The Roots of the Crisis

Why policy makers should have seen it coming. Plus, the role of the yen "carry trade."

This Time Is Different: Eight Centuries Of Financial Folly
By Carmen M. Reinhart and Kenneth S. Rogoff, Princeton University Press, 485 pages, $35

Reviewed by Glenn C. Altschuler

REFERRING TO THE CHARACTER IN THE Road Runner cartoons who runs off a cliff and fails to realize there's nothing beneath him until he starts to fall, Paul Krugman predicted in 2007 that Americans would soon have a "Wile E. Coyote moment"—and then pay the price for massive current-account deficits.

He was branded an alarmist. Until it was too late, a long list of leading academicians, investors and policy makers, including then-Fed Chairman Alan Greenspan, proclaimed that the U.S. need not worry about huge capital inflows. And that securitization and option prices had done much to tame the business cycle by spreading (and thereby limiting) risk.

In This Time Is Different, Carmen Reinhart, a professor of economics at the University of Maryland, and Kenneth Rogoff, a professor of public policy and economics at Harvard, demonstrate that these worthies could have—and should have—known better. A tour de force of quantitative analysis covering financial crises affecting 66 countries over the past 800 years, the book identifies pre-crisis patterns that recur with eerie consistency. This Time Is Different is a must-read for anyone on the lookout for canaries in coal mines.

Reinhart and Rogoff make a compelling case that their "signals approach," grounded in a historical perspective, can deliver valuable information about whether an economy is "showing one or more of the classic symptoms that emerge before a severe financial illness develops."

Domestic debt, they argue, is an important and often ignored barometer of economic health. It goes a long way toward explaining why so many countries have defaulted at seemingly low external-debt thresholds. Even in mature economies, including that of the mighty United States, borrowing binges invariably unwind, often quite precipitously, with sharp declines in asset prices and consumption, and high unemployment.

Rapidly rising housing prices should have set off alarm bells, as well. Especially when the cumulative real-price increase in the United States over a decade was more than three times the 27% gain for the preceding 100 or so years—and the total value of mortgages reached 90% of GDP.

Housing prices, the authors indicate, are a remarkably accurate predictor of banking crises. And banking crises often follow periods of financial liberalization or deregulation. "For all its this-time-is-different hubris," the authors write, "the United States proved no exception." In 2004, to cite just one example, the Securities and Exchange Commission, without angst, allowed investment banks to triple their leverage ratios.

International institutions, the authors emphasize, might help avert crises by promoting greater transparency in reporting data. Although it's better than most, the United States "runs an extraordinarily opaque accounting system."

In the past two years, the federal government (including the Federal Reserve) added huge off-balance-sheet guarantees and trillions of dollars of difficult-to-price assets to its books—and refused to disclose details about these assets to the U.S. Congress. The authors have a suggestion: If, in advance of the next crisis, transparency rules were written by an outside agency like the International Monetary Fund, any failure to follow them might generate early-warning signals to lenders that would, ultimately, enforce better behavior.

As capital continues to flow across borders, Reinhart and Rogoff believe that some international financial regulation is necessary. They understand, of course, that it won't be enacted anytime soon. Or provide a magic bullet. Or prevent someone in authority, 20 years from now, from saying, "This time is different."

At the moment, alas, their data aren't encouraging. With unemployment moderating very slowly and massive deficits impeding further action by the federal government, the aftermath of the first global financial crisis of the 21st century, like many of its predecessors, promises to be nasty, brutish, and long.

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