

Book Review of: **This Time Is Different: Eight Centuries of Financial Folly**

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Introduction

Typically economists take a narrow view – say three decades - to study fundamental issues. This book introduces a new 800 year comprehensive database for studying international debt and banking crises, inflation, currency crashes and debasements. Their overall dataset includes 66 countries in Africa, Asia, Europe, Latin America, North America and Oceania. It shows that it is the norm – not the exception - to have banking crises and debasement, and they tend to occur in waves. In various sections the authors use different datasets to illustrate their positions.

The first parts of the book cover in great detail the history of bank crises, inflation and sovereign default for 66 countries with various groupings: geographical groups, developed and emerging groups. This “dataset” reveals that the phenomenon of serial default is a universal rite of passage throughout history for emerging countries as they move to developed country status. The data shows that high inflation, currency crashes, and debasements often occur with defaults. The paper also looks at the global consequences of sovereign defaults, including its impact on commodity prices and capital flows from the rich countries. It also covers how the economic shocks from leading countries can stimulate financial crises worldwide. The authors conclude that the 2007-2008 U.S. subprime financial crisis and subsequent recession was a logical outcome of the facts and circumstances that occurred prior to 2007/2008 and that our current recession crisis is hardly the exception, but follows the rule.

The final part of the book summarizes the factors that led to the 2007 financial crisis and details its characteristics. It then suggests its impact, and guesstimates how long it will

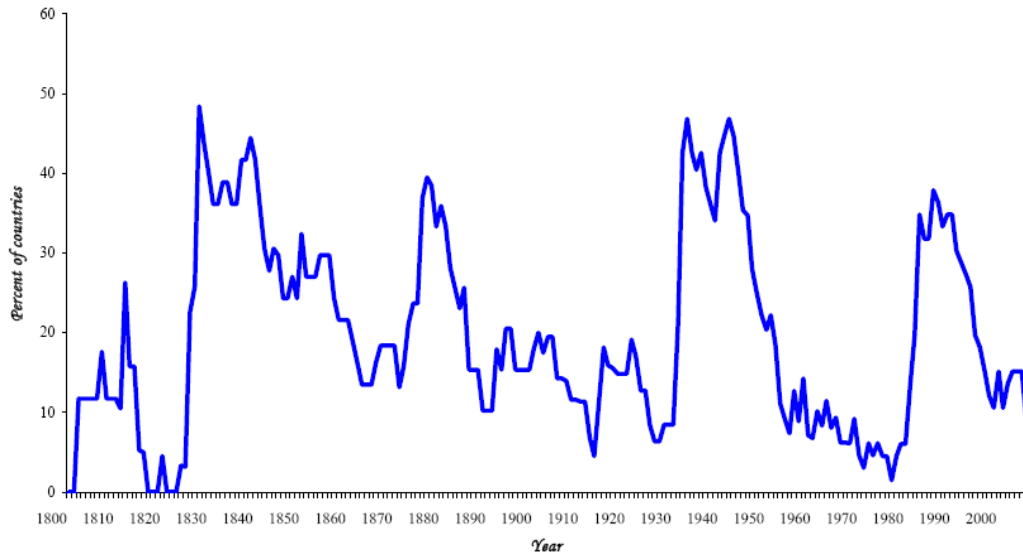
last. Finally, the authors briefly discuss how these crises might be mitigated or avoided. It should be noted that the current recession is entitled the "Second Great Contraction."

The title of the book is ironic in that this time, the basic economics are the same as have existed last 800 years. We haven't figured out how to develop different standards for value nor eliminate business cycles and crises yet.

## Sovereign Default History

*Figure 5.1*

*Sovereign External Debt: 1800-2008*  
*Percent of Countries in Default or Restructuring*

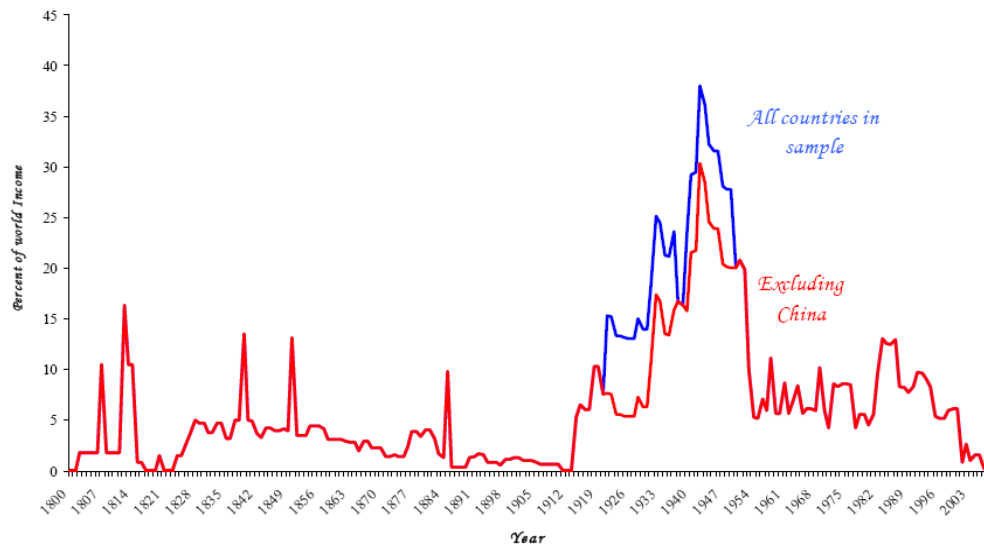


Sources: Lindert and Morton (1989), Macdonald (2003), Purcell and Kaufman (1993), Reinhart, Rogoff, and Savastano (2003), Suter (1992), and Standard and Poor's (various years).

Notes: Sample size includes all countries, out of a total of sixty six listed in Table 1, that were independent states in the given year.

**Figure 5.1** plots the years 1800 to 2008 and the percent of independent countries in default or restructuring. This dataset represents countries that produce than 90% of global GDP. The first spike in sovereign defaults was during the Napoleonic War. During 1799 to 1815, the percent of countries in default jumped to 25%. During the 1820's to 1840's, one half of the sample countries were in default. In the 1840's it jumped again – with about 40% of the sample in default and in the 40's and 50's, about 45% were in default. Finally in the 1990's it soared to nearly 40% again. The conclusion drawn here is that serial default on external debt is the norm throughout every region of the world – not the exception - and that governments choose not to learn from history.

