Eight Centuries of Financial Folly
A Panel Discussion
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The Panel was organized by Ott to discuss a recent work: "This Time is Different: Eight Centuries of Financial Folly", by Carmen M. Reinhart and Kenneth Rogoff (2009; Princeton University Press, Princeton and Oxford).

The volume offers an extensive analysis documented with data of financial crises going back EIGHT centuries. Based on this analysis, Reinhart and Rogoff (henceforth referred to as R and R) advanced the hypothesis that the 2007 U.S. subprime financial crisis that has given rise to a global tidal wave of financial panic is not out of "experience". When put in a historical perspective, the 2007 financial crisis, although severe, did not seem to depart much from other banking and debt crisis in the advanced economies as well as the emerging market economies.

The book takes its reader into a journey covering eight (8) centuries to make their case: "This time is not different". This in sharp contrast to the "illusion" that is widely held (according to R and R) that "this time is different". In this historical journey, the authors never make you, the reader, lose sight of the fact that "financial folly" is the norm rather than the exception. To convince you of that, R and R put before the reader two things: Historical data and data analysis.

The historical data about the financial crises covering "eight centuries"—from 1200 to 2008—was sorted out by two criterion: (a) By quantitative thresholds: Inflation, currency crashes and debasement (see their table 1.1, p. 7), and (b) By events: Banking crisis and external Debt default (see their table 1.2, p.11).

Their data analysis led them to challenge the contention that "This Time is Different". This challenge is posed through an analysis of 5 cases: (1) The buildup to the emerging market default of the 1930's, (2) The debt crisis of the 1980's, (3) The debt crisis of the 1990's in Asia, (4) The debt crisis if the 1990's and early 2000's in Latin America and (5) The United States subprime crisis of 2007 to the global financial crisis.

Besides the historical narrative and data analysis, a salutary feature of the volume is in its emphasis on comparative quantitative analysis of events covering 66 countries at different levels of development and different periods of time. The analysis purports to show that financial crises are not unique to one economy versus another, one century compared to another. That is, it is a part of the course. The question is then: why do leaders and followers in the global economy insist that "this time is different"? They respond to this ("Folly" Ott's word) in two segments of the book. First, in chapter 1 (pp.15-20) the explanation is embedded in the belief that financial crises are things that happen to people in other countries; that the world economy is in a much better shape (this time around) marked by price stability and growth and that globalization, the technology boom, a superior financial system and a better understanding of monetary policy preclude falling in the crisis abyss of the past.

The second challenge against the contention that "this time is different" is given in their chapter 13, in particular with reference to the US subprime crisis. According to R and R, despite the fact that the crisis that began in 2007 shared many parallels with asset price booms, the characterization of the debate (in the US) surrounding the this-time-is different mentality finds its roots in the belief that the US has the "most reliable system of financial regulation", the most innovative financial system, a strong political system, and the world's largest and most liquid capital markets, superior monetary policy institutions and that rapidly emerging developing countries needed a "secure place to invest their funds".

They give six reasons for the belief that this time is different (see p. 214). Having enumerated these reasons, R and R left the reader to wonder: Given that these indeed are sound reasons for the belief that this time is different, why did we end up with a global financial crisis? An answer to this question could not be given in a "nutshell". It requires a full reading (and understanding) of previous episodes of financial crisis. As the authors wisely phrase it: “How relevant are historical benchmarks in assessing the trajectory of a crisis such as the global financial crisis of the late 2000s”. According to R and R, given that authorities now have “more flexible monetary policy frameworks”, the authorities have learned to act much quicker than previously. On the other hand, they warned that “we would be wise not to push too far the conceit that we are smarter than our predecessors”. (p. 238)

As mentioned earlier, the panelists focused on two types of crisis: Banking crisis and Debt crisis.

Drs. Nace and Querido focused on the banking crisis; Dr. Bissessar on the debt crisis. Dr. Dittrick commented on the hypothesis offered by Reinhart / Rogoff.

