Will the U.S. Sub-Prime Crisis Be as Bad as History Suggests?

By Susan Weiner
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Read Advisor Perspectives' analysis of this study in today's issue.

If history is a good guide, the U.S. economy will stay in the doldrums much longer than we'd like—a minimum of two years. That's the scary implication of "Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historical Comparison" by Carmen M. Reinhart of the University of Maryland and the National Bureau of Economic Research (NBER) and Kenneth S. Rogoff, Harvard University and NBER.

There are patterns to how financial crises play out, say Reinhart and Rogoff, who have studied many of them for *This Time is Different: Six Centuries of Financial Folly*, their forthcoming book. For their recent paper, they narrowed the universe to the events they consider most relevant to the current crisis: 18 post-World War II banking crises in industrialized countries, including the 1984 savings and loan crisis in the U.S. Of those 18 cases, they identify a particularly dire Big Five, including Spain (beginning in 1977), Norway (1987), Finland (1991), Sweden (1991), and Japan (1992).

Reinhart and Rogoff present this graph, illustrating the severity of the decline in US housing values, as compared to the other countries they studied:

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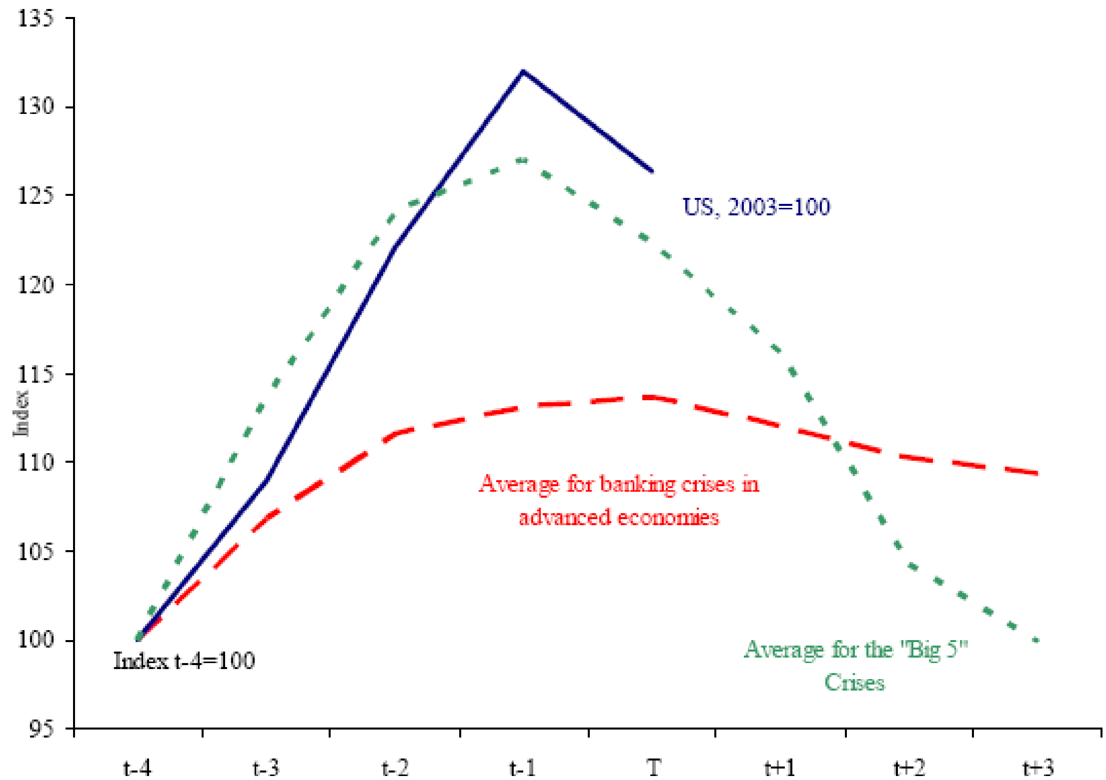
Figure 1: Real Housing Prices and Banking Crises



