Carmen Reinhart on Lessons from Past Financial Crises

By Susan B. Weiner, CFA
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Digging ourselves out of the current financial crisis will likely take many years, according to a study of similar historical crises around the world.

In an interview with *Advisor* Perspectives, Carmen M. Reinhart, professor of economics at the School of Public Policy and the Department of Economics at the University of Maryland, who coauthored "The Aftermath of Financial Crises" with Harvard economist Kenneth S. Rogoff, says this crisis won't be any different. [Ed. Note: We've discussed her earlier research in "Carmen Reinhart: Putting the Sub-Prime Crisis in Perspective and the Risks that Remain**"** and **"**Will the U.S. Sub-Prime Crisis Be as Bad as History Suggests?**"**]

According to the Reinhart-Rogoff paper, severe financial crises around the world, including all of the crises since World War II and the crises in Norway in 1899 in the U.S. in 1929, typically share several characteristics:

- "Asset market collapses are deep and prolonged. Real housing price declines average 35 percent stretched out over six years, while equity price collapses average 55 percent over a downturn of about three and a half years."

- "The aftermath of banking crises is associated with profound declines in output and employment. The unemployment rate rises an average of 7 percentage points over the down phase of the cycle, which lasts on average over four years. Output falls (from peak to trough) an average of over 9 percent, although the duration of the downturn, averaging roughly two years, is considerably shorter than for unemployment."

- "The real value of government debt tends to explode, rising an average of 86 percent in the major post–World War II episodes."

"A key finding of my work is that crises, especially banking crises, tend to be protracted," Reinhart said. She believes the U.S. experience will mirror these historical averages, she said, because "the crises that make up those averages were extremely severe crises and we are in an extremely severe crisis." The increasingly globalized economy of recent years will make recovery more challenging because "it will make it far more difficult for many countries to grow their way out through higher exports, or to smooth the consumption effects through foreign borrowing," according to her paper. But U.S. output may not decline as sharply as the averages, she said. That's because the averages include the sharp declines in output characteristic of crises in emerging markets.

A bleak U.S. employment outlook, with a safety net

"U.S. unemployment is only heading up," Reinhart said. She believes it could rise to 11%-12%, a roughly 7% increase from its low of 4%-4.5%. "If you look closely at the crisis experience, especially in advanced economies, they had a huge impact on unemployment. We're already starting to see that," she said. A 7% increase is about average for the systemic financial crises analyzed in her most recent paper. It falls short, however, of the more than 20% increase in unemployment that the U.S. experienced in the Great Depression.

Unemployment tends to rise less in emerging markets than developed markets. But that's not because the governments of emerging markets have discovered a great solution. Instead, according to Reinhart's and Rogoff's paper, "greater (downward) wage flexibility in emerging markets may help cushion employment during periods of severe economic distress. The gaps in the social safety net in emerging market economies, when compared to industrial ones, presumably also make workers more anxious to avoid becoming unemployed."

Reinhart is skeptical of the Obama administration's assertion that its stimulus package will create or save more than three million jobs. "It will create jobs, but the exact order of magnitude is a bit optimistic," she said. Why? Because the government is relying on the private sector to create most of those jobs, and the private sector is feeling the credit crunch. "With credit conditions so out of line with anything normal, you can't expect maximum bang for your buck," said Reinhart. Businesses will be reluctant to create new jobs under these circumstances. Another concern: "A lot of the very good stimulus policies in the pipeline don't have immediate impact," said Reinhart.

Fix banking first

History doesn't offer much guidance about the impact of economic stimulus packages. "Being able to employ a 'big time' countercyclical policy at a time of crisis is a luxury that few have," said Reinhart. Japan, which suffered a prolonged economic crisis starting in 1992, is the only historical example. But Japan didn't recognize and act on its crisis until fairly late in the game, said Reinhart. In that sense, she figures the U.S. is in better shape.

Still, the U.S. isn't a "poster child" for rapidly recognizing the magnitude of financial crises, Reinhart said. Countries like Sweden have historically done better at recognizing and fixing their banking problems by recapitalizing, encouraging mergers and acquisitions, and even nationalizing banks outright. “When this much of the financial industry is insolvent, you have to be very pragmatic and very broad-minded about how you’re going to approach it,” she said.

Reinhart believes that policymakers need to pay attention to banks and other financial institutions. “What’s most important is to fix what’s broken,” she said. “The core of the problem isn’t infrastructure; it’s the financial sector, which has a huge bad debt overhang.” She’d like to see more emphasis on TARP, the Troubled Asset Relief Program. Fixing the problems of the financial sector is a prerequisite to entering into “full gear recovery mode,” she said.

Recovery and beyond

Current U.S. policy is correct in one important respect: Reinhart does not expect deflation. “That’s a story for the 1930s, when monetary policy was on a completely different planet,” she said. The U.S. money supply may have contracted during the Great Depression, but today the Federal Reserve is committed to using all of the tools at its disposal to help the economy grow.

Reinhart is more concerned about inflation. “We are not there yet, but as public debt piles up, we’ll have to think about inflation,” she said. High levels of public debt tempt the government to use inflation to reduce the cost of paying off that debt. But inflation is probably a couple years in the future.

Looking forward, Reinhart is reluctant to forecast rates of U.S. economic growth and she doesn’t see the U.S. recovering until well into 2010. As for the future of the dollar, “over the very long haul, I do think the imbalances in the U.S. economy, like the big current account deficit, will come back to haunt us,” she said. But, she noted, that’s not a one-year forecast or even a three-year forecast.

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