A look into the Banking Crises (Nace and Querido) [1]

Banks traditionally borrow at short-term (in the form of deposits). Deposits can be redeemed on relatively short notice. Bank loans however have a far longer maturity and are difficult to convert into cash in short notice. For example, a bank uses deposits to loan funds for the construction of a shopping mall. The bank is confident

[1] The views expressed in the presentation are those of the authors and do not necessarily represent Bank of America views or policy.

that in the long term, the loan will be repaid, as the shopping mall owner rents out the stores. But in the short term, the mall owner does not generate revenue to be able to pay the interest and principal of the loan.

When a bank has a large deposit base and a large portfolio of illiquid loans it has good prospects in the long-term. However, if depositors all want to withdraw their funds at the same time, the bank might not be able to pay them all. A crisis would arise, especially when the government does not insure deposits, or when the insurance is not sufficient.

Beside the bank, other borrowers can suffer from a crisis of confidence as well. That is what happened in the United States in 2007. As confidence in the investments made fell, lenders increasingly refused to roll over their short-term loans, throwing assets on the market at significantly lower prices than normal – 'fire sale' prices. Distressed sales drove asset prices down further, causing more losses and lower confidence. Since banks often hold similar portfolios of assets, if all tried to sell at once, the asset market liquidity can dry up completely.

Thus even in the case where a bank was solvent, during a bank run it has to liquidate its assets at fire-sale prices which destroys its balance sheet. A bank run occurs when depositors loose faith in the bank and start withdrawing their assets in masse. However, if bank run occurs in a single bank, the bank can borrow from other private banks, which offer deposit insurance to one another. When the problem is wide spread, private insurance pooling doesn't work. If people and institutions lose confidence in the banking sector, the whole system can go bust.

These events have serious consequences. According to Reinhart and Rogoff *"Countries can outgrow a history of repeated bouts with high inflation, but no country yet has graduated from banking crises." (R & R, page 139).*

According to R and R banking crises have impacted advanced, emerging and poor economies. This finding is derived from data analysis of a sample of 66 countries with the dataset spanning over two hundred years for most countries. The R&R data covers basically two kinds of banking crises: (1) Crises such as the ones experienced in emerging and advanced economies and (2) Crises typically occurring in poor economies.

Banking Crises and Bank Runs

These events are common in emerging markets and developed economies. According to R and R, banking crises characterized by bank runs are what they refer to as the "Second Great Contradiction", which took place in the U.S. in the late 2000s. According to R and R the U.S. financial crisis (2007- 2008) was driven by a real estate housing bubble, the increase in housing prices, cheap foreign capital in the mist of an expanding current account deficit and a regulatory environment which allowed the dynamic between these factors to magnify (In their chapter 13, the authors enumerate the causes of the U.S. financial crisis in the late 2000's).

The roots of the financial crisis in poor economies are somewhat different. According to Reinhart and Rogoff banking crises are common in repressed financial systems. Under financial repression, banks are vehicles that allow the government to squeeze more indirect tax revenue from citizens by monopolizing the entire savings and payments system. This allows government to fund its debt at very low interest rate, making financial repression a form of taxation. (*Example: India in early 1970s where government capped interest rates at 5%; inflation reached 20% & government can still choose to default on its obligations. (R & R 143))* The authors provide evidence on the connection between government debt and banking crisis for two regions by country: Africa and Asia (Table 10.1).

In Table 10.5, the authors offer evidence on incidence and frequency of banking crises by region from 1800 (or since a country's independence) to 2008 (for Africa, Asia, Europe, Latin America; advanced and emerging economies).

Their findings may be summarized as follows:
Banking Crises occur in both advanced and emerging economies alike; the frequency of default on external debt is significantly lower in advanced economies than in emerging markets; the average length of time a country spends in sovereign default is far greater than the average amount of time spent in financial crisis. As economies develop, so does the likelihood of banking crisis.

Reinhart and Rogoff provide documentation of causes of financial crisis, the linkages between asset prices (i.e. housing and equity) to bank crises. Two significant findings are noteworthy: High international capital mobility has repeatedly produced international banking crises; and that financial sector liberalization with inadequate regulation is so highly correlated with banking crises.