They provide this data showing the decline in equity prices:

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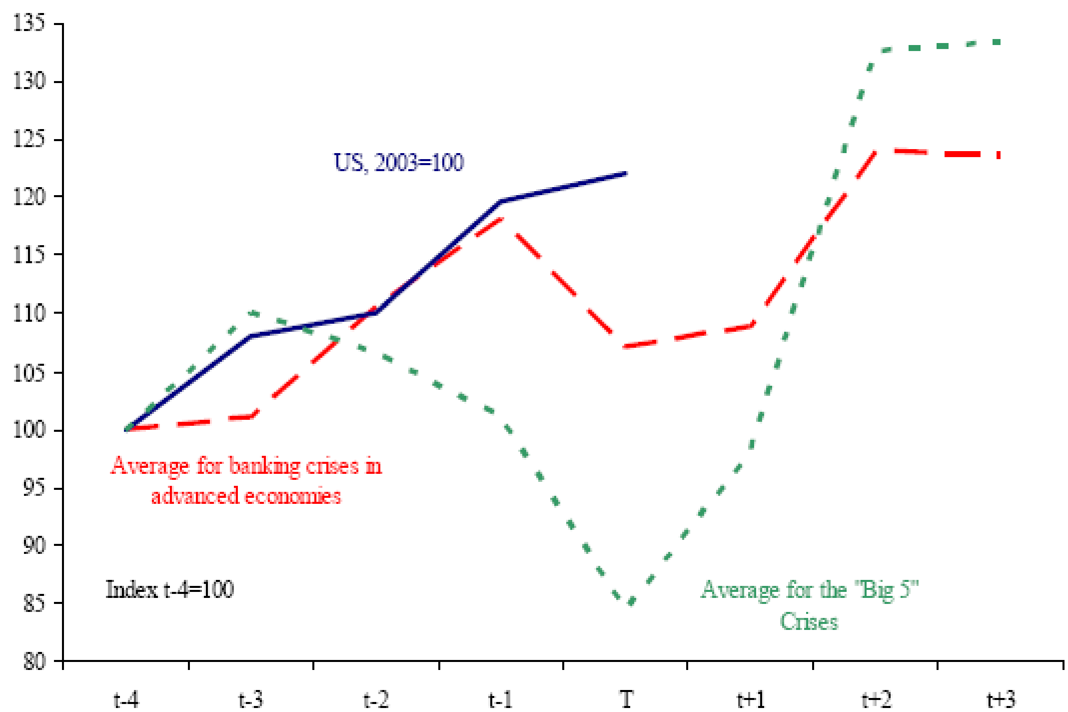
Figure 2: Real Equity Prices and Banking Crises



In the above graphs, T represents the onset of the financial crisis.

These 18 crises suggest how bad things could get in the U.S. On average, economic growth dropped by more than 2% and took two years to recover. In the Big Five worst case scenarios, growth dropped by more than 5% and remained below pre-crisis trend for more than three years.

Could the U.S. experience something similar? Reinhart and Rogoff compare the U.S. situation to these historical crises in terms of asset prices, real economic growth, and public debt, which are standard metrics for analyzing financial crises. They compare the patterns of percentage change for the U.S., the 18 crises, and the Big Five over seven-year periods. The periods start four years prior to the crisis (t -4) and continue to three years following the onset of the crisis (t +3). Real housing prices in the U.S. look mighty frothy, peaking above the average for the Big Five and running dramatically higher than the 18-crisis average. The story is similar for equity prices. As the authors put it, “Once again, the United States looks like the archetypical crisis country, only more so.”

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Nor does the U.S. fare well in terms of current account deficit as percent of gross domestic product (GDP). Capital inflows accelerated pre-crisis, just as they have in the 18 historical crises. In fact, this trend has been much more pronounced in the U.S., where deficits have exceeded 6%,

Real per capita GDP also follows the pattern set by the other 18 countries. “Growth momentum falls going into the typical crisis, and remains low for two years after,” on average.

