession beckons, the statement invites still more ridicule. At the AEA conference, it fell to Alan Taylor of the University of California to make the case (in the spirit of debate as much as from heartfelt advocacy) that things might not turn out quite as badly as the Reinhart-Rogoff analysis suggests.

A crucial factor is the cost of the final bill. The average rich-world banking crisis in the Reinhart-Rogoff sample leads to recession. But this result is driven by the "big five" blow-ups (among them the implosion of Japan's banking system in the 1990s). Mr Taylor notes that the other 13 had little discernible effect on the wider economy. If all of America's subprime borrowers defaulted and only half of the \$1.3 trillion lent to them was recovered, the losses of \$650 billion would amount to around 5% of GDP—on a par with the smallest of the big five crises. If losses turned out to be lower, as most estimates suggest, America would probably get off lightly.

A problem shared

Another reason to be cheerful is that the subprime crisis does not strictly correspond to previous banking crises, where losses were concentrated on banks at the heart of the payments and lending systems. Although the banks are more exposed to losses than at first seemed likely, many distressed creditors are either overseas banks or hedge funds. That has costs of its own, not least damaging uncertainty about where exactly the subprime bodies are buried. But the scattering of losses outside America should export some of the economic harm.

And, of course, the Federal Reserve may yet save the day. Mr Taylor finds evidence from the paper's sample of crises to suggest that a swift policy response helps to limit the economic fall-out. In the worst cases, the average levels of interest rates were broadly the same in the years after the initial trauma as they had been before it. In countries that experienced only limited economic damage, policy rates were kept materially lower after the crisis struck.

These arguments offer hope that the worst effects of the subprime disaster may yet be contained. But the scale and scope of America's housing boom-and-bust suggest that problems will not be restricted to subprime lending. Falling house prices threaten the solvency of plenty of prime borrowers too. Many more mortgagees will be hurt by lost housing equity. The credit-market malaise is also likely to lift default rates in the corporate sector, causing additional bank losses.

And although the export of subprime exposure has helped preserve the capital of American banks, it has rocked banks abroad. The results are unlikely to be pretty. Mr Rogoff sought to stay close to home, as he was addressing the AEA. But, in an aside, he noted that some European countries—Spain, Britain and Ireland—fit just as snugly into the template of asset boom, indebtedness, capital inflows and economic woes to come. Given the reach of the housing boom and financial derivatives, he might also have noted that a pessimist would find it just as easy as an optimist to say that this time things are different.

* "Is the 2007 Sub-Prime Financial Crisis So Different? An International Historical Comparison", by Carmen Reinhart and Kenneth Rogoff