The authors also examined both the costs of a financial crisis and the costs incurred by society (government bailout) for addressing the crisis.

The African Story

Nace and Querido turn to the African countries' experiences. Unfortunately, not all of the Sub-Saharan African countries (the focus of IEPS) were represented in R and R sample of 66 countries. [2]

Data and analysis are given for South Africa, Nigeria, Kenya, Angola, Côte d'Ivoire, Mauritius, Central African Republic, Zambia and Zimbabwe. Because of lack of data (especially on public debt), for some of these countries for some periods, crisis events reported for these countries are not as complete as was the case for countries in other regions. Nonetheless, there is lessons to be learned from the findings. To put the African story in a contemporary perspective, a look at few key indicators may be in order.

According to Overseas Development Institute (2009), Sub-Saharan Africa (SSA) has enjoyed significant growth, net foreign direct investment (FDI) inflows grew

[2] A follow up conference is arranged by the Institute for Economic Policy Studies (IEPS) to address the impact of the global financial crisis on Sub-Saharan African countries. For details see IEPS webpage at www.iespolicy.org/events.html

progressively from $13 billion in 2004 to about $33 billion in 2007; portfolio equity flows took off, reaching a value of $15 billion in 2006; bonds flows rapidly increased, by $7.13 billion from 2006 to 2007; and international banking activity all expanded significantly. Given the financial under-development of SSA economies, it was believed that such countries would not be greatly affected by the global financial crisis. This belief turned out not to be the case, however. The global financial crisis has impacted developing countries through stock markets, banking sector (borrowing from advanced economies, foreign ownership of banks, exposure to sub-prime market), foreign direct investment (FDI), remittances, exports, imports, terms of trade, and aid. These adverse effects led the IMF to revise its growth forecast for the region.

Sub-Saharan Africa in effect has been hit hard by reduced external demand, plunging export prices, weaker remittances and tourism revenues, and sharply lower capital inflows, notably FDI. It was projected that FDI would decelerate sharply in 2009 to 1 percent, down from 5.7 percent, on average, recorded for the past three years. Sharp cuts in remittances and official aid flows also represent a risk for the region, because many Sub-Saharan African countries rely on aid flows for budget support and because remittances are a vital cushion against poverty.

The IMF growth forecast revision for SSA represents a reduction in GDP per capita of up to US$20 for every person in sub-Saharan Africa due to the financial crisis (*Overseas Development Institute 2009*). Aside from forecast of low GDP growth, it is evident that portfolio equity flows had slowed down and sometimes reversed, consistent with sharp falls in stock markets in South Africa, Nigeria, Kenya, Mauritius and Côte d'Ivoire. The first signs of contraction of international bank lending in these countries have already emerged. For example, banks' total foreign claims on Zambia declined from $2908 million in June 2008 to $2607 million in September 2008, and Ghana experienced a similar drop over the same period.

A few words about International banking in SSA

International private banking activity through both cross-border lending and local market activity (i.e. lending through local affiliates) is relatively limited in sub- Saharan African countries. International claims (i.e. claims denominated in foreign currency) to sub-Saharan Africa, during the third quarter of 2007, accounted for only 6% of the total compared to 43% for Europe and Central Asia, and 20% for Latin America and East Asia (*World Bank's Global Development Finance 2008*). Sub-Saharan Africa thus, was less vulnerable to shocks in global interbank rates caused by the financial turmoil. However, the current financial crisis affected Sub-Saharan African countries through deterioration in their domestic banks. Foreign ownership of the banking sector in sub-Saharan Africa has increased over the last decades such that it is currently comparable to those in

Europe, Central Asia and Latin America and is much higher than the level of foreign ownership in East Asia, South Asia and the Middle East and North Africa.

Foreign ownership in principle implies that parent banks located in other countries (UK and France), when faced with bank runs, might start to withdraw funds from their African subsidiaries to offset losses in home countries. This clearly would increase African banks' likelihood for sustaining bankruptcy and financial collapse. Foreign ownership of SSA banking system represents an important channel through which global financial crisis affects their economies.

