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BOOK REVIEW

Mark Kritzman, Senior Editor

THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL CRISES

By Carmen M. Reinhart and Kenneth S. Rogoff
(*Reviewed by Bruce Grantier*)

"This Time is Different: Eight Centuries of Financial Crises", by Carmen M. Reinhart and Kenneth S. Rogoff[1] has been widely quoted in investment commentaries, by other notable academics, and in the financial press. For example:

- Bill Gross: "The Ring of Fire" in PIMCO's *Investment Outlook*, February 2010:

(An) excellent study provides… eight centuries of financial crisis by Carmen Reinhart and Kenneth Rogoff, …a voluminous, somewhat academic production but it has numerous critical conclusions gleaned from an analysis of centuries of creditor/sovereign debt cycles.

- Niall Ferguson: "Empire at Risk": in *Newsweek*, December 7, 2009:

History strongly supports the proposition that major financial crises are followed by major fiscal crises. "On average," write Carmen Reinhart and Kenneth Rogoff in their new book, "This Time Is Different," government debt rises by 86 percent during the three years following a banking crisis."

- Daniel Fisher: "The Global Debt Bomb" in *Forbes*, February 8, 2010:

More debt weighs heavily on GDP says Carmen Reinhart… coauthor with Kenneth Rogoff of This Time is Different"… Reinhart found that a 90% ratio of government debt to GDP is a tipping point in economic growth. Beyond that developed economies average growth rates of 2% points less than economies that have not crossed the line. (The US government debt to GDP ratio is currently 84%).

The book has received praise as:

- One of *USA Today's* "Year's Best Business Books To Make Sense of Financial Crisis",
- Listed on Bloomberg.com by James Pressley as one of "our favourite financial-crisis books this year", and,
- Runner up on *The Atlantic* "Books of the Year" list.

Well known historian, Niall Ferguson, (whose recent book, "The Ascent of Money" was reviewed in the Second Quarter 2009 *Journal of Investment Management*) has described the book as:

"*…quite simply the best empirical investigation of financial crises ever published.*"

The authors have published extensively on financial crises—a few of their papers are noted in the endnotes.[2] The authors have

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become poplar conference speakers and I have been fortunate to have attended a few—needless to say very worthwhile. I have to compliment them on their diplomacy. In one webcast interview, after many questions about past and present financial crisis, the interviewer's final question was "so why is this time different?" Admirably suppressing their surprise, they replied, "We only meant that ironically".

This Time is Different includes financial crises of all sorts, up to 66 countries, going back to the 1300s—debt defaults (sovereign and domestic), hyperinflation, currency crises, and stock market crashes. Among the best known books on financial crises is Charles P. Kindlebergers' "Manias, Panics and Financial Crises"—several other such books as are shown in the endnotes.[3] Reinhart and Rogoff's book stands out in that it catalogues both the surprisingly high repetition of financial crises and the equally surprising frequency of participants who believe "this time is different."

In this review I (1) begin with a summary of the main types of crises, (2) discuss the "this time is different" syndrome, and various models, including the most common behavioural biases, and (3) summarize the main takeaways from this book.

1 Summary of the main types of crises

The book is organized around six main types of crises:

1. Sovereign debt defaults

- External debt defaults in Europe from 1300 to 1800, including the Florentine city-states, the Napoleonic Wars, and Spain's numerous defaults due to inflation and debasement of its currency associated with New World silver and gold discoveries.
- Default and rescheduling from 1800 onward in the emerging economies of Asia, Africa, Latin America, and to a lesser extent Europe (due to World Wars I and II).
- The concept of "graduation," whereby now mature/wealthy economies have had no recent sovereign debt defaults. For example, the last defaults that occurred were for the United Kingdom in 1594, Spain in 1647, and France in 1778.

2. Domestic government bond defaults

- Defaults on domestic debt are on a far smaller scale than sovereign defaults (70 domestic versus 250 sovereign over 1900 to date) but nonetheless surprising when one considers that domestic debts are really debts to the country itself.
- A discussion of the political tradeoffs governments face when they are faced with the prospect of domestic defaults.

