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Q&A: Reinhart and Rogoff on the Crisis, the ‘Mother of All Moral Hazard’

*Economists **Carmen Reinhart** of the **University of Maryland** and **Kenneth Rogoff** of **Harvard University** have spent much of this decade combing through data on financial crises through history, and trying to quantify what makes them happen.*

The two, who began their project while working at the International Monetary Fund, have just published “This Time is Different: Eight Centuries of Financial Crisis.” The book is an early stab at analyzing that data, and measures some common elements in most financial crises, such as big run-ups in debt and, of course, hubris. (The two are making their data available to other researchers.)

We took a moment to chat with them about what their work shows, and what comes next.

What, if anything do past crises tell us that can be used to prevent future crises?

Rogoff: A lot of people who called the crisis did it sort of on gut feeling of what seemed to big, what seemed unsustainable, without any frame of reference. What leverage ratios are, what housing price inflation is dangerous, what are the warning signs. In order to have a meaningful quantitative analysis you’ve got to have the facts. It’s amazing how little the authorities have at their finger tips.

Reinhart: You can’t just focus on a single indicator, you have to look in conjunction. Our book is not about a bubble in housing or a bubble in the equity market. You look at pricing in these markets in conjunction with what is happening with capital inflows and the current account deficit. What is happening in conjunction with indebtedness. When several of these indicators start running off the charts simultaneously, you have a vulnerable situation.

Rogoff: In January 2008 we presented our paper where we used the data in the book and the general approach of the book, where we said looking at the standard set of crisis indicators, and what had happened in the past four years, we said the U.S. would be lucky to avoid a deep recession at this point. That was at a point where most people were saying, well, maybe we’ll have mild recession.

How good has the response policymakers been to this crisis?

Reinhart: I would break that into three parts. One is monetary policy one is fiscal policy and one is restructuring of the banking structure. I would say monetary policy in terms of speed and magnitude gets very high marks…

Rogoff: …post crisis.

Reinhart: Post crisis. Monetary policy has done what it can to limit damage. Fiscal policy I would also give high marks to. We moved in the right direction in as timely a manner as possible.
Where I’m really having difficulty, and I really would rate the policy response fairly low is in the handling of the financial sector restructuring. Mistake number one was the chaos of a year ago. The rules of the game were not announced by anyone. One day you’re bailing out AIG whereas a couple of days before you decided not to bail out Lehman. In addition to all the uncertainty that goes with a crisis atmosphere, the government’s inability to articulate policy layered another layer of uncertainty.

Mistake number two has to do with the speed and the forbearance to guarantee everything. At zero interest rates you can carry a lot of dead weight debt for a long time, but that isn’t resolution, that’s postponement.

Rogoff: We’ve created the mother of all moral hazard problems. We have deposit insurance writ large, everything is insured. Even if the government backs away from it, it has no credibility. This idea that we’ll get rid of too-big to fail banks and we’ll be OK — that’s nuts because a really big bank is only going to fail if there’s a systemic crisis. But if there’s a systemic crisis a lot of little banks are going to fail too, and it’s not credible that your going to let so many little banks go. The government needs to have much stronger regulation on short-term borrowing to try to prevent the short-term leverage buildups that the financial system tends to gravitate towards. That’s a recurrent theme across most of the crises that we looked at. There’s a huge build-up of short-term leverage somewhere in the system — could be consumers, corporates, the government — and it gives this false sense of profitability and sustainability that collapses when confidence is lost.

What are some of the things that surprised you while you were compiling your research?

Rogoff: To see the universality of serial default, how few exceptions there were to countries defaulting on their debt again and again at some point in their history.

Reinhart: We had been thinking of about defaults in emerging markets without really being attuned to the fact that the advanced economies of today were once serial defaulters in their own right.
Another moment was when we were still at the Fund. We had wanted to look at a more comprehensive measure of debt, including domestic debt. If you talk about he U.S., that’s all there is, but when you turn to open economies the data is exclusively is for external debt. Rogoff was chief economist of the Fund and we weighed on departments at the IMF to furnish data on domestic debt – which they simply did not have.
Which is fairly appalling when you consider that one of the key elements of the medium term outlook for the IMF is debt sustainability. Debt sustainability exercises were being done only looking at external debt without taking into domestic debt.

Rogoff: That was surreal, really. Here we are at the IMF and we’re being asked if Argentina can pay its debts and can Turkey pay its debts and can Brazil pay its debts. Looking historically to find benchmarks, all we had was external debt. It just doesn’t seem possible that governments can obfuscate so effectively.

You think it was obfuscation?

Rogoff: Absolutely. I have to believe somewhere in the history of the IMF the idea [to collect countries’ domestic debt data] came up from time to time, and it was just, well, we can’t supply that.
There was also this belief [among policymakers] that if there was debt owed to locals, who cares — they’ll just inflate it away, it’s not going to affect sustainability because the government can do anything it likes to the locals. But if you step back and think about it, the locals own the government. Often the people holding the debt are very rich, powerful institutions and individuals. If you owe them a lot of money, of course it makes it harder to pay foreigners.

Reinhart: We had to solicit a survey to get domestic debt data from the IMF desk officers. Then we discovered we weren’t the first to put together data on domestic debt, guess what the League of Nations before World War II had been doing this.
Not only were they tracking domestic debt, but they were detailing when defaults on domestic debt occurred. That opened up a whole slew of aha moments, when we saw how many domestic defaults there had been. Uncovering that was really an eye opener for us.

Rogoff: That data was totally unused in the academic or policy literature after World War II.

What’s the next step for this research?

Rogoff: We have just scratched the surface of what this data set shows. We provide something that we hope other scholars will use and build on and improve for decades.

Reinhart: There’s a lot more data to be had to complete the picture of these cycles of rising leverage that are associated with inflated asset prices and their subsequent crashes.

Rogoff: Many people have come out of the financial crisis saying we need different economic models, and that certainly might be true, but I think a more pressing lesson is we need better and more complete data over very long time spans. You can't study 100 year floods with 25 years of data.