No but this time really is different

Michael Pettis | May 26, 2008

Today is relatively quiet on the China-financial-news front (the SSE Composite was down 36 bps, but not much else happened), so rather than discuss the most recent numbers and events and their possible implications for financial policy, I want to write about something a tad more theoretical. For the past two months there has been a big buzz about a paper by Carmen Reinhart and Kenneth Rogoff (which I will refer to as R/R) called "This Time is Different: A Panoramic View of Eight Centuries of Financial Crises." As the title implies, the authors examine the historical evidence of financial crises over a long time frame in an effort to develop an understanding of the causes and consequences of financial crises.

As someone who has been interested for a long time by the history of international capital flows and financial crises (a big part of my book *The Volatility Machine* was an examination of developing country crises over the past 200 years), it was a dead certainty that I would read the R/R piece, and sure enough I have just finished it. It was a great pleasure to see so many references to some of the classic and obscure books on financial history that I have read so often that I feel almost as if they were old friends.

There is a lot in this paper and of course it would be hard to discuss all of it, but I thought it might be interesting and useful to take four of the points that the authors make about financial crises and put them in the context of China. None of these points are particularly new, and in fact are generally widely known among people who have studied the history of financial crises, but often they seem counterintuitive or surprising to the general observer.

First, most countries in history, especially rapidly growing developing countries, have experienced periodic financial crises and sovereign defaults. Furthermore R/R argue something that is well-known to financial historians: there are regular patterns of periods of global debt crises, with a significant share of the world's countries in crisis or default, followed by periods where the occasional sovereign default is the rare exception. They point out that "the current period can be seen as the typical lull that follows large global financial crises" (pp. 3) and then follow up two pages later with the rather chilling comment: "each lull has invariably been followed by a new wave of defaults."

China, of course, is no exception to this history. Not only has China experienced financial crises throughout its history, sometimes alone but more often as part of an international wave of financial crises, but Chinese governments have defaulted several times on the country's sovereign debt, including on its external debt, during these periods of global crisis. There were a number of external defaults, for example, in the 19th century, beginning I believe in the late 1860s shortly after the issuance of the Qing's first public bond. R/R point out that in the 20th century China has not defaulted since 1949 – as Max Winkler might have knowingly pointed out (see below), this is largely because China had almost no external debt during much of this time and its domestic debt market was barely functioning – but prior to 1949, in 1921 and 1939, it did default. I myself collect old defaulted bonds as a hobby and I have a number of defaulted Chinese government bonds from the 19th and 20th centuries.

For China, like for any developing country that has access to financing, one of the obvious conclusions from the R/R piece is that there will be more financial crises in the future and possibly even sovereign defaults. The interesting question, as far as I can see, is not whether China is likely to experience financial crises, but rather what form they will take and from the point of view of policy what can and should be done now to minimize the economic impact of these future crises. In fact I would argue that the main role of liability management at the sovereign level is not to prevent the kinds of financial adjustments that often come in the form of financial crisis – that is probably impossible, and for the reasons that Hyman Minsky noted in his work on financial crises – but rather to construct the kinds of balance sheets that minimize the cost of these adjustments by minimizing their impact on the real economy.

Second, "countries experiencing sudden large capital inflows are at a high risk of having a debt crisis." (pp. 8) They elaborate: "Crisis-prone countries, particularly serial defaulters, tend to overborrow in good times, leaving them vulnerable during the inevitable downturns. The pervasive view that *this time is different* is precisely why it usually isn't different, and catastrophe usually strikes again." (pp. 33).

The implication, as I see it, is that during periods of large capital inflows countries experience all the heady pleasure of growing economies, rising asset prices, loose money and overly easy access to financing. These periods can lead both to overconfidence – the idea that conditions can suddenly reverse themselves seems improbable at best, i.e. this time really is different – and to inefficient and risky forms of borrowing. After all during the heady boom times the biggest winners are systematically those that take more risk, so, as Hyman Minsky might theorize, during boom times the whole system tends towards greater and greater risk-taking.