Linkages between developed and developing economies such as SSA expose their economies to financial risks encountered in the advanced economy especially during banking crisis. The sudden drying up of liquidity and increased uncertainty impacts the pricing of risk. In effect, increased risk aversion, a reassessment of growth prospects, and the need for firms and investors in high-income countries to strengthen their balance sheets resulted in a large-scale repatriation of capital from developing countries.

Financial institutions in developing countries although believed to have little direct exposure to U.S. subprime mortgage securities or related assets, large write-downs on mortgages and other assets incurred by major banks and securities firms that operate worldwide have forced these institutions to reduce lending activity in order to restore their balance sheets. This rebalancing of assets had a significant reversal in capital flows, away from developing countries and toward high-income countries, notably the United States.

In short, extensive analysis by Reinhart and Rogoff show that the incidence of banking crises is remarkably similar in developed and developing economies. It is found that indicators of financial crisis are there for all to see. They show that financial liberalization and a surge of capital inflows tend to precede banking crises. Moreover, banking crises contribute to declines in real GDP growth and government revenue and public debt.

External Debt Crisis: Bissessar

Interactions between government debt especially external debt and financial crisis are well documented in Reinhart and Rogoff's study. Their debt analysis covers developed, emerging and developing economies. In their volume, Reinhart and Rogoff provide a historic review of debt and financial crises for 66 countries dating from the fourteenth century to the current U.S. subprime crash in 2007. The focus in this section is in Sub-Saharan Africa. The summary of findings presented below for 13 African countries are derived from R and R study. In the presentation, Bissessar split the African countries' sample into Sub-Saharan African countries (SSA) and North Africa (NA). This division not only follows the tradition of international agencies in making a distinction between North Africa and Sub-Saharan Africa but also because these two areas, even though belonging to the same continent differ in many aspects not least of which their level of economic development and financial structure.

From their data and measures of default (R and R: Table 3.1, 6.3 and 6.5), one finds that the majority of these 13 African nations are newly independent states with mostly current debt defaults. The range of years spent in default or rescheduling varied from 0 for Mauritius to almost 60 for Angola. Of note is the fact that Central African Republic, Côte d'Ivoire and Zimbabwe had the highest shares of years in default/rescheduling, while in North Africa, Egypt and Tunisia recorded the lowest share of years in default (3.4 for Egypt and 5-3 for Tunisia).

Two distinct elements in R and R analysis of the African subsample's experience standout: Debt forgiveness and debt rescheduling. As to the first, debt forgiveness, if were to take place, would allow African countries a breathing room; to allocate resources to development and economic growth rather than for debt repayment. Loan rescheduling, however would increase the countries' debt burden specially if draconian 'pay-up now' policies by major international lending agencies were used. Strict loan rescheduling not only raises but also in many cases makes an indebted country, debt intolerant.

R and R provide evidence on the African sample fragility as a foreign borrower derived from two indicators: Institutional Investor sovereign ratings (IIR hereafter) and the ratio of external debt to GNP (R and R Table 2.3). Ratings closer to "0" represent higher debt default, whereas ratings closer to "100", lower debt defaults. By subtracting a country's IIR ratings from 100, a proxy for default risk and external debt default are calculated. Their findings paint Africa as somewhat riskier (0.33) than the emerging economies of Asia but less so than the Middle East.

As to the second measure, Africa had a rating of 0.56 still much higher than the Middle East (0.48) and the Western Hemisphere (0.47) ratings.

Assessing debt trends over the period 1970-2007 R and R report that as debt rises, debt defaults are increased. From their data, one finds that, the total external debt into the region has risen sharply from the mid-1980s and has stayed in the range of US$150 - US$200 billion. When Sub-Saharan African countries in the sample are considered, Nigeria and South Africa having recorded the highest levels of debts, while Kenya and Zambia the lowest. North Africa, Algeria has significantly lowered its debt while Tunisia has seen an increase. To shed more light on the significance of indebtedness to the development process, it is useful to look at key indicators: The ratio of external debt to GDP and the value of net exports. Also data on debt service provides evidence on the burden of external debt as exports surplus are need to amortize the debt.

