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The Four Most Expensive Words

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In the literature on financial crises, it has become a familiar meme to scour the history books and dig up unfortunately timed quotes on the rosiness of conditions on the eve of economic collapse. Thus, Irving Fisher infamously wrote on October 17, 1929, that "[U.S.] stock prices have reached what looks like a permanently high plateau . . . [, and] I expect to see the stock market a good deal higher within a few months" (*New York Times* 1929). Unfortunately, it seems that no one bothered to follow up on Fisher's prognosis in light of the Standard & Poor 500's decline of 19 percent in the following two weeks, much less its spectacular 85-percent decline in the subsequent three years. Perhaps it was because Fisher was far from alone: Commentators from sources as diverse as the *Ladies' Home Journal* and the *Wall Street Journal* were all uniform in their opinion that the prospects for the world economy in general and U.S. economic growth in particular remained bright.[1] That the stock market had scaled such unprecedented heights is itself indicative of both how well-received the prevailing wisdom was and how well-leveraged the true believers were in this perceived new era of U.S. prosperity.

With the benefit of 80 years' hindsight, the folly preceding this particular crash is evident: U.S. corporations (and households to a lesser extent) were awash in a sea of debt; many of the financial and manufacturing powerhouses of the day, such as the Kruger empire, were to be revealed as accounting fictions; and even the real sources of this new-found prosperity, such as the rise of the assembly line and radio-electronics industry, were susceptible to the fact that key innovations could be easily replicated by competing firms, suggesting that the attendant productivity gains—while a great boon to consumers—would be hard for firms to capture and transform into enhanced profitability in the future. An unreflective student of history is then left slightly perplexed. How could they have ignored the blatant deviation of stock prices from any reasonable fundamental value? How could they not see the dangers inherent in the system of reparations erected in the wake of World War I? How could they have been so blind to the fragility of a grossly leveraged financial sector?

Likewise, uncharitable observers 80 years hence will wonder many of the same questions with respect to the current global financial crisis. How could U.S. homeowners and financial institutions not see the mathematical impossibility of perpetual increases in home prices above the rate of nominal income growth? How could the various governments of the world not see the gross distortions attendant on a developing country—albeit a very large one—financing the decade-long consumption binge of the world's richest nation? And again, how could they have been so blind to the fragility of a grossly leveraged financial sector?

The answer, of course, comes from the widely held perception in each instance that "this time is different." The historical literature—ranging from ancient to contemporary—is littered with a wide range of such manias that in the cold light of day look peculiarly delusionary. Consequently, there is a large narrative and theoretical literature addressing the numerous episodes of speculative booms morphing into financial busts. The narrative literature starts at the very latest with Charles Mackay's (1980) contribution from 1841, *Extraordinary Popular Delusions and the Madness of Crowds*, which in its early chapters is devoted to a peculiar species of mass delusion, the financial asset bubble, considering in turn the Dutch tulip bubble of 1637, the British South Sea Company bubble of 1711–20, and the French Mississippi Company bubble of 1719–20. However, the most influential contribution in this genre is almost certainly Charles Kindleberger's (2000) *Manias, Panics, and Crashes: A History of Financial Crises*. What emerges from Kindleberger's broad examination of financial catastrophes across time and space is a typology of financial crises that admits a prime role for irrational behavior in financial markets in fomenting bouts of euphoric and overzealous trading to be followed by waning confidence, panicked selling, and ultimately, outright financial crash. Underlying all historical episodes, Kindleberger finds the need for a lender of last resort to mop up after the carnage has set in and stanch the expansion of the crisis into the broader economy with the judicious and timely provision of tangible liquidity and intangible confidence. The

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

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theoretical literature has tended to be narrower in focus, perhaps to its disadvantage. Thus, Douglas W. Diamond and Philip H. Dybvig (1983) on banking panics and Paul R. Krugman (1979) on currency crises represent some of the key references in this literature but have remained outside the realm of general consumption. An interesting exception to this rule has been the resurgence of the work of Hyman Minsky (1982a, 1982b) on the "financial instability hypothesis," which sought to endogenize the formation of financial crises within capitalist economies.