Or as the old banking saw would have it, bad loans are made during good times. Of course during the good times it is generally hard to believe that favorable conditions can so abruptly reverse themselves, so the best strategy seems to be

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one that effectively doubles the bet, but as I argue in *The Volatility Machine*, it is precisely those financing structures that magnify the impact of the boom times that make the busts so terrible.

A lot of my blog readers may bridle at my discussing China in the context of "crisis-prone countries", but before I get swamped with outrage, let me suggest that there is at least the possibility of regarding China as a crisis-prone country from a financial point of view. And as long as that possibility exists it would be prudent for businesses and government officials to consider the risks very seriously.

There are at least two reasons I would argue that China can be considered crisis-prone. First, almost every country in history during its stage of rapid development has been crisis-prone, and it is useless simply to assume that China will be an exception – and I note, by the way, that nearly every other country has, at one time or another, considered itself an exception to this rule, to its great subsequent dismay. Rapidly-growing and rapidly-transforming countries have always been, and are likely still to be, prone to crisis. China's economy is volatile, its financial system is rigid and very poor at allocating capital efficiently, and like any country undergoing rapid social and economic transformation, its social, political and institutional structures are unable to change as rapidly as the underlying economic and social circumstances. All these create the conditions for serious imbalances, whose subsequent adjustments often come in the form of financial crises.

Second, and perhaps contrary to consensus opinion, so far China certainly hasn't been an exception. Over the past 200 years before 1949, the period I know best, China has had regular financial crises, as many as other developing countries have had, and the only reason these have not been as famous as some of those of other countries, e.g. Latin American countries, is because they occurred at lower levels of debt or with much smaller financial systems. China's pre-1949 history certainly doesn't suggest anything exceptional.

From 1949 until the mid-1970s China has not really had a financial system as we would understand it, and so it is hard to argue that it has suffered from the same kinds of financial crises as market economies have, although it did suffer numerous economic crises, including, most spectacularly, the 1958-61 Great Leap Forward. Over the past 30 years, however, with the re-establishing of a functioning financial system China has had at least three pretty serious monetary and financial crises. The first, during the period 1985-1987, was a period of high inflation and instability. Because of the very limited information available it is hard for me to get a very precise sense of the causes and consequences of the crisis, but many of my Chinese friends who lived though the period seem adamant that it was a period of very difficult economic adjustment.

Far better known was the second crisis, the 1993-94 inflation and banking crisis, which led, among other things, to the rise of Zhou Rongji and the series of radical and often unpopular reforms he implemented to repair the country's tattered financial and monetary system. Finally, in 1997-98 during the Asian crisis, China also experienced a series of sharp financial adjustments, after which time the country's banking system was massively bankrupt. I don't have the numbers in front of me but I believe the World Bank estimated the cost of the banking cleanup at 55% of China's GDP – making it one of the costliest banking crises of modern times.

To return to R/R's point about sudden large capital inflows, remember that large capital inflows will never occur in countries about which there is a consensus that they are at significant risk of crisis, so please dismiss altogether the argument that China is different and money is entering the country because investors have correctly assessed the risk to be low. Every country experiencing large capital inflows was firmly believed to be "different" – this is almost a necessary pre-condition for large capital inflows into risky, developing countries. The point is that today China is experiencing large capital inflows, and historically, according to R/R, large capital inflows have often preceded financial crises. That proves nothing about China's future, of course, but it should at least create worry among policy-makers.

Third, the widely-held belief that sovereign debt crises are largely external debt crises is incorrect – historically they have been just as likely, or even more likely, to be domestic debt crises. In fact I have been working on a piece that will argue that the next set of sovereign crises is likely to be driven largely by domestic debt, not external debt.

This is a particular important problem in the current environment, and not just for China. One of the consequences of the Asian crisis of 1997 was the determination on the part of many governments, including that of China, that it was necessary to build balance sheets that would protect them from the re-occurrence of similar currency crises – by limiting external debt and accumulating reserves. Unfortunately this meant explicitly or implicitly setting up currency regimes that resulted in the monetization of large capital inflows (as central banks created local currency or local-currency equivalents, like central bank bills, with which to purchase these inflows).

