



Book This Time Is Different

Eight Centuries of Financial Folly

Carmen M. Reinhart and Kenneth S. Rogoff
Princeton UP, 2009
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Recommendation

Every so often, experts sucker people into bidding up the prices of stocks or real estate because they announce that the economy has fundamentally changed. As the aftermath of the real estate bubble illustrates, the basics of economics don’t really change, no matter what fantasies people come to believe. Economics professors Carmen M. Reinhart and Kenneth S. Rogoff present a thorough historical and statistical tour of financial hubris through the centuries, a postmortem that will make you wonder how anyone ever believed “this time is different.” The staid tone, formulas, charts and somewhat confusing organization make this fascinating history challenging to absorb. Yet, the content, which sweeps ambitiously and carefully across centuries and countries, rewards the persistent reader with many insights and gems, like the nation-by-nation appendix of fiscal history low points. *BooksInShort* recommends this analytical overview to history buffs, investors, managers and policy makers who seek perspective on “financial folly.”

Take-Aways

- The central bankers, policy makers and investors involved in every financial bubble are utterly convinced that, in terms of economic events, “this time is different.”
- Otherwise-savvy people ignore the telltale signs of a bubble when they are in the grasp of “this-time-is-different syndrome.”
- Even brilliant thinkers like former Federal Reserve Chairman Alan Greenspan fall victim to this syndrome.
- Bankers and economists in the ’20s predicted that wars would not recur and the future would be stable.
- From 2003 to 2007, conventional wisdom said central bankers’ expertise and Wall Street innovations justified soaring home prices and rising household debt.
- In fact, rising home prices and financial innovation are strong indicators of a bubble.
- Currency debasement was common for centuries. In the past 100 years, inflation has replaced debasement.
- Sovereign defaults are a normal part of global capitalism, although they ebb and flow.
- Financial crises have occurred regularly over the past two centuries.
- To avoid future bubbles, bankers and economists should use an early-warning system and a stricter regulatory scheme.

Summary

When You Hear “This Time Is Different,” Don’t Walk, Run

Every few decades, the economy’s major players develop bulletproof confidence in the efficiency of markets and the health of the economy. Known as “this-time-is-different syndrome,” this unrealistic optimism afflicted bankers, investors and policy makers before the 1930s Great Depression, the 1980s Third World debt crisis, the

1990s Asian and Latin American meltdowns, and the major 2008-2009 global downturn. Conditions differed, but the same mindset – a dangerous mix of hubris, euphoria and amnesia – led to each of these collapses.

“More money has been lost because of four words than at the point of a gun. Those words are ‘this time is different’.”

In each case, decision makers adopted beliefs that defied economic history. In the 1920s, conventional wisdom held that large-scale wars were a thing of the past, and that political stability and economic growth would replace the volatility of the years preceding World War I. Events quickly proved the optimists wrong. By the 1980s, economists were convinced that high commodity prices, low interest rates and reinvested oil profits would prop up the economy forever. Before the 2008 recession, popular thinking said globalization, better technology and sophisticated monetary policy would prevent an economic collapse. Every time, fiscal leaders thought they had learned history’s lessons and that this time the economy was different.

“No matter how different the latest financial frenzy or crisis always appears, there are usually remarkable similarities with past experience from other countries and from history.”

The most recent financial meltdown centered on the U.S. housing market, which regulators allowed to inflate despite a series of cautionary red lights. In 2005 and 2006, U.S. home price increases far outpaced growth in gross domestic product (GDP). In retrospect, home prices were clearly in a speculative bubble. Yet, even as inflation grew, former Federal Reserve Chairman Alan Greenspan argued that the economic situation was different. He theorized that financial breakthroughs like widespread securitization made real estate more liquid and supported rising prices. He waved off concerns about the massive U.S. current account deficit. While cash from China, Japan, Germany and elsewhere flooded into the U.S. as a safe haven, American consumers borrowed like never before.

“This-time-is-different syndrome...is rooted in the firmly held belief that financial crises are things that happen to other people in other countries at other times.”

Other influential leaders also downplayed the current account deficit. Greenspan’s successor, Ben Bernanke, and Treasury Secretary Paul O’Neill argued that high savings rates abroad and low savings rates at home were part of the natural order. But, not everyone was as sanguine. Nobelist Paul Krugman predicted an abrupt moment when the foolhardiness and “unsustainability” of America’s profligate international borrowing would become widely apparent. The trends gave reason for pause. The ratio of household debt to GDP hit 80% in 1993, rose to 120% in 2003 and rocketed to 130% in 2006. In this easy-money setting, lenders threw mortgages at some borrowers who couldn’t afford homes. Subprime borrowers were trapped when their loans’ initial low rates soon soared to unaffordable heights. The cool-headed analysis of a few high-profile contrarians like Krugman couldn’t stop the party. This-time-is-different syndrome ran from 2005 to 2007.