**Figure 5.2**  
**Sovereign External Debt: 1800-2008**  
**Countries in Default Weighted by Their Share of World Income**

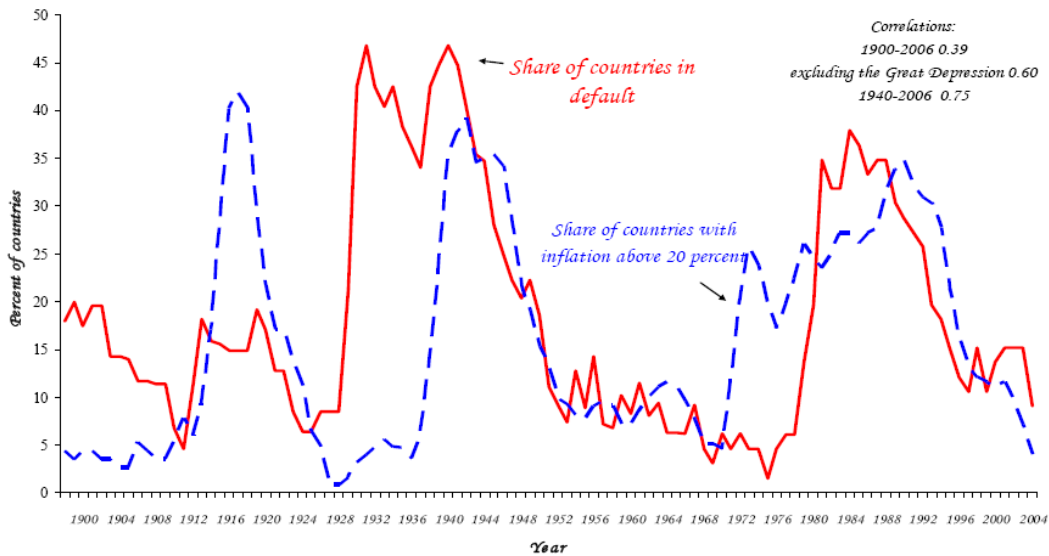


Sources: Lindert and Morton (1989), Macdonald (2003), Maddison (2003), Purcell and Kaufman (1993), Reinhart, Rogoff, and Savastano (2003), Suter (1992), and Standard and Poor's (various years).  
 Notes: Sample size includes all countries, out of a total of sixty six listed in Table 1, that were independent states in the given year. Three sets of GDP weights are used, 1913 weights for the period 1800–1913, 1990 for the period 1914–1990, and finally 2003 weights for the period 1991–2006.

In **Figure 5.2** the data from 1800 to 2008 is weighted by the dataset's share of the world income. In this chart, the 1930's and 1940 are by far the largest period of default, peaking with nearly 38% of the world's income generated by countries in default. Remember, the United States, Canada, New Zealand and Australia among others were not included, as they did not default on sovereign debt.

Figure 5.4

*Inflation and External Default: 1900-2006*



Sources: For share of countries in default, see Figure 1; for high inflation episodes, see Appendix I.  
Notes: Both the inflation and default probabilities are simple unweighted averages.

**Figure 5.4** correlates inflation with external default for the period 1900 to 2006. There are three times where over 30% of countries had high inflation rates - exceeding 20% annually. Also note that inflation rate increases have a very close lagging correlation to the default cycle.

The authors show that default episodes from 1946 – 2006 had a median life of 3 years and 6 years from 1800 – 1945. Apparently we are improving in this category.

In analyzing the cumulative year of default since independence, it might surprise you that France, Germany and Spain led the list with 8 defaults since independence. **Table 6.6** shows that Greece leads the pack year-wise with 50.6 total years in default. Greece has been in default 28% of the time since independence; Russia is next with 39 years in default.

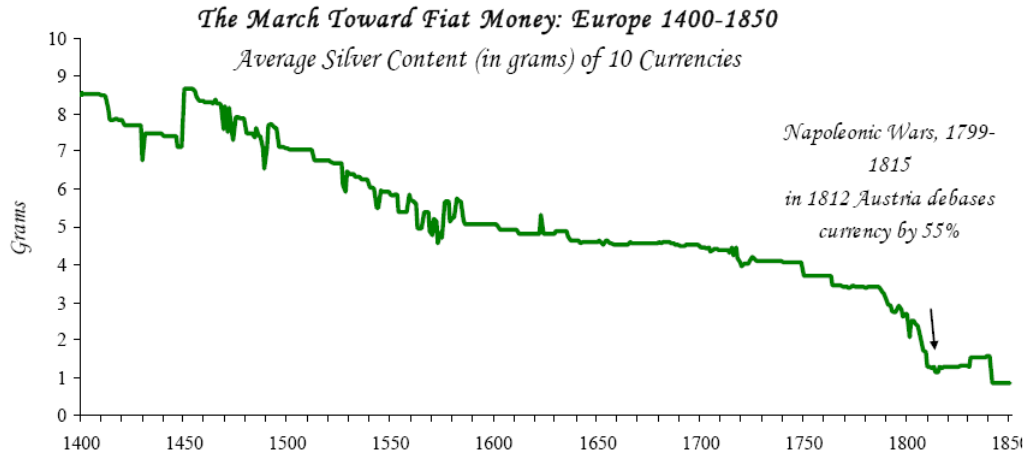
**Table 6.6 - The Cumulative Tally of Default and Rescheduling: Europe, Latin America, North America, and Oceania, Year of Independence - 2006**

<i>Country</i>	<i>Year of Independence</i>	<i>Share of years in default or rescheduling since independence or 1800</i> <sup>1</sup>	<i>Total number of defaults and/or reschedulings</i>
<b>Europe</b>			
Austria	1282	17.4	7
Belgium	1830	0.0	0
Denmark	980	0.0	0
Finland	1917	0.0	0
France	943	0.0	8
Germany	1618	13.0	8
Greece	1829	50.6	5
Hungary	1918	37.1	7
Italy	1569	3.4	1
Netherlands	1581	6.3	1
Norway	1905	0.0	0
Poland	1918	32.6	3
Portugal	1139	10.6	6
Romania	1878	23.3	3
Russia	1457	39.1	5
Spain	1476	23.7	13
Sweden	1523	0.0	0
Turkey	1453	15.5	6
United Kingdom	1066	0.0	0
<b>Latin America</b>			
Argentina	1816	32.5	7
Bolivia	1825	22.0	5
Brazil	1822	25.4	9
Chile	1818	27.5	9
Colombia	1819	36.2	7
Costa Rica	1821	38.2	9
Dominican Republic	1845	29.0	7
Ecuador	1830	58.2	9
El Salvador	1821	26.3	5
Guatemala	1821	34.4	7
Honduras	1821	64.0	3
Mexico	1821	44.6	8
Nicaragua	1821	45.2	6
Panama	1903	27.9	3
Paraguay	1811	23.0	6
Peru	1821	40.3	8
Uruguay	1811	12.8	8
Venezuela	1830	38.4	10
<b>North America</b>			
Canada	1867	0.0	0
United States	1783	0.0	0
<b>Oceania</b>			
Australia	1901	0.0	0
New Zealand	1903	0.0	0

<sup>1</sup> For countries that became independent prior to 1800 the calculations are for 1800–2006.  
Sources: Authors' calculations, Standard and Poor's, Purcell and Kaufman (1993), Reinhart, Rogoff and Savastano (2003) and sources cited therein.

## Inflation the Old Fashioned Way – Currency Debasement

*Figure 11.2*



Sources: Primarily Allen and Unger and other sources listed in Table AI.4.