The net effect has been that the fight to protect national balance sheets from currency and external debt mismatches has led to excessively loose monetary policies which converted these external mismatches into over-extended domestic financial systems, with a wholly different but perhaps equally destabilizing set of mismatches. In the case of China, and several other countries, the currency regime has led to explosive lending growth, speculative real estate and stock markets, a large "informal" banking system, and inverted domestic debt structures. It also seems to be leading to a rapid rise in inflation, although there is still a sharp debate about how serious this inflation is likely to be. These can easily create the conditions for the kinds of financial crisis which occurred, for example, in the US during much of its developing stage. The

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US suffered from financial crises nearly every 10-15 years, in some cases extremely damaging crises (the 1790s, the 1830s, the 1870s and the 1930s, for example), but they were never external debt crises, mainly because the US had little external debt.

Fourth, successful countries, i.e. countries that have managed to make the transition from developing to developed economy, have generally had limited experience with sovereign defaults. That might seem obvious at first, but it is not so obvious where the causality runs. As the authors write: "Do high growth rates help avert default, or does averting default beget high growth rates?" (pp.16) At least part of this answer must have to do with the special damage caused by sovereign default. It is worth noting that the United States, one of the most economically successful countries in history, has a very low incidence of sovereign default, but, as I mention above, it does not have a low incidence of system-wide financial crises. On the contrary, the US, especially in the 18th and 19th centuries seemed to have had financial crises fairly regularly (and by some accounts still does), but they rarely if ever involved the federal government debt.

Why? Is it because the US government was particularly prudent and/or careful? I doubt it. I suspect it has a lot more to do partly with the peculiarities of US political life such that for much of its history the central government struggled with the states over centralized power, including over its fiscal role, and partly with the deep distrust Americans had until the middle of the 20th century for banks and for government debt – after all Andrew Jackson won his 1836 campaign largely on opposition to the Bank of the United States, a quasi-central bank that was closed down when its charter was not renewed in 1838. Until recently the US government simply did not have enough debt on which to default – most debt was at the state, municipal, and corporate level, but at the state and corporate level there were more than enough defaults to satisfy any historian.

My own theory is that sovereign debt crises are an especially brutal kind of crisis because when the central government is in default, or perceived to be near default, the country suffers from a whole set of financial distress costs that make it very difficult for the financial system to clear. In those cases every domestic borrower, even healthy ones, suffers from capital flight and disinvestment, and the economy cannot begin again to grow until the sovereign credit has been substantially repaired, unlike the kinds of financial crisis that affected, say, the US, in which there was no or little perceived threat of a sovereign default. In that case after the crisis bottomed out investors were not afraid to snap up cheap assets and restructure troubled companies and, in so doing, they restored economic growth. This does not happen when the central government is in default.

I won't go into it in too much detail (again I discuss this extensively in my book) but one conclusion is that the sovereign credit must be protected at all costs. For that reason governments should push as much borrowing as possible off the central balance sheet, including, most importantly provincial, municipal and project-related borrowing. In the case of China, it should probably cut its links to provincial and municipal borrowing as soon as it can and it should try to push the financing decision as far down as it can. It should also refrain from protecting large borrowers from the consequences of their borrowings, although this may be culturally very difficult for an actively interventionist government to accept.

As good as the R/R paper is there are, inevitably, some things I would have liked to see discussed more. For example there has not been much discussion in the R/R paper about the role of contingent liabilities in sovereign crises. As a very interesting book published last March by the IADB (*Living with Debt*) notes repeatedly, very often the debt that "caused" the financial crisis was not the long-term accumulation of fiscal deficits but rather the very sudden emergence or conversion of contingent liabilities. These contingent liabilities suddenly exploded – for a variety of reasons – and were generally structured in ways that exacerbated both the previous good conditions and the current bad conditions.

