This Time Is Different: Eight Centuries of Financial Folly by Carmen M. Reinhart and Kenneth S. Rogoff

Review by David Orrell

An acquaintance of mine—I'll call him Peter—who works in the construction industry has a recurring problem with his finances. Peter always made reasonable money, but his taste for the good life meant he spent more than he had, covering the deficit with one of his many credit cards. There was the occasional crisis, but he would make it up somehow.

In the late 1990s he started managing projects, which paid better. His lifestyle picked up even more – he bought an apartment, a new car, and enjoyed a constant sequence of holidays in exotic locations. He remortgaged and bought a piece of land with a friend, where he built a house as an investment. Then the market crashed, and the house went unsold. Now the credit card companies are taking him to court.

I always thought that Peter had a special issue with money. But after reading *This Time Is Different: Eight Centuries of Financial Folly*, by Carmen M. Reinhart and Kenneth S. Rogoff, I realise that, actually, the entire world economy organises its affairs along similar principles, with massive build-ups of credit, adventures in exotic emerging markets, real-estate crashes, and struggles with debt – just on a much larger scale.

Investors with the kind of exposure to the markets over the last few years that Peter has had may feel that they've personally lived through eight centuries of financial folly, but economics professors Reinhart and Rogoff show that our recent experience is nothing new. In many ways, the book reads like a credit report for the world economy, with a detailed analysis of past performance on loans. The conclusion: human beings shouldn't be trusted with so much as a bar tab. According to the authors, a tendency towards crises seems to be part of our financial DNA: "serial default on external debt – that is, repeated sovereign default – is the norm throughout every region in the world, including Asia and Europe."

Without wanting to single anyone out, Greece it seems has "spent more than half the years since 1800 in default." The country has a poor role model in Dionysius, who in the fourth century BC fixed his financial problems by recalling, at the pain of death, all one-drachma coins, restamping them as two-drachma coins, and using them to pay his creditors. Generating inflation has remained an internationally popular debt-reduction technique to the present day, although governments now try to be somewhat more subtle about it.

While countries appear able to graduate from recurrent sovereign debt crises, even the most developed economies remain prone to banking crises. Such events appear to follow remarkably similar patterns in rich and poor countries. Their greatest cost is not the ensuing bailout, but the ballooning government debt, which on average rises in real terms by 86 percent over the three years following a bailout.

According to Reinhart and Rogoff, the precursors to banking crises include:

- massive current account and trade-balance deficits
- asset price inflation, especially in real estate
- rising household leverage and slowing output
- financial liberalization and innovation: "Inadequate regulation and lack of supervision at the time of liberalization may play a key role in explaining why deregulation and banking crises are so closely entwined."

Since the U.S. and other countries were all exhibiting typical precrisis behavior before the sub-prime debacle, many readers will ask with the authors, "Why did so many people fail to see the financial crisis of 2007 coming?" Part of the problem appears to be in the models used to assess economic risk: "in analyzing extreme shocks ... standard macroeconomic models calibrated to statistically 'normal' growth periods may be of little use." But the deeper issue, according to the authors, is the "this-time-is-different" syndrome. Leaders and institutions from the Federal Reserve to the IMF bought into the story that recent financial innovations such as debt collateralisation had made the world a safer place.

Potential solutions include international institutions to enforce financial regulations and transparency on public and private levels of debt as well as real-estate prices, and also serve as a counterweight to domestic political pressure.

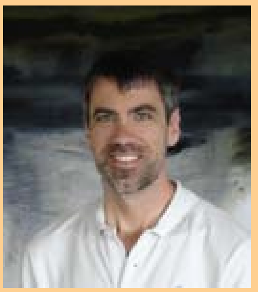
The greatest strength of this book lies in its data, which should prove a valuable resource for financial forecasters. Featuring empirical analysis of 66 countries over nearly eight centuries, the book's stated aim is to be "expansive, systematic, and quantitative." I could verify the truth of this after reading just the first 16 pages: the Table of Contents, the List of Figures, and the List of Boxes. The data include extensive information on domestic public debt – the unearthing of which is described as "an exercise in archaeology" – and real-estate prices, which play a key role both in the lead-up and the aftermath of crises (on average they suffer a decrease of about 35 percent over 4-6 years).

"Why did so many people fail to see the financial crisis of 2007 coming?" Part of the problem appears to be in the models used to assess economic risk. . . But the deeper issue, according to the authors, is the "this-time-is-different" syndrome.

While the data analysis is extensive, it is mostly in the form of tables and time series and does not exploit techniques such as network diagrams that can help visualise the network connectivity that leads to contagion. The book also avoids theory, and there is no mention, for example, of the agent-based models that are now being used to simulate stock market crashes and other crises.

These points aside, the book will be essential reading for anyone who wants to put the recent crisis into some historical perspective – and get some ideas on how to prevent, or at least delay, the next one.

This Time Is Different: Eight Centuries of Financial Folly by Carmen M. Reinhart and Kenneth S. Rogoff, Princeton University Press, ISBN: 978-0691142166, hardcover, 496 pages, published September 2009, US $35.00



David Orrell is author of *The Future of Everything: The Science of Prediction* (2007) and Head of Modeling and Simulation at the systems biology company Physiomics. His latest book is *Economyths: Ten Ways Economics Gets it Wrong.*

david@postpythagorean.com