Halfway Back to Prosperity?

By Kerry Pechter *Wed, Feb 1, 2012*

Carmen Reinhart, co-author with Kenneth Rogoff of the best-selling "This Time Is Different," spoke at the IMCA conference in New York this week. We're five years into a 10-year recovery from the credit binge, she said.

"If you study the history of financial crises," the economist and best-selling author Carmen Reinhart told 800 investment consultants in the ballroom of a Times Square hotel this week, you discover that "they cast a long shadow."

Reinhart's 500-page tome, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton, 2009), makes dry reading. But she spoke with almost operatic passion this week as she warned the members of the Investment Management Consultants Association that the nation is only about five years into what, historically, is a decade-long deleveraging process.

"I'm talking about a muddling-through scenario where growth recovery is weaker than what we are used to since World War II," she said mordantly. Her (voluminous) research shows that median GDP growth and unemployment have been 3.1% and 2.7%, respectively, in the 10 years before credit crises. During the decade after the feverish borrowing hits its peak, median GDP drops to 2.1% and unemployment rises to 7.9%.

"In the post-crisis decade," she said, "housing prices are lower, unemployment is higher and GDP is lower, because of private sector deleveraging. That is true whether government debt is low or high, and whether it follows a policy of austerity or expansive. There's about seven years of deleveraging, and that puts a damper on economic activity."

In her talk, Reinhart, since 2010 a senior fellow at the Peterson Institute for International Economics, espoused no particular economic ideology. She said she embraced the Obama stimulus as a way to stop the Panic of 2008 from fissioning into a full-blown depression, but now worries about paying down the debt.

Reinhart, whose family fled Cuba when she was a child, acknowledged that much of today's public debt is private debt that governments were forced to cover. Without sounding like a deficit dove, she seemed to favor a policy of mild inflation and debt relief through negative real interest rates—i.e., "financial repression"—over a deflation that flattens debtors or a slash-and-burn austerity. She blamed no one and offered no easy exits from our current fiscal and monetary dilemmas.

Her main point was that, not unlike Joseph's dream of seven fat years followed by seven famine years, credit booms and busts have historically follow a regular cycle of winding up and winding down.

"The buildup in leverage typically takes seven to 10 years, and same amount of time is spent in deleveraging," Reinhart told the investment consultants. "Deleveraging doesn't start big-time until about three years into the crisis. The crisis in the US began in the summer of 2007, so this summer we'll be five years into the crisis."

The current recovery probably won't be quick and easy. "I was in Bear Stearns in the early 80s, during the severe recession of 1982 and the spectacular recovery that followed. What were the factors in the spectacular recovery? Household debt in 1982 was 45% of GDP. Today, even after deleveraging, household debt is still 90% of GDP. So the capacity of households to respond is more difficult," she said.

"The risk of a 'double-dip' is alive and well," she added. "In the 15 severe crisis episodes we studied, double-dips occurred in the seven of them. Economies went from a subpar recovery to a renewed patch of softness. And if you look at the causes of double-dips, we're prime candidates."

For the record, Reinhart explained how we got where we are.

"The pattern that we're seeing play out in Europe and, with less drama, in the U.S., is a common pattern in history. The process begins with financial innovation, liberalization, and globalization. That facilitates credit and leverage booms. During the boom phase of the cycle, asset prices soar. We feel wealthier and borrow more," she said.

"Eventually the boom in private debts ends up as a severe financial crisis, which morphs as the financial industry goes into crisis. Eventually the economy implodes and goes into recession. The fiscal side is hit by lower revenues, which, absent stimulus, worsens the deficit. The private debts become public debts. The debts of Fannie Mae and Freddie Mac went from the private-sector to public-sector balance sheets, and added 25 percentage points to government debt."

After the crises, the responses have also followed a pattern, as central banks and governments try to steer a middle path between inflating away the debt (helping debtors) and maintaining the value of their currencies (helping savers).

"At the end of WWII, all of the winners were mired in public debt. What was the most conducive policy for recovery? Low interest rates with a little bit of inflation. That combination of low stable nominal rates and inflation produces negative real interest rates. It's a tax on the bondholder. It's a transfer from savers to borrowers. In periods of high debt, it's a form of debt relief," she said.

"Given this environment, of deleveraging, of public and private credit events, it's not surprising that central banks, both in the U.S. and the other advanced economies, will go to great lengths to keep rates as low as possible for as long as possible. If the problems are both public and private indebtedness, and excess capacity, then the inflation concerns traditionally voiced by central banks will be placed on the back burner for some time to come," she added.

"Countries go to great lengths to avoid restructuring, i.e., default. The usual alternative is inflation to liquidate debt. We've done it. Germany did it after World War I and Brazil did it in the 1980s. Financial repression is a subtle type of debt restructuring."

Reinhart predicted no quick resolution of the current financial crisis in Europe. "The Greek default at first looked unprecedented for an advanced economy," she said. "But, since independence, Greece has been in default 48% of the time, with the last default in 1964.

"In Davos, I heard optimism as spreads have come down on Irish and Italian debt. People said, 'The worst is behind us. We've endured crisis.' I disagree. There will be more restructurings. Portugal is probably next on the list. Ireland has massive external debt sitting there unresolved. Italy and Spain are in the too-big-to-fail category. More defaults and restructurings will be with us for awhile."

At the same time, she warned about the downsides of a surge of capital into emerging markets. "Low rates in the advanced economies make yields on emerging market bonds very attractive, and emerging markets have been attracting a lot of capital flows. Many have attracted higher flows than they would welcome. Over past two years, there's been some optimism that emerging markets are the right engine of growth and the right destination for money," she said.

"But large capital inflows can be destabilizing. They can be too much of a good thing. Banking crises are more likely when a country sees large capital inflows. The US had record inflows. So did Spain, Greece, Ireland, and the UK. All had huge capital inflows, but it didn't end any better than it has in the emerging markets.

"During the last two years, we've seen Brazil, Korea and others attract a lot of flows, with internal leverage growing in those countries, and appreciated currencies. Vulnerabilities are there that weren't there two years ago. Emerging markets have weathered the storm because they had reduced their external debts extensively."

Here in the U.S., Reinhart said she is trying to see into the future, without much success. "During the height of the crisis, I for one received the stimulus with open arms, she said. "It made the key distinction of stabilizing the panic, a preventing a bad recession from becoming a collapse like the 1930s.

"But now, five years since the crisis, [it's clear] that that debt will have to be repaid through some form of restructuring. Services and entitlements will be reduced or they will be reneged on. I don't know of any instance where the magnitude of debt accumulation is like it is today. I've been working on an analysis for planning on how to deal with the surging debt problem but it hasn't gone very far."