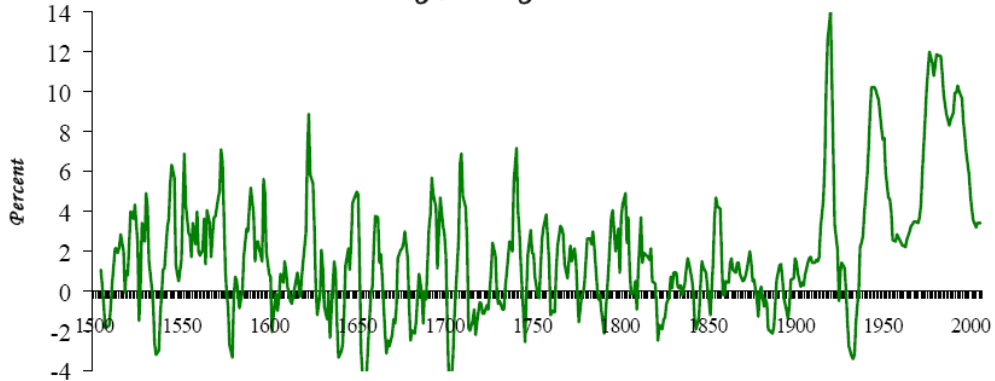
Notes: In the cases where there is more than one currency circulating in a particular country (in Spain, for example, we have the New Castille maravedi and the Valencia dinar) we calculate the simple average.

**Figure 11.2** shows the changes in the silver content in 10 European currencies between 1400 and 1850. The single year record is held by Austria which in 1812 debased its currency by 55%.

## Default through Inflation

*Figure 12.1*

*Median Inflation Rate All Countries  
5-Year Moving Average: 1500-2006*



Sources: There are innumerable sources given the length of the period covered and the large number of countries included. These are listed in Table AI.

Another way to default on debt is to lapse into periods of high or extremely high inflation. No emerging country, including the United States, has managed to escape bouts of high inflation. We note in **Figure 12.1** that the five year average inflation has jumped in the 20<sup>th</sup> century as governments have perfected this repayment model for excessive debt. **Table 12.3** summarizes the inflation maximum rates, with Germany and Poland leading the way.

*Table 12.3 – “Default” through Inflation:  
Europe, Latin America, North America and Oceania, 1800-2006*

Country	Beginning of period covered	Share of years in which inflation exceeded		Number of hyperinflation years <sup>1</sup>	Maximum annual inflation	Year of peak inflation
		20 percent	40 percent			
<b>Europe</b>						
Austria	1800	20.8	12.1	2	1,733.0	1922
Belgium	1800	10.1	6.8	0	50.6	1812
Denmark	1800	2.1	0.5	0	48.3	1800
Finland	1861	5.5	2.7	0	242.0	1918
France	1800	5.8	1.9	0	74.0	1946
Germany	1800	9.7	4.3	2	2.22E+10	1923
Greece	1834	13.3	5.2	4	3.02E+10	1944
Hungary	1924	15.7	3.6	2	9.63+26	1946
Italy	1800	11.1	5.8	0	491.4	1944
Netherlands	1800	1.0	0.0	0	21.0	1918
Norway	1800	5.3	1.9	0	152.0	1812
Poland	1800	28.0	17.4	2	51,699.4	1923
Portugal	1800	9.7	4.3	0	84.2	1808
Russia	1854	35.7	26.4	8	13,534.7	1923
Spain	1800	3.9	1.0	0	102.1	1808
Sweden	1800	1.9	0.0	0	35.8	1918
Turkey	1800	20.5	11.7	0	115.9	1942
United Kingdom	1800	2.4	0.0	0	34.4	1800
<b>Latin America</b>						
Argentina	1800	24.6	15.5	4	3,079.5	1989
Bolivia	1937	38.6	20.0	2	11,749.6	1985
Brazil	1800	28.0	17.9	6	2,947.7	1990
Chile	1800	19.8	5.8	0	469.9	1973
Colombia	1864	23.8	1.4	0	53.6	1882
Costa Rica	1937	12.9	1.4	0	90.1	1982
Dominican Republic	1943	17.2	9.4	0	51.5	2004
Ecuador	1939	36.8	14.7	0	96.1	2000
El Salvador	1938	8.7	0.0	0	31.9	1986
Guatemala	1938	8.7	1.4	0	41.0	1990
Honduras	1937	8.6	0.0	0	34.0	1991
Mexico	1800	42.5	35.7	0	131.8	1987
Nicaragua	1938	30.4	17.4	6	13,109.5	1987
Panama	1949	0.0	0.0	0	16.3	1974
Paraguay	1949	32.8	4.5	0	139.1	1952
Peru	1800	15.5	10.7	3	7,481.7	1990
Uruguay	1871	26.5	19.1	0	112.5	1990
Venezuela	1832	10.3	3.4	0	99.9	1996
<b>North America</b>						
Canada	1868	0.7	0.0	0	23.8	1917
United States	1800	1.0	0.0	0	24.0	1864
<b>Oceania</b>						
Australia	1819	4.8	1.1	0	57.4	1854
New Zealand	1858	0.0	0.0	0	17.2	1980

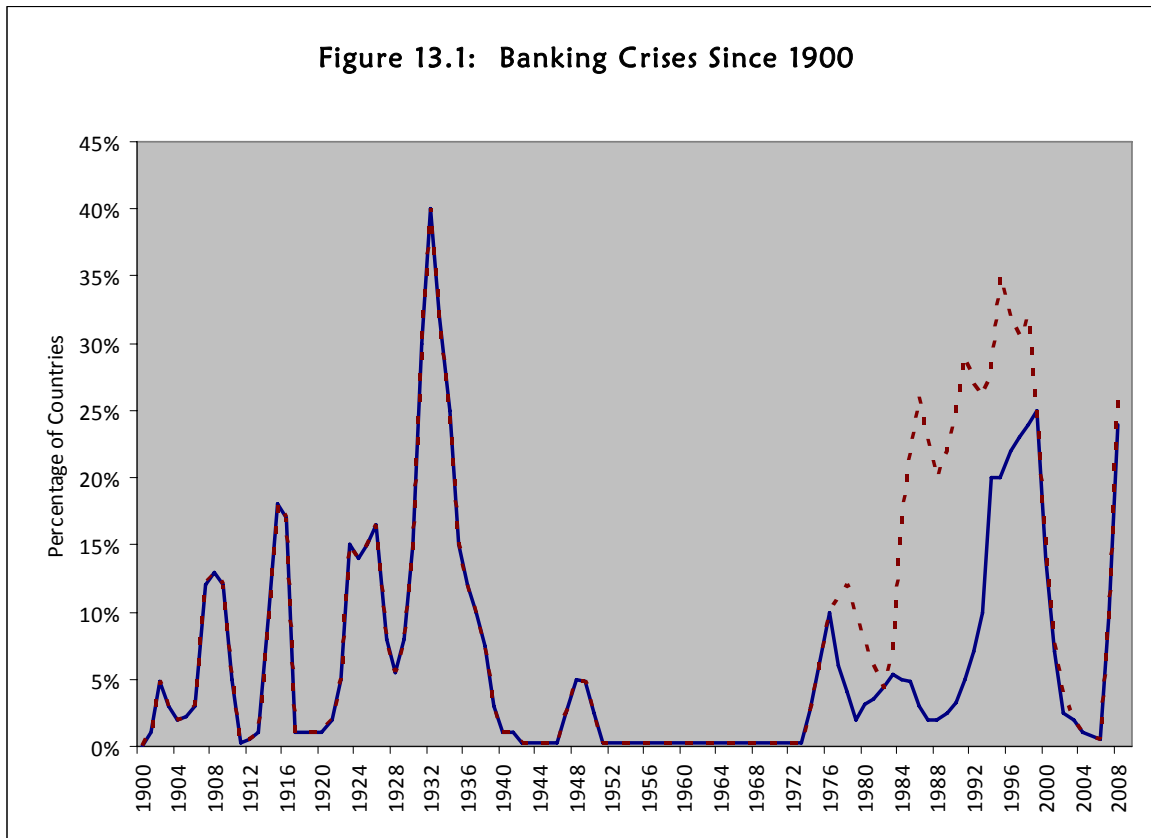
## **The U.S. Subprime Meltdown and The Second Great Contraction**

The last section of the book analyses the current Second Great Contraction and its ongoing impact on the United States and world economies.