However, what has previously been missing has been a truly quantitative history of financial crises until now.[2] In their work *This Time is Different: Eight Centuries of Financial Folly*, Carmen Reinhart and Kenneth Rogoff break this trend and, in so doing, highlight two aspects of financial crises that, although fairly well-appreciated, have been woefully underexploited in the past.[3] First, systemic financial crises are comparatively rare events. Up until the most recent episode, the last comparable crisis in terms of global reach (but hopefully not length or intensity) was the Great Depression. And even in the case of more geographically delimited events, the post–World War II era—although seeing its fair share—has only given rise to perhaps half-a-dozen truly significant crises. Thus, turning to history for insights seems a natural way to proceed, as in Reinhart and Rogoff's work. Second, despite all their differences in terms of dramatis personae and triggering events, financial crises share a surprisingly common trajectory, with rising asset prices, surging debt levels, and subsequent repayment difficulties being evident in almost all episodes. Thus, employing a comparative approach, as in Reinhart and Rogoff's work, rightly emphasizes the generality of economics without foregoing the specificity of history.

To call this book "timely" would be a vast understatement. The discussion of the crisis—both its sources and consequences—has dominated news outlets for many months and will undoubtedly heavily feature in academic discussion for years, if not decades. The arrival of the book in the summer of 2009 reflects in part the luck—if one can call it that—of Reinhart and Rogoff in beginning this project early in the first decade of the twenty-first century, when both were at the International Monetary Fund. However, it is also indicative of a considerable degree of foresight on their part. For all the criticism implying that the economics profession was blindsided by this crisis, the authors—both separately and jointly—have been on the forefront of warning readers about the dangers of the debt-fueled expansion of recent years, particularly in the form of the gargantuan current account imbalance between China and the United States and the fallout attendant upon the so-called "subprime crisis" (see Obstfeld and Rogoff 2004; Reinhart and Rogoff 2008).

The basic premise of the book is that although debt may prime the engine of economic growth, too much debt may be hazardous to a country's health. The generic chronology proposed in the book is that times of economic boom and financial calm allow for debt to begat debt. As the boom quickens, the quality of projects and schemes funded by all this debt declines, sometimes precipitously. Inevitably, things take a turn for a worse—the new technologies fail to deliver the brave new world promised, the new financial instruments prove worse at mitigating financial risks than was supposed, or the economy suffers from a surprising and, in some instances, devastating external shock. In the ensuing confidence crisis, short-term credit is refused, and the former sure-fire loans fail to perform, weighing down the balance sheets of consumers, firms, and governments, and setting the stage for an economy's underperformance for many years to come. Underlying this entire process is the tendency for more prudent voices to be discounted, ignored, and tagged as "chicken littles," "naysayers," or simply and irredeemably "old-fashioned." And that tendency is precisely for the reason that this time around the lessons of history and the old rules of valuation, accounting, and plain common sense no longer apply.

The specific means by which Reinhart and Rogoff establish this general tendency come in the book's six parts. The first part of the book lays bare the tools that the authors use in their postmortem of financial crises. By delineating the types of crisis along the lines of those defined by quantitative thresholds (inflation, currency crises, and debasement) and those defined by events (banking crises, external default, domestic default), Reinhart and Rogoff are making clear not only their criteria, but also their intention to keep the book within the realm of a general audience. It is here that their "this-time-is-different syndrome" makes its first appearance, and it is illustrated by the run-ups and fall-outs associated with the Great Depression and the various debt crises of the 1980s and 1990s. Their terse discussion of the five episodes under discussion also makes it very clear that this book will be a significant departure from the typical approach in writing the history of financial crises that is lavish in detail, long in narrative, and short on data.

This is followed by one of the more foreboding chapters of the book, although (perhaps) not by design. The chapter focuses on the condition of what Reinhart and Rogoff call "debt intolerance," which they define as the "syndrome in which weak institutional structures and a problematic political system make external borrowing a tempting device for governments to employ to avoid hard decisions about spending and taxing" (21). In their framework, debt intolerance is primarily an affliction of emerging markets that find themselves subject to "a vicious cycle of loss in market confidence, spiraling interest rates on external government debt, and political resistance to repaying foreign creditors" (21). From the perspective of the spring of 2010, these issues seem to be playing out in real time in the context of the current Greek and the emerging (potential) European debt crisis. Of course, it takes very little imagination to transpose the woes of the European Union to the North American continent where the U.S. Congress seems to be rapidly descending to the level of party and personal politics that have paralyzed the state of

California in the recent crisis. Unfortunately, Reinhart and Rogoff are not particularly sanguine about a nation's chances of escaping this condition, and the only policy prescription they offer is to keep debt levels low for many years, in anticipation of much-needed but somewhat ill-specified changes in economic and political institutions. They also establish the fact that default often occurs at fairly low levels of external debt, suggesting that there may be more at work than the simple external debt-to-GDP or debt-to-export ratios with which economists and market analysts are generally enamored.

