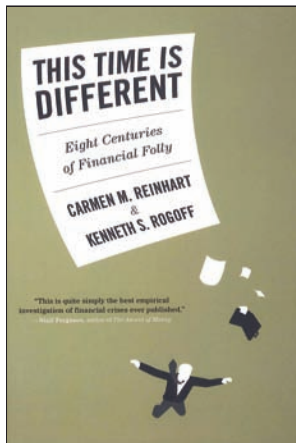
BookReview

The Precursors of Financial Crises



THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY

BY CARMEN M. REINHART
AND KENNETH S. ROGOFF
PRINCETON: PRINCETON
UNIVERSITY PRESS, 2009, 463 PAGES

REVIEWED BY STEPHEN SLIVINSKI

The subtitle of this new book by University of Maryland economist Carmen Reinhart and Harvard University economist Kenneth Rogoff gives the reader the best hint to the content inside. The heart of the book consists of a wealth of new data and analysis — much of which appears in a nearly 100-page appendix — on public indebtedness, currency crises, and financial meltdowns over the past eight centuries. The scope of the data — much of which have never been collected before — is impressive and the book stands as a testament to the scholarship of its authors. Such a treasure trove should not go unnoticed by economic historians.

The broader theme of the book is indicated by the main title. In their tour of the data, the authors highlight empirical regularities that tend to correlate with the onset of financial crises. Most of the book deals with the levels of government indebtedness that predate financial crises. The run-up in sovereign debt (particularly "external debt" issued to bondholders who reside outside the country) has often presaged defaults of one form or another by the government. This is seen more frequently in developing economies that tend to be more affected by swings in export prices and international financial conditions.

Yet, while developing nations can fall into the trap of serial default on bond debt, all nations, including developed economies, have at one time or another indulged in another, less severe, form of default: the inflation of the nation's currency. Reinhart and Rogoff rightly spend some time seeking to counter the notion, all too common in conventional discussions of the topic in the media, that currency debasement is a distinctly different creature than debt default. Instead, the authors suggest that inflation is akin to defaulting on a bond or restructuring a debt because the outcome is the same: The government forces the bondholder or currency holder to accept a payment lower in real terms than the original value of the debt. Reinhart and Rogoff call it "default through debasement" and note that if "serial default is the norm for a country passing through the emerging market state of development, the tendency to lapse into periods of high and extremely high inflation is an even more striking common denominator."

The other empirical regularity they encounter as a precursor to financial crises is a run-up in asset prices — particularly housing prices — above a long-term trend. More often than not, the authors argue, borrowing fuels the asset price bubble. The bursting of the bubble then tends to precipitate a banking crisis that drags down lending institutions. In addition, recessions that accompany banking crises tend to be deeper and harder to recover from than other recessions.

The authors close, however, with a chapter that perhaps inadvertently points out the principal shortcoming of the book itself. Once they have firmly established how often leverage and asset price appreciations precede crises, they go one step further to suggest that the regularities may be a basis for a real time "early warning system" for policymakers. So, for instance, since housing prices are at the top of their list of "reliable indicators" of an impending banking crisis, real-time collection of housing price data might help regulators anticipate potential crisis scenarios.

Yet the authors don't weave a robust narrative to suggest how the variables interact. Although excessive leverage, a capital windfall from abroad, and faster-than-usual housing price appreciation do tend to correlate with financial crises, determining which variable might potentially burst the bubble is much harder. And, contrary to the spirit of the book's title, it's plausible that different crises can be precipitated by all three aspects occurring in various sequences.

The authors do acknowledge that the metrics identified by their analysis will not provide "an obvious indication" of an impending crisis. But any early warning system that is built on a theory-free framework is bound to be problematic.

It's also important to acknowledge that the empirical regularities don't occur in a policy vacuum. Institutions matter, and the embedded rules of financial markets and the regulations that govern financial firms and depository institutions play a role in economic outcomes. The case for an early warning system for policymakers is weakened by this lack of analysis — and, in the end, a sober analysis of how regulatory institutions work and the limitations on what government can effectively do might even topple the case for codifying these early warning metrics. Foremost among the concerns may be the notion that any governing body given power to act on threats to systemic stability may actually encourage the type of behavior it was designed to discourage.

Despite such caveats, Reinhart and Rogoff have written a very valuable book, one that can be read profitably by a lay audience, policymakers, and academic economists alike. **RF**