A few years ago, many financial “experts” believed that improvements in financial engineering and the federal government’s clever and disciplined monetary policy had tamed the business cycle and reduced the risk of crises spreading throughout the economy and the globe. But they were wrong again.

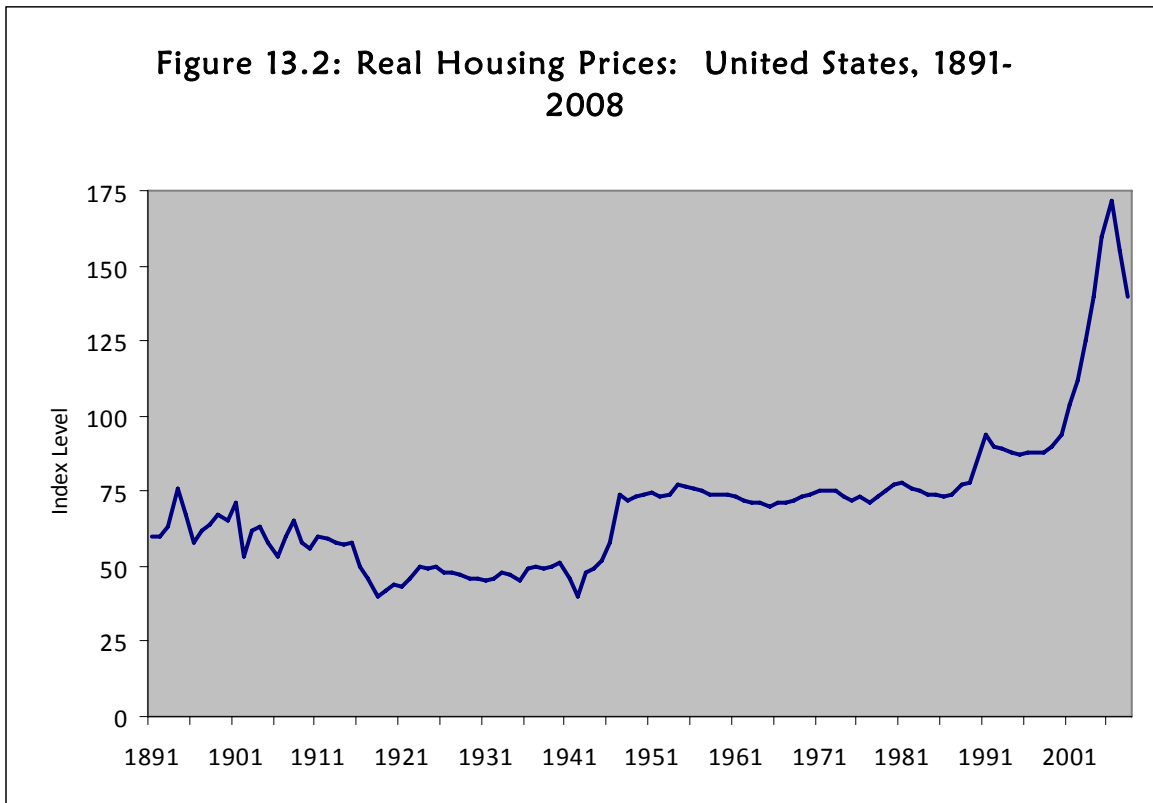
The authors believe that the crisis that began in 2007 had “all the signs of an accident waiting to happen.” These classic signs of a coming financial crisis were also evident in Great Britain, Spain, Iceland, and other countries. The authors start with the statement that “no other financial crisis since the Great Depression has been nearly as global in nature” and the readers may find the comparisons sobering. They therefore call it the Second Great Contraction.

## Review of Banking Crises since 1900



**Figure 13.1** tracks countries that together produce 90% of world income. Figure 13.1 shows the proportion of countries with banking crises weighted by their share of world income. Note that since 1900 only a few times has the percentage of countries having a banking crisis exceeded 20%: (i) the Great Depression at 42%, (ii) 1993 to 2000 at about 25% and now with the Second Great Contraction.

During the late 1980's and early 1990's the Nordic countries experienced some of the worst banking crises that the wealthy economies had known since WWII. These crises followed a **surge of capital inflows and soaring real estate prices – classic precursors of problems to come**. For example, in 1992, Japan's asset price bubble burst and started a decade long banking crisis. The authors conclude that the causes of the recent U.S. financial crisis of 2007 to current are "rooted in the bubble in the real estate market..." and "a massive influx of cheap foreign capital resulting from a record trade balance and current account deficits" and a permissive regulatory system.



**Figure 13.2** shows the sharp increase in real housing prices in the U.S. from 1891 – 2008. Note the major increases starting in the late 1990’s.

“The global financial crisis of the late 2000’s ... stands as the most serious global financial crisis since the Great Depression. The crisis has been a transformative moment in global financial history whose ultimate resolution will likely reshape policies and economics for at least a generation.”

### Why Didn't We See It Coming?

Part of the generally accepted point of view during the 2004-2007 time frame was epitomized by Federal Reserve Chairman Alan Greenspan statements that the new, safer securitization and option pricing methods from Wall Street were improved ways to spread risk and make illiquid assets such as houses more liquid. Hence you can justify higher prices for these riskier assets.

Very few politicians or economists were particularly concerned with the current account deficit – over \$800 billion in 2006 (6.5% of GDP). U.S. Treasury Secretary Paul O’Neil famously argued that it was natural for other countries to lend to the United States and that the current account was a “meaningless concept.”

In 2004, Ben Bernanke said that the emerging countries wanted to ensure themselves against future financial crises and invest in safer U.S. assets and that “Japan and Germany with higher savings wanted a safe dynamic resting place, which meant the United States”.

One result of the huge capital inflows to the U.S. was that the financial sector, which generated about 4% of U.S. GDP in the mid 1970’s, jumped to generating about 8% of GDP by 2007. This easy, low cost money and home price increases encouraged individuals to turn their previous illiquid assets (their homes) into ATM machines. The non-U.S. world were net savers, and by 2004 – 2006 “the United States was soaking up two out of three of these saved dollars...”. The consequence was the sharp rise in household debt to GDP percentage: it was 80% in 1993, 120% in 2003 and 130% by the middle of 2006.

