

BOOK REVIEW

**REVIEW OF “THIS TIME IS DIFFERENT:  
EIGHT CENTURIES OF FINANCIAL FOLLY”  
BY CARMEN M. REINHART AND KENNETH S. ROGOFF**

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*ABSTRACT* *This Time is Different: Eight Centuries of Financial Folly* is an essential reading on the history of financial crises for anyone interested in economics and finance. Compiling an extensive new database of macroeconomics and financial time series for sixty-six countries in five continents for eight centuries, and conducting a detailed and meticulous analysis, the book presents a comprehensive survey of financial crises and reaches a simple yet powerful conclusion: we have been here before. In other words, times may change, locations may change, actors may change but human nature does not. Despite how different the latest financial crisis always appears, financial crises often exhibit more similarities than differences throughout history. Being aware of these similarities is an essential step towards improving the global financial system, both in order to reduce the risk of a future crisis and to better manage a crisis when it happens. This review presents a brief summary of the book and a discussion about its implications for the current and the future possible crises.

*JEL* E02, E58,F01, G01, G02, G20

*Keywords* This Time is Different: Eight Centuries of Financial Folly, Financial crises, Book review

*ÖZ* *This Time is Different: Eight Centuries of Financial Folly* finansal krizlerin tarihi üzerine yazılmış, ekonomi ve finansa ilgi duyan herkes tarafından okunması gereken bir kitaptır. Beş kitada bulunan altmış altı ülkenin sekiz yüz yıllık makroekonomik ve finansal zaman serilerini içeren geniş bir veri seti oluşturarak detaylı ve titiz bir inceleme yapan bu kitap, finansal krizlere ilişkin kapsamlı bir tarama yaparak basit ancak güçlü bir sonuca ulaşmaktadır: biz bunu daha önce de yaşadık. Bir diđer deyişle, zaman ve mekân deđişebilir, oyuncular da deđişebilir; ancak, insan doğası deđişmez. En son yaşanan kriz önceki krizlerden ne kadar farklı gözükse de, tarih boyunca finansal krizler farklılıklardan çok benzerlikler gösterir. Bu benzerliklerin farkında olmak, gelecekteki bir finansal kriz riskini azaltmak ve kriz olması durumunda daha iyi yönetilmesini sağlamak açısından küresel finansal sistemi iyileştirme yolunda önemli bir adımdır. Bu kitap eleştirisinde, kısa bir özet sunulmakta ve mevcut durumda yaşadığımız kriz ve ileriki dönemlerde yaşamamız muhtemel krizlere ilişkin kitabın olası çıkarımları tartışılmaktadır.

*THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY ÜZERİNE BİR ELEŞTİRİ*

*JEL* E02, E58,F01, G01, G02, G20

*Anahtar Kelimeler* This Time is Different: Eight Centuries of Financial Folly, Finansal krizler, Kitap eleştirisi

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*“Nobody can hope to understand the economic phenomena of any, including the present, epoch who has not an adequate command of historical facts and an adequate amount of historical sense or what may be described as historical experience. “*

*– Joseph Schumpeter*

## 1. Introduction

Harvard economist Joseph Schumpeter remarked that of the three building blocks of economics—economic theory, statistics and economic history—economic history is by far the most important.<sup>1</sup> The importance of economic history is on display in *This Time is Different: Eight Centuries of Financial Folly*, by Carmen M. Reinhart of the University of Maryland and Kenneth S. Rogoff of the Harvard University, whose pioneering previous work has been influential in both academic fields as well as on policy debates.

Already being a true classic, the book is an essential reading giving a panoramic overview of the history of financial crises by “masterfully blending economics, finance, history, politics, and psychology into a digested format” (Kose, 2011). It offers a detailed analysis of crises dating from England’s fourteenth century default to the recent subprime crisis of the US. Having covered a wide episode of crises, the book presents an extensive look at various financial crises, ranging from sovereign external debt crises to banking panics, without overlooking past inflation spikes, medieval currency debasements, modern exchange rate crashes, and finally, the recent US subprime meltdown.

As a major contribution, the book introduces a comprehensive new dataset encompassing external and domestic debt, trade, GNP, inflation, exchange rates, interest rates, and commodity prices for sixty-six countries in five continents through eight centuries. In addition to compiling this extensive dataset, the book also provides a systematic dating of external debt and exchange rate crises as well as the cataloguing of the dates for domestic inflation and banking crises. In doing so, the book seeks to offer a broader insight to the history of financial crises with the final aim to boldly demonstrate that financial crises, rather than being unique to individual countries, are universal, recurring, and inevitable.

Utilizing this comprehensive dataset, the book carefully examines patterns of currency crashes, episodes of high and hyperinflation, sovereign defaults on external and domestic debt, in addition to cycles in housing and equity prices and capital flows. With this clear and sharp analysis, the book illustrates the sequencing of financial crises by also documenting that financial fallouts happen in clusters with surprisingly consistent frequency and duration. The book is built on this main finding that major default

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<sup>1</sup> Schumpeter (1954).

episodes are typically spaced some years (or decades) apart, thus creating an illusion, - a financial folly- among policymakers and investors that “this time is different”, the widespread yet false belief that economic actors had learned from their mistakes and financial crises are not going to return for a very long time.

The view that domestic debt is a novel feature of the modern financial architecture constitutes a recent example to this false belief that is referred to as the “this time is different syndrome” by the authors. The book mainly focuses on this false belief which asserts that “financial crises happen to other people at other times and places, but not to us here and now, because we are doing things better, we are smarter, and we have learned from past mistakes, so old rules of valuation no longer apply.”