“A highly leveraged economy can unwittingly be sitting with its back at the edge of a financial cliff for many years before chance and circumstance provoke a crisis of confidence that pushes it off.”

It manifested in several beguiling arguments, which seem foolish now:

- The U.S. has the world’s largest, most sophisticated financial markets, so it can handle massive inflows of capital.
- Developing economies will keep sending money to the U.S., which is a safe haven.
- Globalization sets the stage for higher leverage and larger debt loads.
- The U.S. has the best monetary policy institutions and policy makers.
- Innovative financial instruments unleash a solid, new demand for housing by allowing previously untapped borrowers to take out mortgages.

“Innovations such as securitization allowed U.S. consumers to turn their previously illiquid housing assets into ATM machines, which represented a reduction in precautionary saving.”

In truth, the warning signals were coming through loud and clear. To see just how near the U.S. economy came to an implosion, look at the 20th century’s “Big Five” crashes in developed economies: Spain in 1977, Norway in 1987, Finland and Sweden in 1991, and Japan in 1992.

These meltdowns shared some common themes:

- **Capital inflows predict financial crises** – “Capital flow bonanzas,” as in the U.S. in 2005, characteristically preceded the Big Five crashes and, later, the 2008 subprime meltdown.
- **A wave of financial innovation often leads to crisis** – The creation of new mortgage-related mechanisms intended to reduce risk boosted the 2005-2006 housing boom.
- **A housing boom often portends a financial crash** – Prices can take years to recover. After the Spanish, Norwegian, Finnish and Swedish crashes, home prices took four to six years to hit bottom. In Japan, real estate prices remained low 17 years after the boom.
- **Financial liberalization often precedes a crisis** – Throughout the 1980s and 1990s, financial crises almost inevitably followed spates of loosened financial regulation.

“The U.S. conceit that its financial and regulatory system could withstand massive capital inflows on a sustained basis...arguably laid the foundations for the global financial crisis of the 2000s.”

Strikingly, large, sophisticated financial markets are as prone to crashes as smaller, less-advanced markets. No real differences in length or severity distinguish crashes in less-developed nations (Indonesia, the Philippines, Argentina, Colombia) from those in developed economies (the U.S., the U.K., Japan). This should alarm those who claim that conditions are different in advanced markets.

A Brief History of Economic Crises

The past 180 years offer a smorgasbord of financial crises to study. They include:

- **The crisis of 1825-1826** – This global contagion affected Europe and Latin America. Greece and Portugal defaulted.
- **The crisis of 1890-1891** – Argentina defaulted and suffered bank runs. Baring Brothers faced failure. The U.K. and the U.S. were among the nations affected by this crisis.
- **The panic of 1907** – Bank runs hit Europe, North America, Latin America and Asia.
- **The Great Depression** – Commodity prices cratered. Interest rates and inflation soared during this global meltdown.
- **The downturn of 1981-1982** – Commodity prices plunged. U.S. interest rates reached the highest levels since the Depression. This crisis hit most emerging markets.
- **The debt crisis of the 1980s** – Widespread sovereign defaults, hyperinflation and currency devaluations primarily hurt developing African and Latin American nations.
- **The Japanese crisis of 1991-1992** – Real estate and stock market bubbles burst in Japan and the Nordic nations, also affecting other European economies. Japanese real estate prices still hadn't returned to prebubble levels nearly two decades later.
- **The “tequila crisis” of 1994-1995** – The Mexican currency collapse ensnared emerging economies in Latin America, Europe and Africa.
- **The Asian contagion of 1997-1998** – This crisis began in Southeast Asia and spread to Russia, the Ukraine, Colombia and Brazil.
- **The global contraction of 2008** – The bursting of the U.S. subprime real estate bubble triggered stock market crashes, currency collapses and banking crises.

“Severe financial crises rarely occur in isolation.”

Debt defaults are one common result of financial crises, but in the years leading up to 2008, debt defaults were nonexistent. This probably played into this-time-is-different thinking. After all, if nations were servicing their debts, why not believe that the economic situation was really different. Alas, for more than a century, credit defaults have moved in rolling waves and lulls, and a short period without sovereign defaults is hardly reason to believe that the world has changed. The ebb and flow of credit defaults also fooled onlookers just before a flood of defaults hit in the 1980s. That time, Citibank Chairman Walter Wriston pronounced, “Countries don't go bust.” Technically, nations don't run out of money and close as businesses do. But nations often fail to pay their debts.