Unfortunately, many American borrowers were using the home ATM machine that had variable resetting teaser rates, and they could not afford the payments when the rates reset. Another factor that added to the economy’s fragile nature was the SEC’s decision in 2004 to allow investment banks to triple their leverage ratios. All was well with American mortgage lenders and specialized financial instruments, so well that the IMF concluded an April 2007 report that risks to the global economy had become extremely low and there were no great worries (or so they thought).

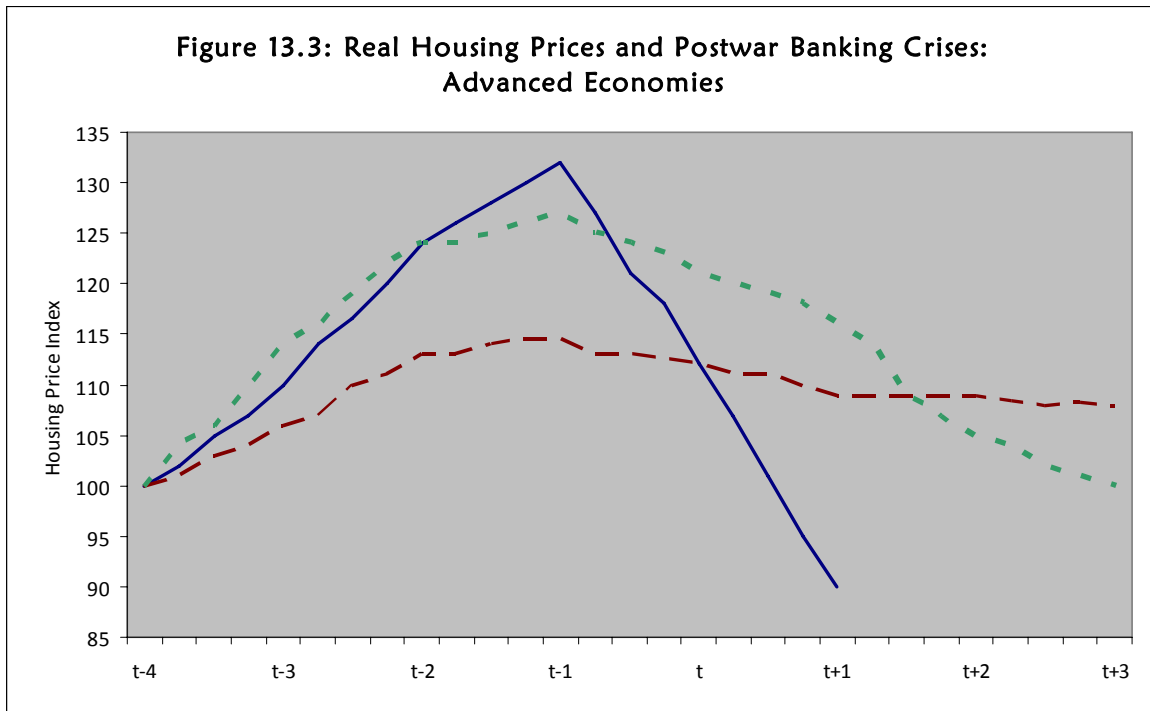
### **Post WWII Bank Centered Financial Crises**

There have been eighteen (18) bank centered financial crises in industrialized countries since World War II. Of these, five were more major in nature and are labeled the “Big Five” by the authors.

All of the Big Five recessions involved major declines in output over a protracted period often lasting two (2) years or more: The Big Five are:

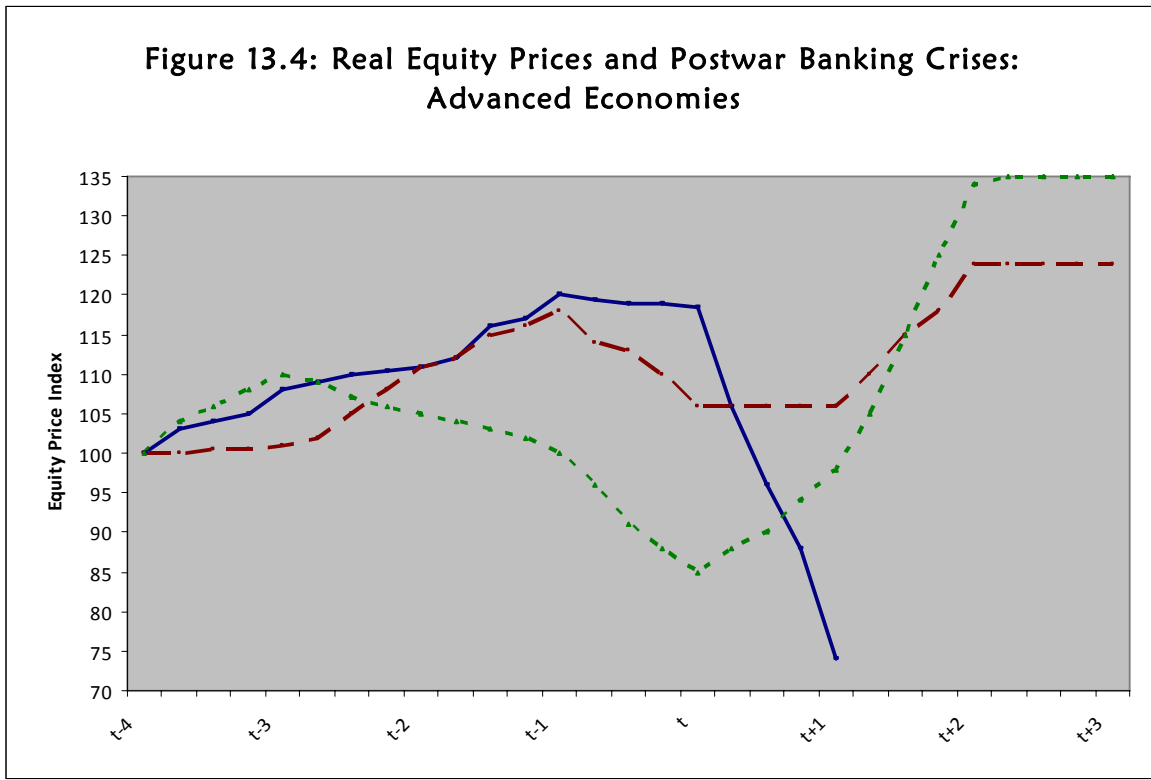
1. Spain - 1977
2. Norway – 1987
3. Finland – 1991
4. Sweden – 1991
5. Japan – 1992