Debt to GDP ratios: 1970 – 2007

R and R provide data on the debt/ GDP for Sub-Saharan countries over a 30 year period. Their data (when available for the entire period) shows for the majority of countries a ratio in excess of 30 percent with the ratio peaking in the 1980's and 1990's. Some countries: Angola, Egypt, Algeria and Zambia have succeeded in reducing the debt/GDP ratio in the later part of the 1990's and in the 2000's. As an example, Algeria succeeded in reducing its debt/GDP from 79 percent in 1995 to 4 percent in 2007, likewise for Nigeria where the ratio fell from 144 percent in 1993 to 5 percent in 2007.

Net Exports as a Ratio to GDP: 1960 – 2008

Net exports or the balance of merchandise trade represents the difference between the services exported to the rest of the world minus the value of goods and services imported from the rest of the world. A trade surplus represents positive inflows while a deficit represents outflows. R/R African sample gives balance of trade position from 1960 – 2008. From the data Algeria and Angola had surpluses above 30 percent of GDP while Côte d'Ivoire and Nigeria had surpluses around 10 percent of their GDP. These surpluses occurred in the mid-1990s when good governance was declared as a development goal by the World Bank and these nations were changing their political structures. The remaining countries in the sample stayed in deficit position during the period.

Debt Service a percent of Exports: 1975 - 2007

Total debt service as a share of exports from 1975 to 2007 are reported by R and R.[3] Most of the countries had persistent debts ranging from 0 to 70 percent of their exports. When Sub-Saharan countries are separated from the North African countries, the trend is slightly different. In the former, debts service to exports ranged from 0-50 percent and have a cyclical pattern; while in the group the rate is between 0 -70 percent decreasing over the period by approximately 10 percent.

[3] Total debt service is the sum of principal repayments and interest actually paid in foreign currency, goods, or services on long-term debt, interest paid on short-term debt, repayments (repurchases and charges) to the IMF. Exports of goods and services includes income and workers' remittance. Source: World Bank, Global Development Finance.

North America seems to have significantly reduced their debt service to manageable levels with the exception of Algeria, who has successfully reduced its debt service share from 70 percent to 0 in 1993.

Other key variables such as development assistance, budget balance position as a percent of GDP, the inflation rates as well as GDP growth are reported in R and R to give an adequate picture of their path in the aftermath of the crisis.

The picture that emerges and hence the projected path of the Sub-Saharan countries is very much dependant on the level of debt and debt services relative to GDP as well as whether or not the country is a net exporter or importer of oil and natural gas.

The question as to whether or not Sub-Saharan African countries as well as North African countries will survive the financial crisis clearly depends on the country's vulnerability to economic downturns and demand for its exports.

Food for Thought

The summary of the presentations at the Prague Conference given above is but a first step towards understanding the economic challenges facing Sub-Saharan African countries as they grapple with the set backs and debt burden in the road to development, a topic which will be dealt with in future conferences. For now one needs to reflect on the message(s) contained in Reinhart and Rogoff.

Given that the subtitle of their book states: Eight Centuries of Financial Folly", one is left to wonder about such folly:

Is it a folly to live beyond one's mean?

Is it folly to cheat one's countrymen or the world's at large?

Is it a folly not to learn from one's mistake?

Is it a folly to fool the Fools?

If there is one insight the book has left on the reader's mind is that: neither a leader nor an ordinary citizen is likely to learn from their mistakes. And why should they if someone else can be left holding the "crisis bag". As Reinhart and Rogoff aptly put it:

> The lesson of history is that even as institutions and policy makers improve, there will always be a temptation to stretch the limits. Just as an individual can go bankrupt no matter how rich he(she) stands out, a financial system can collapse under the pressure of greed, politics and profits no matter how well regulated it seems to be." This Time is Different: Eight Centuries of Financial Folly, (p. 291).