The Second Great Contraction

The exact timing of the financial crisis may have been unpredictable, but the trajectory of subsequent events has been entirely average and typical, says Kenneth Rogoff

BY JONATHAN BARNES

THREE YEARS AFTER THE GLOBAL FINANCIAL CRISIS, events are seeming eerily familiar to Kenneth Rogoff, co-author with Carmen Reinhart of the 2009 book *This Time Is Different: Eight Centuries of Financial Folly*. Historically, financial crises and their economic effects have tended to follow a similar pattern, and this one is no different, closely tracking the average for financial crises since 1945. In an interview with *CFA Magazine*, Rogoff, the Thomas D. Cabot Professor of Public Policy and professor of economics at Harvard University, explains his views on the predictability of crises and their aftermath, the likely time frame for recovery, why the current crisis might more accurately be called "the Second Great Contraction," the link between debt burdens and growth, and the possible return of financial repression.

Has this financial crisis been predictable?

There are two sides to a crisis: the timing of when it unfolds and what happens afterward. Predicting the timing is nearly impossible. Some countries are more vulnerable than others, and some bubbles are eventually going to burst. But to predict the timing—even within a couple years of a crisis—is really impossible in theory and in practice.

The exact timing of the crisis depends on confidence, which in turn depends on human emotion. Also, as Reinhart and I show, there is often a lot of hidden debt that comes jumping out of the woodwork when the crisis unfolds. This can include debt the government was hiding in its books and/or debt that is implicitly guaranteed. So, in terms of when a crisis begins, one can perhaps talk about a window of 5–10 years, but it is very difficult to be exact.

Now, *after* the crisis, there is a more predictable pattern. The broad parameters of what happens in the aftermath of a crisis (in terms of macroeconomic variables) are surprisingly consistent across time, place, historical circumstance, legal institutions, and political systems. It is absolutely one of the things that fascinated us in researching the book. We never imagined that there would be such quantitative similarities.

By analogy, it's extremely difficult to call the timing of a heart attack. Even if a really good cardiologist finds you have a lot of risk factors, you might go 20 or 30 more years without an issue. On the other hand, even if you exhibit no risk factors, it is still possible you might have a major heart attack a week later. But once you've had the heart attack, how it unfolds and how you recover has a narrower range of trajectories.

What about the crisis surprised you most?

The single most surprising thing is how this crisis has been tracking the average of the post-war financial crises Reinhart and I examined in our January 2009 paper ("The Aftermath of Financial Crises"), work that we present in chapters 10 and 14 of our book. Would we have guessed in January 2009 that the U.S. financial crisis would so closely track our quantitative benchmarks on unemployment, housing output, equity prices, and debt run-ups by government? The qualitative similarities are no surprise—we found them across crises. But the quantitative results

are remarkable. The U.S. crisis is so average. We are dazed watching it unfold. Even the sovereign debt crises unfolding today in Europe are part of a very consistent pattern. As we strongly emphasize in the book and related papers, sovereign debt crises tend to occur a few years after an initial financial crisis.

Are there likely outcomes we can expect?

The good news is that, so far, they have all ended. But the time frame for recovery after a financial crisis is typically more in the range of 6–10 years, compared with the time frame for a recovery from a normal recession, which is typically a year or two. It has become very clear that we are not going to have any kind of super-fast post-recession recovery that, again and again, forecasters seem to be calling for.

Can anything be done to hasten the recovery?

There is an element to which the crisis just has to run its course. Perhaps the biggest issue is how fast the country can restructure debt and its financial system. The bad news for the United States is that we did everything possible to preserve the status quo. We didn't directly tackle mortgage debt in any aggressive way. We did everything possible to kick the can down the road. We did everything possible to preserve the existing financial system. In this respect, we have paralleled the Japanese approach, a point my co-author Carmen Reinhart has stressed from the outset. There is a risk of a longer, slower recovery because of this strategy.

What could have been done better?

You can look at examples like Canada and Sweden in the early 1990s where recovery was faster, but these crises were milder in many ways. The credit bubble was less. These economies had their crises occur in isolation and had giant depreciations of their exchange rate, which gave them an export boost. Importantly, both Canada and Sweden started with huge, overweening governments and enjoyed big efficiency gains by shrinking those governments. I hesitate to say how much faster we could have gotten out of the present situation, and there were risks in any direction we moved. But there are things one might have done differently.

I certainly would have had the U.S. government take over more equity in the financial firms that it was helping. I also think it could have been more aggressive in restructuring senior bank debt, which was considered a third rail. At least there should have been much greater conditionality on the bank bailouts. At every turn I would have liked to see the Fed have a more inflationary policy than it did—in order to accelerate deleveraging.

What's your view on the U.S. debt-ceiling deal of early August?

The silver lining in the debt deal is that Washington finally began to get serious on the long-term government debt trajectory. Unfortunately, that progress was poisoned by the use of the debt ceiling as a blunt weapon for forcing concessions. I think it is an awful way to do business. Responsible countries separate the debt-ceiling issue from fiscal decisions. The trouble is—and I don't need to explain this to your readers—we had already spent the money. We were debating lifting the debt ceiling, but the government had already locked in many commitments it couldn't really back out of. To not raise the debt ceiling was never really an option.

Do you see a link between debt burdens and growth?