## Impact on Housing Prices



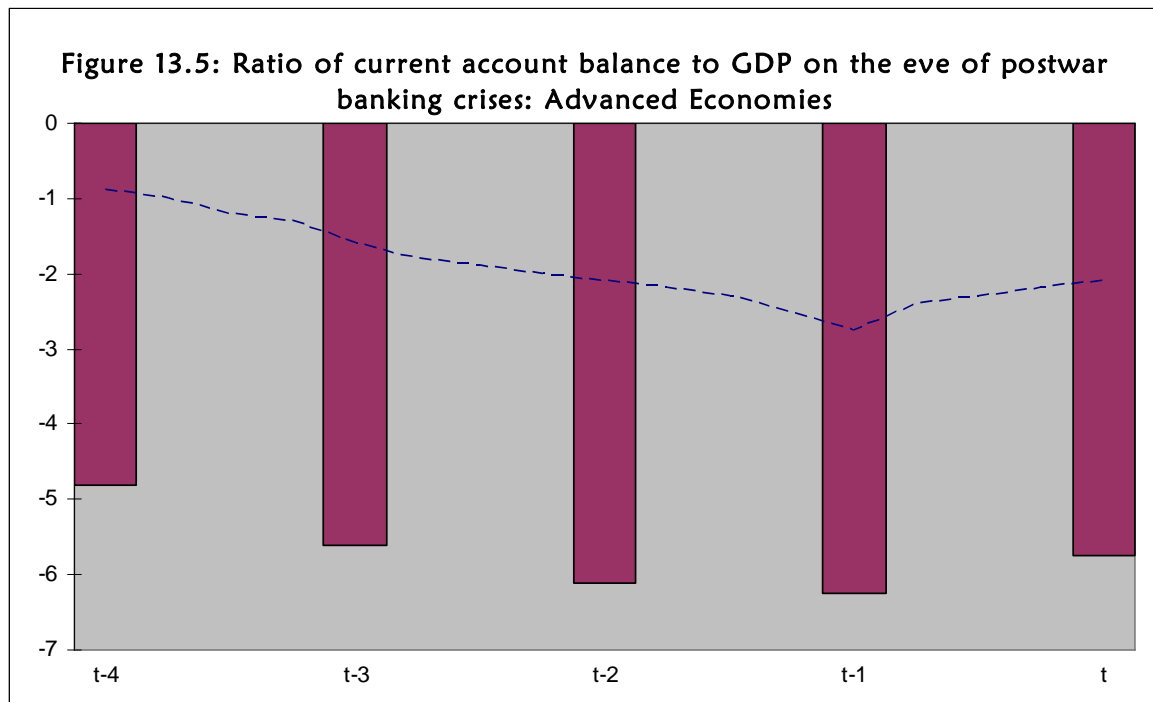
The data in **Figure 13.3** shows that a massive run-up in housing prices usually precedes a financial crisis. The reader should note also that the U.S. exceeded the average price changes for the Big Five in both the run-up in real estate prices and the subsequent post-crisis drop during the T-4 to T+1 period.

Impact on Equity Prices



Next we look at the equity price changes associated with crises – see **Figure 13.4**. Here again, the U.S. has a more volatile pattern than the Big Five’s historical averages.

## Current Account Deficits



Next let's look at the current account balance on the eve of postwar banking crises for advanced economics – see **Figure 13.5**. Our ratio of negative current account percentage to GDP is several times the average for the Big Five.

At the beginning of 2009, the consensus based on forecasts published in the Wall Street Journal was that this recession would be deeper than the average experience of the “Big Five”.

## Government Debt and Duration of Recession

The analysis of the Big Five recessions shows that the real central government debt increased substantially as compared to four years prior to the crisis. We have already passed the average increase of the Big Five and are climbing rapidly with the high deficit anticipated in 2010 and beyond. The total cumulative real public debt increases for the Big Five on average was 86% in the three years following a bank crisis. Since WWII the crises have had an average duration of peak to trough of 1.7 years vs. 4.1 years in the Great Depression and an average of 4.4 years for output to reach pre-crisis levels. This

could mean that the end of the Second Great Contraction will be by the end of 2012, if we (U.S.) meet the “Big Five’s” average duration.

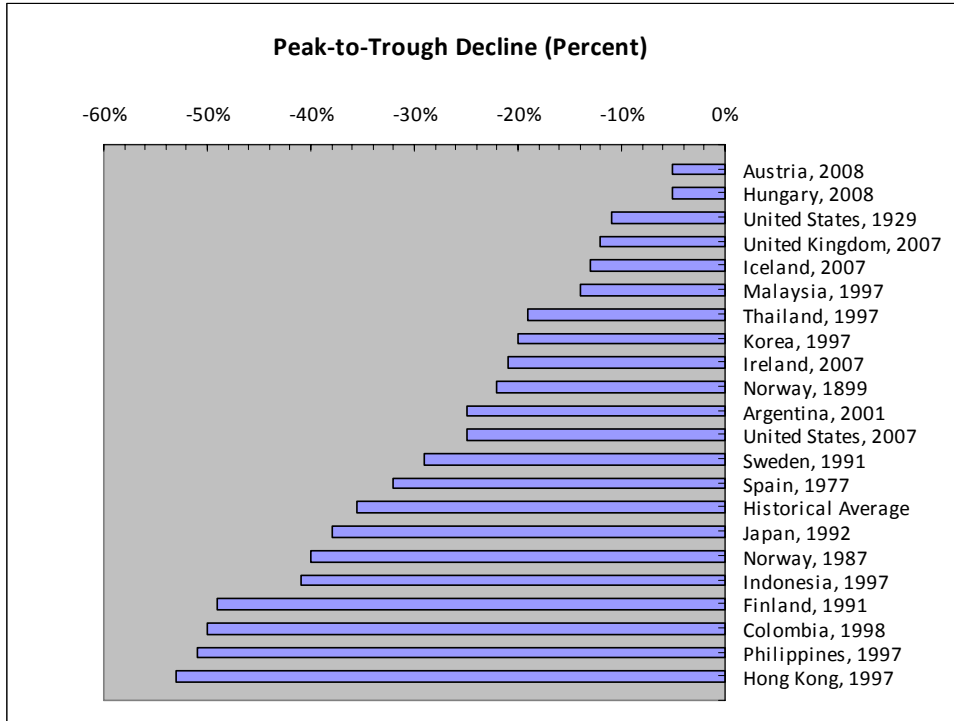
Authors’ Warning: Considering what has happened in recent years “were the United States an emerging country, its exchange rate would have plummeted and interest rates soared”. However exactly the opposite happened in 2008. The dollar appreciated and interest rates fell as investors viewed other countries as even riskier than the U.S. But buyer beware; that can change unless we re-establish a long term fiscal sustainability.

### **The Aftermath of Financial Crises**

In this section, the authors summarize the consequences of systemic banking crises: significant drops in housing and equity prices, unemployment, a drop in government revenues and dramatic increases in total government debt. The following exhibits show the impact in these areas. This sample dataset includes all the recessions for developed countries plus the Great Depression and the current recession in the U.S. – 21 in total.