The two most common forms of this have been the explosion in the relative value of debt denominated in foreign currency, following a currency crisis, and the explosion in contingent liabilities through a collapsing banking system. In my opinion these have been two of the most common causes of "unexpected" financial crisis, and it is worth considering any country's, including China's, risk of either event occurrence.

China, of course, is in little risk of seeing the former happen. With less than $400 billion of external debt and close to $2 trillion of foreign currency reserves, China is at no risk of a recurrence of the 1997 Asian crisis. The real threat for China is in the second set of contingent risks, that of an explosion of liabilities arising though the banking system. I am obviously not the first person to point this out – China's massive loan growth and its stubbornly high NPL ratio in spite of what can only be described as a dream time for bankers suggests at the least that in a sharp downturn there is a very real risk of a surge in NPLs.

As a corollary to the third point I mention above R/R also argue, correctly, I think, that default probabilities depend not so much on the share of external debt to total debt but "much more on the overall level of debt." (pp. 12). This is true – one of my favorite books cited in their paper, Max Winkler's 1933 *Foreign Bonds: an Autopsy*, points out that the only certain thing that can assure us that a country is unlikely to default on its debt is that it have no debt. There is no other factor that is highly correlated with a low incidence of default.

But the overall level of debt is not nearly enough to go on. There are at least two very important additional issues to consider. First, highly diversified, low-volatility economies can support much larger debt burdens than undiversified volatile economies.

This is particularly true of commodity exporting nations. R/R note that “favorable trends in countries' terms of trade (meaning typically, high prices for primary commodities) typically lead to a ramp of borrowing that collapses into default when prices drop.” (pp. 31) Although this comment is not directly applicable to China since China does not rely on commodity exports for its growth – however, as I have pointed out several times to me friends in Brazil, it is a very worrying comment for countries like Brazil – it does suggest that positive shocks in the current account are often accompanied by excess balance-sheet risk-taking, and when these positive shocks turn negative, as they always eventually do, there is a high risk of financial crisis.

Second, certain types of debt are volatility-enhancing while others are not, and some even volatility-dissipating. The former include, for example, foreign currency debt, whose costs decline in real terms when the borrower's economy is flourishing (as the real value of the local currency rises) but can shoot up sharply at exactly the wrong time when economic conditions turn down. The latter might include long-term, fixed-rate local currency debt, whose servicing costs decline during an inflationary shock. Because it can significantly increase volatility, it doesn't take much of the former type of debt to create a high risk of default, whereas the latter is much less risky. I discuss this in great length in Volatility Machine and it would take too much space to discuss it even briefly here, so I will simply note that the structure of debt is at least as important as the amount of debt in determining the risk of a debt crisis.

Comments

Nice piece. Thank you.
Written by Gamma on 2008-05-26 16:02:55

I know this is the "Asia" Economonitor, but care to bring this discussion around to the US. Thoughts on a crash in the greenback and an external debt default?
Written by Gamma on 2008-05-26 16:04:45

Surprisingly enough this has become an extremely unfashionable thing to say, but the probability of a US government external debt default is almost zero. First, and most obviously, the US government has no external debt. It has only domestic debt and it would make no sense to default when the debt can be easily monetized. Secondly, US debt, whether total government debt or government debt held by foreigners, is well within US debt capacity. Comparing US debt ratios with those of defaulted LDCs is as useless as comparing the debt ratio of a Japanese automobile manufacturer with that of an internet start-up. Third, the structure of US debt doesn't contain the possibility of explosive growth in contingent liabilities, which has been at the root of most LDC meltdowns.

I know a lot of fundamentalists will scream that a depreciating dollar or higher than expected inflation is the same as default, but this is nonsense. Aside from the fact that these forms of "default" have very little in the way of an associated financial distress impact -- which is the main cost associated with high default probabilities -- this argument would only make sense if foreign lenders forgave the US government a part of its debt every time the dollar appreciated or dometic lenders forgave US government debt every time inflation came in below expectations. Default, which only has downside, is not the same as market risk, which has upside and downside.
Written by M. Pettis on 2008-05-27 07:43:01

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