Reinhart and I distinguish between public debt (owed by the government) and external debt (owed by consolidated public and private sector to foreigners). Our results on debt and growth pertain to public debt for advanced countries, where outright default is not the main issue. For advanced countries, we find that public debt levels over approximately 90 percent of GDP are associated with slower growth. Below 90 percent, the link is much weaker, though subsequent IMF (International Monetary Fund) studies suggest that more moderate levels of debt (e.g., in the 60–90 percent range) can also impact growth. Currently, the U.S. is hovering around the 100-percent-of-GDP threshold. It is important to stress that our work was the first paper on this topic to use cross-country long-dated historical time series on public debt, the development of which was one of the major academic contributions of our book. Now that our dataset is out, there will hopefully be a great deal of further work casting more light on the topic.

Can you describe the crisis index you've developed?

Reinhart and I wanted an index that captures the global impact of a crisis. We include banking crises, sovereign debt crises, inflation crises, exchange rate crises, and (in some versions) stock price indices (the BCDI index is made up of a weighted "crisis score" for each country in terms of banking, currency, default, and inflation). Looking at the current crisis, it is really the first one since the Great Depression that registers as a global financial crisis, which is why Reinhart and I call it the Second Great Contraction.

Does the BCDI index have predictive power?

No, it's only an index of the severity of the crisis.

How would an "early crisis warning system" work?

There is a whole literature on trying to predict crises, but it is very limited. The problem is that to really be quantitative, you have to have actual numbers. If you are trying to predict a crisis a year from now, you are not going to get very far because of the short datasets. As I explained earlier, the precise timing of a crisis is difficult to call. Even a severely crisis-prone country can go for an extended period before the ceiling caves in.

Subject to those huge qualifications, large credit-fueled appreciation in housing prices is one of the better

markers. Again, that is an area where we were able to make progress by developing a cross-country historical index on the real housing prices, allowing one to look at the behavior of housing around a crisis. Curiously, rating agencies have fairly little predictive power, controlling for other variables. They tend to be lagging indicators. When a rating agency downgrades a country, it typically means that things went wrong a while ago.

Where do you see the "this time is different" syndrome now?

The dramatic "This Time Is Different" was the policymakers going around beating their chests that they had done things better, wiser, and smarter than their predecessors. Look at the September 2009 G20 communiqué which boasted "it worked." The general forecast among the policymakers was that the recovery would be relatively rapid, and they seem to have convinced many Wall Street forecasters as well. In the event, hyperaggressive policy has kept us afloat, but the slow halting recovery has still been a fairly typical one.

Could greater transparency help avoid a crisis?

Of course, transparency would make a difference. It would make it more difficult for countries to dig as deep a ditch. Reinhart and I find that after a deep financial crisis, debt comes jumping out of the woodwork because there is all of this hidden debt. Again, one of the reasons that it is hard to call the timing of a crisis is the data are not easily available.

It is ironic that post-crisis government investigations are crucifying the banks for their accounting sins, which of course there were. But banks have nothing on governments. The most remarkable thing is how much difficulty Carmen and I had getting long-dated government debt data that would allow one to calibrate risks. Even the IMF and World Bank did not publish anything before our book. For many countries, getting debt data is like getting the nuclear launch codes.

In addition to transparency, you also need somebody to process the data and serve as a watchdog agency for financial markets and for the public. One idea that is growing in popularity is the development of independent fiscal councils. Sweden has one. The United Kingdom has a nascent one, which essentially provides independent experts who give assessments of the fiscal policy based on their own independent forecasts.

We do have the Congressional Budget Office (CBO) in the United States. The CBO has a well-deserved reputation for its technical excellence, but it does operate under one fundamental constraint. It is forced to assume that existing laws will be put into place exactly as specified. A true fiscal council needs to be able to make its own judgments. The IMF can play an important role, but it needs to be protected from political pressures.

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What is financial repression? Why is it important?

Carmen and I discuss financial repression in our book, but she has really developed the idea extensively in some of her own recent work. In a developing country like India, there are all kinds of restrictions on what people can do with their money. China famously is very restrictive. The typical Chinese peasants have little alternative but to put their money in a state-run bank, which pays them a pittance in interest—even though the free market rate is much higher. This is what financial repression is. It is a form of hidden taxation.

If a country has financial repression, the government can really stick it to debtholders with inflation, for example, because they have no easy way to escape.

This occurs mainly in developing or emerging markets?

Today, it is mainly in developing countries and emerging markets. Carmen has speculated that it may come back in a big way to the rich countries. I can only say that she is often right in her predictions.

Bringing back financial repression won't be easy, but it can come in through the back door of financial regulations forcing banks, pension funds, and insurance companies to hold government debt at off-market prices. We are seeing some of this in Europe. Ask the Irish, Greek, or Portuguese pension funds what has happened to them lately.

Are the Basel Accords a form of this?

They are. The Basel Accords are basically going to force a higher holding of government debt, but it is not on a scale yet that we saw during the period of extreme financial repression after World War II.

What's your outlook on sovereign defaults in Europe?

It is very hard to guess because so much depends on political choices; this is not a pure economics problem. Perhaps the most likely outcome is that we see defaults in Greece, Portugal, and Ireland, but then Germany will finally be forced to draw a line at Spain and Italy, however painful that may be politically. In that event, the remaining countries in the eurozone will need to enter a much closer monetary and fiscal union.

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