3. Banking crises

- While "graduation" may apply to mature economies, no such phenomenon applies to banking crises. Rich and poor are equally susceptible to banking crises and indeed housing crises as well, which are often the cause of a banking crisis.
- This section covers the proportion of countries with banking crises from 1900 to date, plus,
- Real housing prices in the United States from 1900 to date.

4. Currency crises

- A long history of expropriation through currency debasement in Europe; mid-1200 to 1800, including the change in silver content of currency during the Napoleonic Wars.
- Defaults through inflation in Asia, Africa, and the New World; 1500–1800 are discussed, plus
- Defaults in Europe, Latin America, North America and Oceania; from 1800 to date, concluding with a summary of major currency crashes from 1800 to date.

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5. Inflation crises

- Median inflation rates using 5-year moving averages, from 1500 to date, are calculated, plus,
- The incidence of inflation above 20%, Asia, Africa, Europe, Latin America, from 1800 to date.

6. The subprime crisis

- Global crises from 1890 to date, including global stock markets during global crises and the (ir)relevance of country credit ratings.
- Sequences of prototypical crises, including inflation, growth in debt, trade deficits and banking crises. Excessive debt is a consistent recurrent feature of the model.
- The authors original work was on the BCDI index, which compares financial crises of different types, over time and across multiple countries. The BCDI is a composite index of five types of crisis: banking, currency, sovereign default, inflation and stock market crashes. If all five occur, the country scores a "5" for that year. In the example given, the crisis scores for 18 large economies are then summed, weighted by their share of world GDP for the period 1900 to date.
- The BCDI shows the recent "Second Great Contraction" is equal in magnitude to the Great Depression.

2 "This Time is Different" Syndrome, the Minksy Model, and Common Biases

The phrase "this time is different" was chosen by the authors since, "More money has been lost because of these four words than at the point of a gun." The authors discuss how different financial frenzies have remarkable similarities and also discuss the arguments which prevailed at the time and caused observers to exhibit the "this time is different" syndrome.

Economists refer to a well-accepted model by economist Hyman Minsky[4] describing "The Five Stages of Bubbles":

- *Displacement*: considered an exogenous shock which triggers new profit opportunities.
- *Credit creation*: sometimes caused by credit demand to finance assets, sometimes by monetary ease due to economic stress, sometimes by the optimism of banks and eagerness to lend to new opportunities.
- *Euphoria*: speculation for price increases in excess of fundamental investment values—e.g., "greater-fool theory" or "making money was never so easy."
- *Critical stage/financial distress*: also varies; could be insiders selling, rising price of credit, initial failures of over leveraged investors, generally the first awareness that the bubble may not continue.
- *Revulsion*: wide recognition of losses, scared investors, capitulation, and panic.

The authors devote a good part of Chapter 1 to illustrate human bias and the "this time is different" syndrome. Behaviourists have identified many forms of bias, to which our minds are inherently susceptible. One such behaviouralist, James Montier,[5] notes that some 22 different biases generally fall under four basic sources: self-deception, simplification, emotion, and social interaction, of which the most important are:

- *Over optimism*: people overestimate their ability.
- *Over confidence*: people feel more confident than they should be.
- *Self-attribution*: people take credit for their skill for good outcomes, and blame bad luck for bad outcomes.
- *Hindsight*: people forget or overlook what they knew and when they knew it.

These biases are evident in the predictability of bubbles and forecasting in general. Montier notes that bubbles are often not

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the "black swans," popularized by Nassim Taleb. These so-called "black swan events" are more often recognized and denounced.

As Reinhart and Rogoff put it very clearly:

…The "this time is different syndrome" is simple. It is rooted in the firmly held belief that financial crises are things that happen to other people in other countries at other times: financial crises do not happen to us, here and now. We are doing things better, we are smarter, we have learned from past mistakes. The old rules of valuation no longer apply. The current boom, unlike the many booms that preceded catastrophic collapses in the past (even in our country), is built on sound fundamentals, structural reforms, technology innovation, and good policy.