“Only the two decades before World War I – the halcyon days of the gold standard – exhibited tranquility anywhere close to that of 2003-2008.”

Understanding why a nation might default is easy, given Romania's experience in the 1980s. Dictator Nikolai Ceaușescu decided to deprive his subjects of electricity and heat so the nation could repay \$9 billion debt. Faced with such crushing burdens, most countries simply renegotiate their payment schedules or default. National defaults occurred in waves in the 19th and 20th centuries, from the Napoleonic Wars to the 1980s and 1990s, when emerging markets imploded. A break in the pace of defaults, from 2003 through 2008 fed this-time-is-different thinking, but defaults will probably accelerate in the aftermath of the crisis.

“Henry VIII of England should be almost as famous for clipping his kingdom's coins as he was for chopping off the heads of its queens.”

Defaults are common for a variety of reasons, including:

- **Lenders often cannot enforce debt contracts across national frontiers** – If a U.S. bank lends money to Argentina and Argentina subsequently defaults, the lender has little recourse.
- **Shifting political winds** – Uncertainty surrounding the 2008 presidential election deepened the U.S. subprime crisis. Fears about a shift from a centrist to a populist administration exacerbated Brazil's 2002 financial crisis.
- **Financial contagion** – A slowdown in financial centers hits emerging markets that rely on exports and commodities. First World credit crunches freeze loans to the Third World.

“Fading memories...do not seem to improve over time, so the policy lessons on how to ‘avoid’ the next blowup are at best limited.”

While Latin America is synonymous with sovereign defaults, it is not the only guilty region. True, Argentina, Venezuela, Ecuador and Costa Rica have been serial defaulters, but Indonesia, South Africa, Zimbabwe and Nigeria also have defaulted. Some former serial defaulters are now more reliable. Chile and Brazil, for instance, last defaulted in 1983. The more conservative policies they have used since then have kept them out of default.

Currency Debasement and Inflation

While little hyperinflation occurred in the 2008-2009 crisis, price increases and currency devaluations mark financial crises throughout history. As long ago as the fourth century B.C., Greek royal Dionysius ran a currency scam in which he collected all the coins in circulation (subjects complied under threat of death) and stamped every one-drachma coin with a two-drachma label. By thus doubling the money supply, Dionysius repaid his debts. In the 1540s, Henry VIII of England debased the currency by reducing the silver and gold content in the coins in circulation. Subsequently, rulers in Sweden, Turkey, Russia, Britain (again) and other kingdoms also devalued their currencies by reducing the amount of precious metal in each coin.

“We hope that the weight of evidence in this book will give future policy makers and investors a bit more pause before they declare, ‘This time is different.’ It almost never is.”

As modern economies moved from metal-based coins to paper money, the effects of currency debasement became more pronounced. From 1500 to 1799, the U.S. had the world's highest annual inflation rate, with inflation nearing 200% in 1779. France saw a 121.3% inflation rate in 1622 while Italian inflation reached 173% in 1527. The advent of paper money made ancient inflation look tame. Zimbabwe hit 66,000% inflation in 2007, while Poland suffered an annual inflation rate of 51,699% in 1923. Inflation rates in Germany, Greece and Hungary in the mid-20th century ran so high that expressing them requires scientific notation (9.63E + 26 denotes Hungary's annual inflation in 1946, meaning that the decimal point lies 26 spaces to the right). Just as war grew more destructive with the advance of technology, financial crises grew more wrenching in the era of incessant innovation.

Avoiding the Next Crisis

By definition, this-time-is-different thinking is so infectious that it saps the will of those who might dampen the party. Even so, the following two steps could help avert

repeat performances:

1. **An early-warning system** – Because financial crises follow established patterns, the world's policy makers and investors need a warning system that alerts them to danger signs. For instance, an unusual rise in housing prices reliably predicts a banking crisis. While such signals aren't precise enough to predict a crisis's exact peak, they can give a general indicator. Of course, this-time-is-different thinking means many decision makers ignore clear signs of trouble.
2. **A regulatory scheme with teeth** – When this-time-is-different syndrome takes hold, capital crosses borders in search of the lightest regulations. And regulators turn a blind eye to rules regarding leverage. To avoid future crises, regulators must take an international approach to regulation and enforce the rules – even when everyone believes that the situation truly is different this time.

About the Authors

Carmen M. Reinhart of the University of Maryland and **Kenneth S. Rogoff** of Harvard University are economics professors. Reinhart, who lectures at the International Monetary Fund and the World Bank, is the co-editor of *The First Global Financial Crisis of the 21st Century*. Rogoff, co-author of *Foundations of International Macroeconomics*, is a commentator for *The Wall Street Journal*, National Public Radio and *The Financial Times*. //