Real Estate

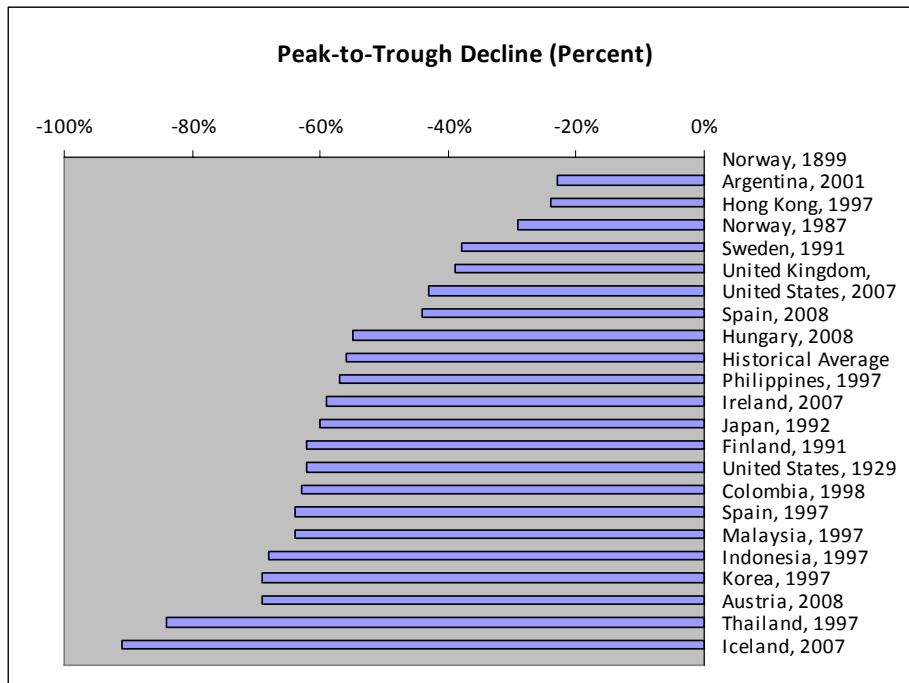
Figure 14.1

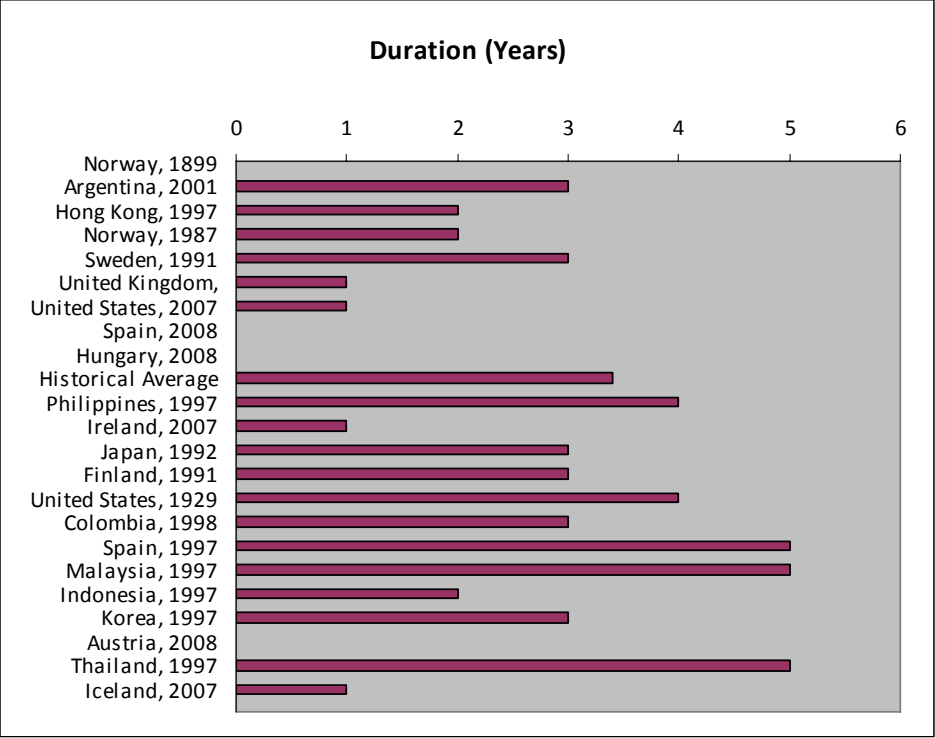


**Figure 14.1** shows the peak to trough declines and the duration of real home prices in the 21 recessions. The historical average price drop is 35.5% with an average duration of 6 years. The most severe real housing price declines were in Finland, Colombia, the Philippines and Hong Kong, where prices dropped 50 to 60%. The U.S. house prices have dropped an average of 28% through late 2008 – twice the percentage during the Great Depression. The average real housing declines excluding Japan is five years.

Equity Prices

*Figure 14.2*

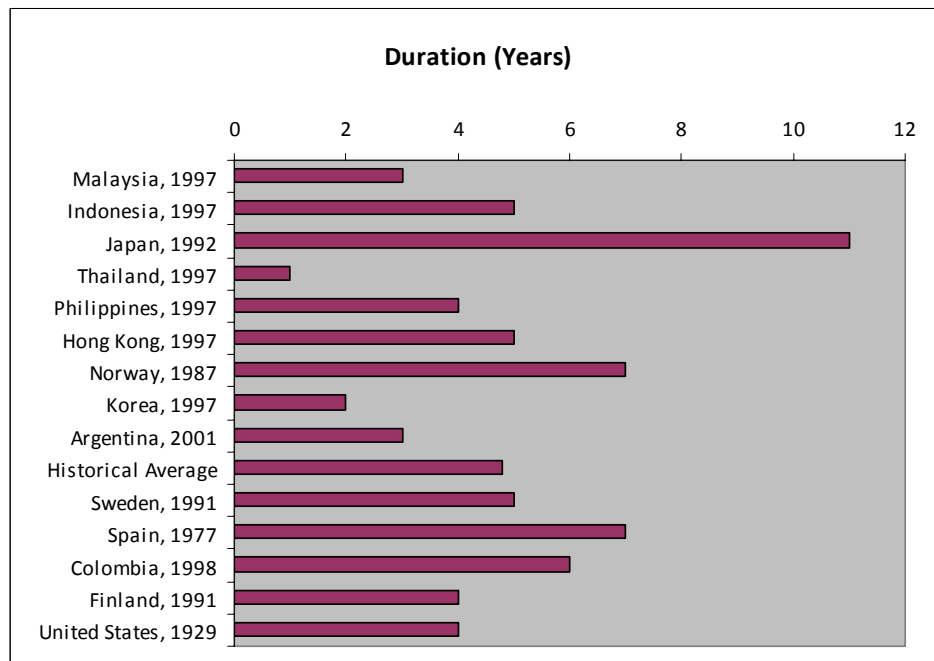
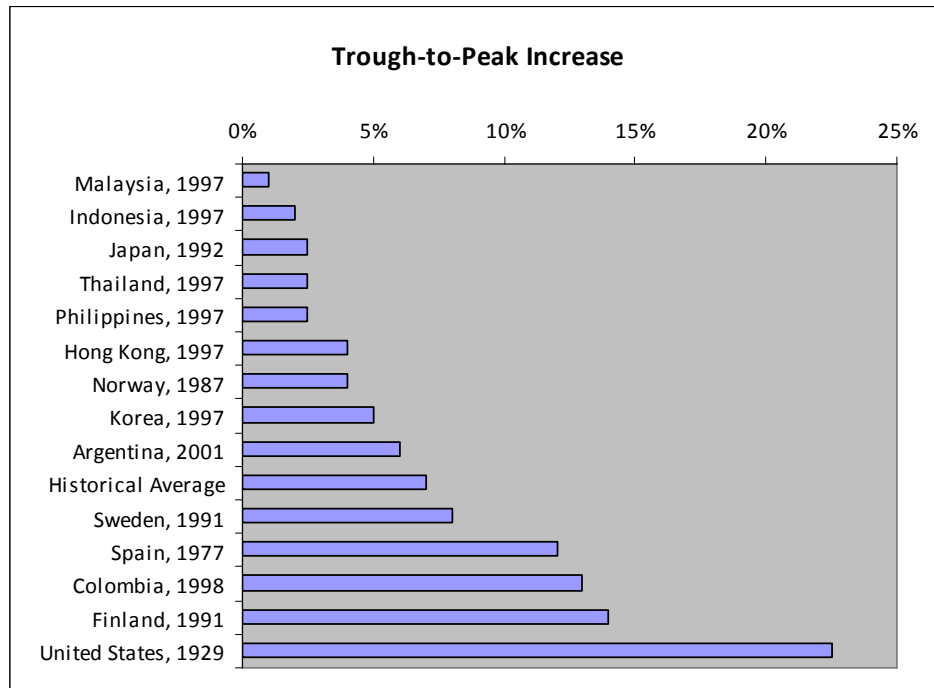