3 Summary of the Main Takeaways

I have attempted to set out below some of the main takeaways as I see them, but apologize in advance for brevity and omissions. The book covers such a vast array of crises, times, and countries, there is much to summarize and I can only recommend the reader find their own lessons from this excellent book.

(1) Excessive debt is a common theme throughout, and is illustrated in the very earliest of financial crises dating back to the 1300s. Related topics include the causes and frequency of sovereign versus domestic defaults, the bunching of crises, concept of "graduation"(growing out) in country defaults, and the concept of a "tipping point" in government debt to GDP ratio. This last topic has become a very important topic, as seen in the Ferguson, PIMCO and Forbes comments at the beginning.

(2) Banking crises have no such concept of graduation—they happen to both rich and poor countries, in remarkably similar fashion, and unfortunately have the characteristic of ensuing extreme recessions.

(3) The author's original work on the BCDI Index is quite valuable in providing a measure for comparing different types of crises across time and country.

(4) A "Sequence of Crises: A Prototype" is found in the next to last chapter. This draws together the work of many economists, including Kindleberger and Reinhart and Rogoff. It illustrates the common patterns in which crises unfold.

(5) The "this time is different" syndrome in the U.S. financial crisis of 2007/2008 was a repeat of past excesses and a reluctance to deal with the ensuing problems, even as they were recognized. Housing prices in real terms doubled over 1996–2006 and equity markets soared, all fuelled by record trade and current account deficits. A surge in default rates (compounded by poor quality loans and subsequent repackaging of mortgages) in 2007 eventually led to a global financial panic and the worst recession since the Great Depression. Thinking at the time, however included:

…Everything is fine because of globalization, the technological boom, the superior U.S. financial system, better understanding of monetary policy, and the phenomenon of securitized debt…Fed and Treasury officials often argued that financial innovations such as securitization and option pricing were producing new and better ways to spread risk, simultaneously making traditionally illiquid assets, such as houses, more liquid… hence higher and higher prices for risky assets could be justified… Fed and Treasury officials also argued that the gaping trade deficit was to a significant extent, simply a reflection of a broader trend toward global financial deepening that was allowing countries to sustain much greater current account deficits and surpluses than in the past.

Notes

[1] Reinhart, Carmen M. and Rogoff, Kenneth S. *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009.

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From their respective websites: Carmen M. Reinhart is Professor of Economics and Director of the Center for International Economics at the University of Maryland. Kenneth S. Rogoff is Professor of Economics, and Thomas D. Cabot Professor of Public Policy, Harvard University.

[2] See, for example: Reinhart, Carmen M. and Rogoff, Kenneth S, "The Aftermath of Financial Crises", *American Economic Review*, May 2009. Reinhart, Carmen M. and Rogoff, Kenneth S, "Banking Crises: An Equal Opportunity Menace", manuscript, University of Maryland, December 2008. Reinhart, Carmen M. and Rogoff, Kenneth S, "Is the 2007 US Subrime Financial Crisis So Different?" NBER Working Paper 13761, January 2008.

[3] Books on the history of financial crises, their economic causes, and, in some cases, their behavioural aspects includes: Chancellor, Edward, "The Devil Take the Hindmost: A History of Financial Speculation", Plume, 2000. Ferguson, Niall, "The Ascent of Money: A Financial History of the World", Penguin Press, 2008. Kindelberger, Charles, "Manias, Panics and Financial Crises: A History of Financial Crises", Palgrave MacMillan, 2005. Mackay, Charles, "Extraordinary Popular Delusions and the Madness of Crowds", New York, 1932.

[4] Minsky, Hyman, "John Maynard Keynes", Columbia University Press, 1975.

[5] Montier, James, "Behavioural Investing: A Practitioner's Guide to Applying Behavioural Finance", John Wiley & Sons, Ltd, 2007. (Reviewed in the Second Quarter 2008 Journal of Investment Management.

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