The final chapter in this section is devoted to detailing Reinhart and Rogoff's primary contribution in this project. This is a global database on the vital signs of economies: prices, exchange rates, gross domestic product, exports, public finances, and debt. Most of the individual sources are well-known to applied researchers in economics and economic history. However, Reinhart and Rogoff's contribution is compiling all this information in one place and also providing a clear and overarching framework for interpreting the data. One of the clearest victories in this regard is their ability to track the composition of public debt across countries and over time. Why this is significant is that for too long researchers have focused on only one aspect of public debt, namely external debt, to the almost complete exclusion of another, namely domestic debt. The distinction is an important one as domestic debt accounts for a sizeable and, in some instances, huge share of all public debt, ranging from 40 to 80 percent for the all-country average in the period from 1900 to 2007. The dangers of ignoring such a sizable source of financial pressure are obvious, yielding a condition that Reinhart and Rogoff hope to remedy with this book.

On this basis, Reinhart and Rogoff proceed to considerations of sovereign external debt crises, the so-called "forgotten history" of domestic debt and default, and the relationship between banking crises, inflation, and currency crises. In all cases, their approach is refreshingly straightforward: Here, the reader will not encounter high-octane theory or hardcore number crunching. Instead, the authors opt for the "core life" of the book to unfold as a series of tables and figures that tend to emphasize the common (or more precisely, average) experience of countries with financial crises of all ilks. The intervening 150 pages can be condensed into a number of take-home messages:

- *Countries don't go bust*. When a country experiences a domestic or external debt default, it is literally never the case that the country itself is bankrupt: barring instances of war, the nation's physical infrastructure, productive capacity, and financial institutions are generally intact. Thus, the ability to pay, while perhaps circumscribed, is almost never wholly lacking. What is oftentimes missing is the willingness to pay. And of course, this willingness to pay is likely to be tied up with issues of political economy, the distributional consequences of default, and future access to international or domestic capital markets. That lending to sovereign governments does take place suggests that the forces of reputation and potential retaliation are at work. However, underlying the experience of all sovereign debtors is the phenomenon of multiple equilibria in which small differences in shocks can lead to large differences in outcomes. One of the key mediating factors in this regard is the ubiquity of the this-time-is-different syndrome and the consequent fickleness of investor confidence.
- *What goes around comes around*. The long history of sovereign default—both domestic and external—suggests that it comes in cycles with periods of extreme financial duress followed by periods of calm. The suggestion is that as the lessons of recent and not-so-recent history are lost, pressure accumulates to begin another leverage cycle and, thus, sew the seeds for another bust. What stands out in this regard is the low level of domestic and external defaults along with the diminished incidence of banking crises that marked the period from the end of World War II into the 1970s. Of course, that this was a period of strong regulation and sometimes outright financial repression should not come as a surprise: The inability of capital to circulate in perpetual search for higher returns stymies the ability for incipient credit booms to take place. An obvious, open question then is whether the costs of such financial regulation outweigh the benefits arising from diminished default and banking crisis risk.
- *Banking crises you will always have with you*. Although the history of sovereign defaults suggests a cyclical pattern at the global level, the fact remains that a number of today's developed countries have graduated from the ranks of serial defaulters, regardless of whether this is in the form of explicit sovereign debt default or the form of implicit default via inflation. Countries as diverse as Austria, France, Greece, Portugal, Russia, and Spain have all been able to shake the specter of default—at least as of this writing—that has haunted them from as long ago as the nineteenth century. The trick that these and all other developed countries have been less successful at managing is the eradication of periodic banking crises. Much of this reflects that the primary function of banks is maturity transformation, that is, turning short-term deposits by their retail customers into long-term loans for their commercial clients. Any erosion in confidence is, therefore, prone to generate a temporary mismatch between the bank's liabilities and its assets on hand. Much of this also reflects the fact that bankers throughout the ages seem particularly susceptible to the this-time-is-different syndrome. Reinhart and Rogoff are quick to point out as well that the costs of banking crises have also neither abated over time nor been limited (or even dominated) by direct bailout costs: They invariably lead to sharp declines in asset prices as retrenchment sets in and investors become

> more guarded, sharp declines in output as the crisis reverberates in a cycle of poor loan performance leading to diminished credit availability, and sharp declines in government revenues that consequently spur an average 86-percent increase in real government debt in the three years following the crisis's onset.