The average decline in equity prices has been 56% and with a 3.4 year duration cycle – see **Figure 14.2**.

## Unemployment

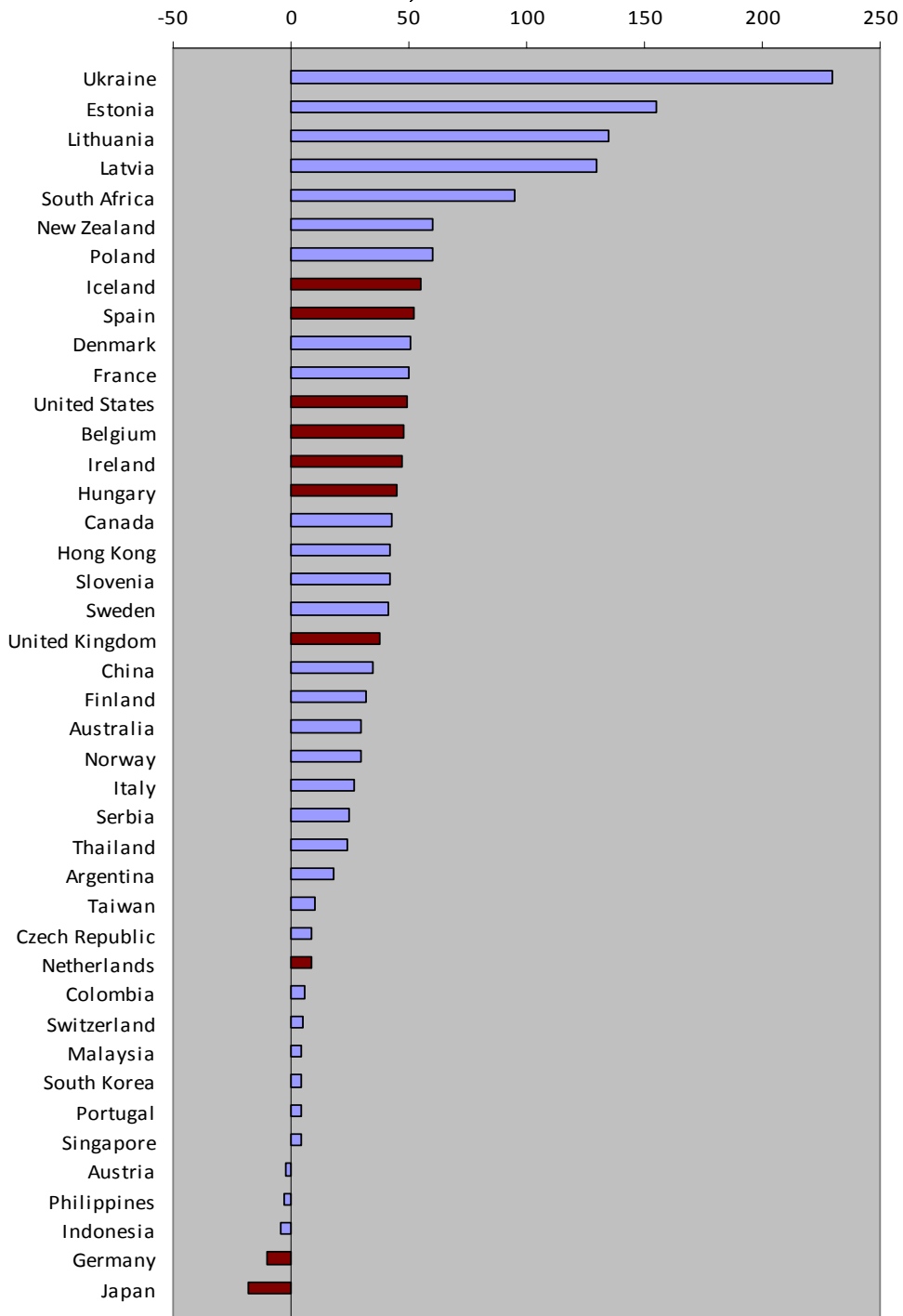
Figure 14.3



In **Figure 14.3** we see that unemployment rises for almost five years after the crises with an increase in the rate of unemployment from the pre-crisis percentage of 7%, on average.

**Worldwide Economic Contagion and Similar Problems**

**Figure 15.1: Percentage Change in Real Housing Prices, 2002-2006**



Prior to 2007 many countries were experiencing sustained capital flow bonanzas; Bulgaria, Iceland, Ireland, Latvia, New Zealand, Spain and the U.K, for example. This fueled a “credit and asset price boom” sending real estate prices soaring in many countries. **Figure 15.1** shows the percentage change in real housing prices in 44 countries between 2002 and 2006. Ukraine prices increased about 225% followed by over 100% in Estonia, Lithuania and Latvia.

Are there any more spillovers on the way? Clearly China has major problems.<sup>1</sup>

The authors conclude that the global contraction of 2008 was “... unparalleled (by a considerable margin) to any other recession since WWII.”

### **Great Depression Comparisons**

The authors discuss key points/impacts and compare the Great Depression with the Second Great Contraction by emphasizing 4 metrics:

1. Stock market rebounded and then declined again.
2. 67% decline in global trade.
3. Real GDP drops 10 to 30%
4. High inflation is a dangerous, but prevalent, method to fund the debt level.

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<sup>1</sup> “China’s Red Flags”, March 2010, [www.gmo.com](http://www.gmo.com).

## What We Have Learned

**This time is not different**, but we regularly forget the lessons of the past by assuming we are smarter, have improved systems, more efficient, etc.

Policy Responses:

- We need to understand the complete picture of government indebtedness – they try to hide the facts. Transparency is important.
- Governments must make plausible assumptions for debt sustainability; for example, if there are sudden drops in capital inflows, how will the interest rates change, etc.
- We need to watch the temptation of governments to inflate away domestic debt. Remember, banking crises tend to be protracted affairs.

“Technology has changed, the height of humans has changed, and fashions have changed. Yet the ability of governments and investors to delude themselves giving rise to periodic bouts of euphoria that usually ends in tears, seems to be a constant”.