

The Washington Post

The book on financial crises: 'You need several levels of defense'

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Sunday, May 23, 2010; G02

THIS TIME IS DIFFERENT

Eight centuries of financial folly

By Carmen M. Reinhart and Kenneth S. Rogoff

Princeton University Press

496 pp. \$35

In "This Time Is Different," Carmen M. Reinhart and Kenneth S. Rogoff construct the richest and most detailed history of financial crises that anyone has developed. Their data set covers 66 countries, five continents and centuries, and it gives them an unparalleled ability to see patterns and predictors among different types of crashes. I spoke to Rogoff about the causes, trajectories and solutions to financial crises. This is an excerpt:

So how did having access to all that historical information change the way you understood our financial turmoil?

We had the major charts and tables ahead of the crisis. The key charts in Chapter 13, for instance, were published before the crisis and said the U.S. was at high risk for a crisis based on virtually every available indicator. And the main prediction we made in our work was that deep financial crises are different than typical recessions. It takes longer to recover from a financial crisis. So economists who had just studied the handful of previous U.S. recessions and used those to benchmark everything -- the majority of forecasters -- missed the boat because this kind of recession is different.

Some of your work argues that financial crises often lead to debt crises.

Our database has historical debt data across over 60 countries. This allowed us to look at what happened to debt after other financial crises. And debt explodes, nearly doubling over three years -- which, in turn, can lead to sovereign-debt crises. Some crises occur in the epicenter countries, where the government did everything possible to save the financial sector but couldn't afford it. Sometimes sovereign debt crises happen in peripheral countries hit by volatility and rising risk aversion, like in Greece.

Has our financial crisis fit the pattern of other financial crises, or was it somehow different?

In many ways, our experience has been a garden-variety, postwar deep financial crisis. The recessions from financial crises typically last a year and a half, and that's about what ours was. With the notable exception of Japan, equity prices tend to bounce back reasonably quickly, and that's happened with U.S. stock prices.

The main way in which this crisis is different from other postwar crises, however, is that it was global. And that adds an important dimension. The Depression was global, and there were global crises in the 1800s, but they're not common. Global crises are more worrisome because a way countries get out of these crises is exports. But not everyone can ramp up exports all at once.

Has looking at other financial crises changed your perspective on how ours began? That is to say, was this really a predictable event, or did we go through a unique problem that became a common crisis?

As Carmen Reinhart and I have emphasized, it really boils down to arrogance and ignorance. Across the huge range of crises we look at, the similarities are remarkable. Countries have different policy responses, central bank systems, political institutions and financial systems, but they share the quantitative markers that precede these crises: Run-ups in housing prices and huge leverage are major indicators.

So the people who think this was all about Lehman haven't read our book. This wasn't about some mistakes made over one weekend the way many books portray it. Housing prices had doubled, debt had exploded, we were set to lose trillions of dollars in the value of our capital stock. Lehman was the spark, but the idea that it could've been largely avoided is very naive. If people think that the only real problem was letting Lehman fail, then that bodes badly for the steps we'll take to prevent future crises.

You mentioned arrogance and ignorance. What do you mean by that?

Our title is ironic. Countries are often in the middle of these huge, speculative bubbles, and yet even the smartest people who know there have been these accidents in the past convince themselves that they won't have the same problem. In the recent crisis, the excuse was, this time, we have global financialization, better monetary policy, rocket-science finance and China. But the system still couldn't take the stress.

You said that there are indicators we can watch to predict when we're vulnerable to a financial crisis, but in general, the problem is that policymakers explain the indicators away. Information, in other words, is not enough, because people create stories to explain the information away.

Start with a really important point: It's very hard to call the timing of a crisis. You can see that an economy is vulnerable, and maybe even fairly reliably say you'll have a crisis in five to 10 years, but until it's upon you it's hard to narrow the window down with any precision.

There's irreducible uncertainty coming from fragile confidence and political factors. The analogy is someone who's vulnerable to a heart attack. You can go to the doctor and they can see your cholesterol is high and you have risk factors, but you might go on for 20 years without anything happening. Or it might be 20 hours.

Because the timing is hard to call, policymakers have trouble getting seized by it. Why worry if it is not going to hit on my watch? And if you're an investor and you're making great money for five more years and then you have a bad year, you still have a good decade. But policymakers, especially, need to have a longer vision because of the human cost of financial crises, particularly in the hugely elevated level of long-term unemployment.

So how do you defend against them?

You need several levels of defense. To depend excessively on regulatory judgment would be naive. The banks and financial institutions are clever at staying ahead of regulators. A big problem there is that regulators don't get paid enough. I watch star regulators and analysts get bid away by the financial firms all the time. You can't have people regulating these hundred-billion-dollar firms who are paid less than executive secretaries at the firms they're regulating.

We found that crises occurred at remarkably regular intervals -- we are talking about 30 or 40 years apart. This last crisis will be etched in our memories for some time to come, but in due time, those memories will fade, and a new generation of successful investors and politicians will come along who underweight the risk.

What do you think about the financial regulation proposal Congress is about to pass?

To be honest, the bill leaves a lot in the hands of regulators. Whether they'll have the knowledge, tools and ability to be successful even if the system remains so complex, is a big question. There are good ideas in there, like pushing derivatives onto open markets with prices. But I've been struck that my colleagues who have examined the legislation most carefully seem the most skeptical.