The book concludes with a section relating the history of financial crises to the current subprime crisis and what Reinhart and Rogoff call the "Second Great Contraction." In this regard, the United States has not deviated too much from the standard playbook of a garden-variety deep financial crisis: The familiar interplay of rising asset prices and burgeoning debt levels in the context of a permissive regulatory (and cultural) environment finds itself at play once again. At the heart of this process, of course, was "the re-emergence of the this-time-is-different syndrome—the insistence that some combination of factors renders the previous laws of investing null and void" (203). Compounding this problem of valuation was the widely held opinion that the United States was fully capable of harnessing the flood of capital flows into its borders and its attendant effects.[4] That is, the players, the instruments, and the particulars may have all changed, but the plot remains the same. Or as Kindleberger (2000, 19) so pithily put it, "details proliferate; structure abides." Here, the book naturally stumbles somewhat. The history-by-numbers approach of the book suggests that the coming years will be painful as bank, household, and government balance sheets tighten, but that approach offers little in terms of practical solutions to either circumvent or alleviate that pain. A more theoretically informed and econometrically geared approach might be useful in this instance, and undoubtedly Reinhart and Rogoff are already busy at work on this front.

A few other areas could be highlighted as particular weak selling points of the book. Throughout, the reader is admonished—as almost from the pulpit—that too much debt is a dangerous thing, but defining "too much" remains an elusive task for Reinhart and Rogoff. Obviously, an inability to service debt suggests too much debt, but this scenario is likely the endogenous outcome of the interaction between debt accumulation and market expectations. So is there any means of generating an assessment of too much debt as an *ex ante* prediction rather than an *ex post* observation? Or, in other words, what are the warning signs? On a related note, it would be interesting to see a consideration of the "shoes that didn't drop": episodes of near default and financial crisis that nevertheless failed to materialize. These are obviously harder to identify by looking at the narrative literature, but a few candidates might include Denmark in the late 1980s, Canada in the early 1990s, and select East Asian countries during the financial crisis of 1997. Thus, by looking at nations that are at the cusp but ultimately free of financial crisis, we may gain a better understanding of how to prevent or at least contain future outbreaks. Finally, the sources of the central phenomena of the book, that is, the proliferation of the this-time-is-different syndrome, go virtually unexplored. It is one thing to claim that the lessons of history are never learned, or at least, never learned well enough. It is quite another to tell us why this is so. Admittedly, this is secondary to their immediate task of tracking the syndrome's emergence in and effects on various economies. However, it would be nice to get a sense of its ultimate cognitive, economic, or psychological bases.

At the same time, none of this should detract from what will surely be one of the standard references in the literature on financial crises for years to come. The work of Reinhart and Rogoff also provides raw material for the wave of studies of financial crises—both empirical and theoretical—that we can anticipate in the near future. In this sense, the book is a natural complement and worthy successor to the work of Kindleberger, as it provides the statistical backbone from which economic theory and historical narrative should hang.

NOTES

1. A notable exception is Malcolm Muir, the editor of *Business Week* at the time, who wrote in its inaugural edition that "American business has been in the grips of an apocalyptic, holy-rolling exaltation over the unparalleled prosperity of the 'new era' upon which we, or it, or somebody has entered . . . [; consequently] stock prices are generally out of line with safe earnings expectations, and the market is now almost wholly 'psychological'" (quoted by Ahamed 2009, 348).
2. Kindleberger (2000, 5) mentions this as a possible way forward, but quickly dismisses the idea, noting that his "thesis does not rest on small differences in quantities" and that such a project would require "an inordinate amount of work with greater costs than benefits." Thankfully, Reinhart and Rogoff have ignored his implicit advice.
3. The book's title references the oft-repeated observation that "more money has been lost because of four words than at the point of a gun . . .[;] those words are 'this time is different'" (xxxvii). Similar quotes to the effect that this phrase constitutes "the four most expensive words in the English language" and "the four most dangerous words in investing" have been attributed to both Friedrich von Hayek and Sir John Templeton.
4. The book digs up this gem from former U.S. Treasury Secretary Paul O'Neill: "the current account is a meaningless concept" (209).

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