The U.S. doesn’t look quite as bad in terms of public debt as a percentage of GDP. It’s well below the 18-crisis and Big Five averages. However, the authors note, “if one wants to incorporate the huge build-up in private U.S. debt into these measures, the comparison would be notably less favorable.”

Reinhart and Rogoff don’t guarantee a protracted economic downturn in the U.S. economy. Indeed, they admit that “the correlations in these graphs are not necessarily causal.”

But Rogoff has expressed pessimism outside the paper he co-authored with Reinhart. “It certainly appears that the U.S. productivity miracle is over… Our resilience as an economy is way down. So it looks like the United States will experience a milder version of the Japanese disease,” said Rogoff in an interview with Steve Lohr, “From Japan’s Slump in the 1990s, Lessons for the U.S.,” *The New York Times* (Feb. 9, 2008). Japan, where a long boom was followed by a decade-long decline, seems to be everybody’s idea of an economic worst case scenario.

Some pundits and advisors don't agree that post-World War II history is necessarily a guide to the future. *Freakonomics* author Stephen Dubner appears optimistic. He responded to Reinhart and Rogoff's article in his blog for The *New York Times*, saying "I am continually surprised at how widespread the perception is that our economy is in a complete nosedive, despite much evidence to the contrary."

Dan Danford, principal and chief executive officer of Family Investment Center in St. Joseph, Missouri, said, "There's an old Indian saying that 'you can never cross the same river twice.' Simply, the currents, wind, silt, temperature, and water levels change every minute of every day, and - though it may look the same - it never really is. Truly, the same problem exists with economics. There are hundreds of shifting variables, and it's always dangerous to observe that today resembles some point in the past. The best we can say is that the situation appears similar. Any other conclusion deserves considerable skepticism."

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On the other hand, some advisors find the Reinhart-Rogoff argument compelling. Like Eve Kaplan of Kaplan Financial Advisors in Berkeley Heights, NJ. "It's hard to make a case against the various indicators Reinhart and Rogoff present in their draft paper because indicators indeed appear to be aligning themselves in a star-crossed manner. Having covered Japan (as an analyst and fund manager) in the 1980s and 1990s, I only can say that a possible 2-5 year "adjustment" to property deflation in the US is getting off relatively lightly compared with the 20-year mess Japan has been mired in. The good news is that the US is not Japan – we never had multiple generation mortgages and our economy is more of a magnet for foreign capital – so it's entirely possible our economy can absorb this mess over a shorter period of 'only' several years."

"The worrisome aspect of this is the other shoe dropping: equity prices," added Kaplan. "Reinhart and Rogoff leave open the possibility that US equity prices will not deflate in the prototypical manner due to extraordinary Federal Reserve stimulus measures – but one has to wonder if US equity prices have indeed discounted a further multiple year period of 'readjustment.' I don't think financial planners and consumers are fully equipped and prepared for significant further downside."

Bert Whitehead, president of Cambridge Connection in Bloomfield Hills, Michigan, is concerned that Reinhart and Rogoff haven't gone far enough in describing the dangers to the U.S. economy. He said, "I am concerned that this is only the tip of the credit crash. It is likely to be followed in the next couple of years by widespread defaults on municipal bonds." Whitehead notes that municipalities have been steadily increasing pension benefits, which he believes they can no longer meet, especially as baby boomers take early retirement. These pensions are not federally guaranteed and several municipalities may be nearing default (e.g., San Diego, Chicago Transit Authority). These burdens will ultimately be borne by municipal bond holders. He said, "Compare the estimated $150 billion which Merrill Lynch, Countrywide, etc. have lost on their sub-prime holdings with the $120 billion in unfunded pension liabilities in Illinois alone!"

Only time will tell who's right and who's wrong. Meanwhile, Reinhart and Rogoff have stimulated an interesting debate.

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