The book, in detailing crises that have arisen over the past eight centuries, exposes this myth and shows that boom-bust cycles occur with relentless regularity on contrast, a trend that is likely to continue in the future. Using this finding, the book concludes that the recent US subprime crisis is hardly unique. In other words, the financial folly is supported by the book’s provocative finding that demonstrates “how little we learned from past mistakes” and shows that financial crises are universal and inevitable.

The main conclusion of the book is very simple: we have been here before. The instruments of financial gain and loss have varied over the ages, as have the types of institutions that come to stage. But financial crises follow a rhythm of boom and bust through the ages. Thus, each time an economy experiences a boom, financial professionals and government leaders explain that we are doing things better than before, we are smarter, and have learned from past mistakes. Thus, the society convinces itself that the current boom, unlike the many booms that preceded the catastrophic collapses in the past, is built on sound fundamentals, structural reforms, technological innovation, and good policy. However, as the book shows, countries, institutions, and financial institutions may change over time but human nature does not. Despite how different the latest financial crisis always appears, remarkable similarities exist with past experience from other countries and history. Being aware of these similarities is an essential step towards improving the global financial system, both in order to reduce the risk of a future crisis and to better manage a crisis when it happens.

## **2. Basic Lessons**

The invaluable findings and contributions of the book can be summarized as below:

- Common theme to all crises is excessive debt accumulation, whether by the government, banks, corporations or consumers. Banks, companies, and individuals borrow excessively in good times due to absence of

awareness of the risks that will follow when a crisis hits inevitably. However, booms accompanied with excessive debt accumulation always end badly. Outcomes include sovereign defaults (government fails to meet payments on its debt), banking crises (heavy investment losses, banking panics), exchange rate crises (Asia, Europe, Latin America in the 1990s), high inflation (a *de facto* default), and combinations of the preceding (1930s, today).

- Sovereign debt crises are commonly observed in history but the absence of such crises over the last decade created the false belief among government officials that they will never occur again, propelling countries to borrow excessively.<sup>2</sup> Furthermore, history of large public debt in emerging markets has been ignored by economists who view its emergence in the beginning of the 21<sup>st</sup> century as a stunning new phenomenon. An event may be rare in a three-decade span but may not be rare over a longer period of analysis.

- Markedly rising asset prices, slowing real economic activity, large current account deficits, and sustained debt accumulation are important precursors to financial crisis. The aftermath of severe financial crises is characterized by asset market collapses which are deep and prolonged, profound downfalls in output and employment, and exploding government debt not only due to bailouts, but also due to shrinking revenues and soaring interest rates.

- Advanced economies may have "graduated" from serial default on sovereign debt and recurrent episodes of very high inflation, but history tells us that "graduation" from recurrent banking financial crises is much more elusive, and that advanced economies are as vulnerable to them as emerging economies.

- Technology has changed, the height of humans has changed, and fashions have changed. Yet the ability of governments and investors to delude themselves, giving rise to periodic bouts of euphoria that usually ends in tears, seems to have remained constant.

With a view to challenge "this time is different syndrome" by conducting an extensive review of financial crises, the book draws attention to the significance of some basic insights as regards mitigating and managing a financial crisis. First, having a complete picture of government indebtedness

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<sup>2</sup> On the preface of the book, the authors state that "...but was it right for so many policy makers to declare by 2005 that the problem of sovereign default on external debt had gone into deep remission? Unfortunately, even before the ink is dry on this book, the answer will be clear enough..." In fact, towards the end of 2009, following the publication of the book, fears of a sovereign debt crisis were intensified among investors given the soaring government debt levels across the globe together with a wave of downgrading of government debt of certain European states. The problems mounted as Greece, Portugal and Ireland were exposed with a serious threat of default in the second quarter of 2010, and were heightened further as the threat was expanded to cover Italy and Spain. This situation so-called the European sovereign debt crisis still poses a major threat not only to Euro area countries but to global economy in general.

is crucial, especially considering the fact that domestic government debt is often ignored, but still matters. Similarly, having data on housing prices is also important for being able to develop an early warning of crises. Second, policy makers must recognize that banking crises are often protracted in nature and cause fiscal balances to deteriorate as bailout costs mount. Third, premature celebration for countries that seem to have recently graduated from debt default is dangerous as many have soon fallen back into default.

### 3. Some Remarks

The book deserves great merit in the measureless effort spent in order to place a variety of financial crises into a perspective and to fully convince the readers that financial crises are normal and to be expected. The book also demonstrates simply yet powerfully that “this time is different” is a common misperception and assumption among financial institutions, investors, economists, and policy makers. The reader, in turn, feels overwhelmed as to how the economics and financial professions largely missed a true understanding of the events leading up to the most recent crisis.

Given the scholarly but non-technical style appealing a broad audience, the entire book can be easily read, despite having 463 pages, a significant portion of which is devoted to tables, graphs, and statistics. Besides, most chapters are self-contained and appropriate for selective reading, and hence, can easily be skipped without losing the basic insight. Indeed, the book is satisfyingly coherent that the reader can manage to grasp the message to be conveyed.

On the other hand, some discussions in the book are overly lengthy since the main message is reinforced repeatedly (and even redundantly) throughout the text. Also, the accuracy of the data certainly needs a further check. Furthermore, the book, even though citing a huge body of literature on previous work, offers surprisingly little economic theory to accompany the findings. In this regard, it is interesting to see the absence of reference to the “financial instability hypothesis” by Minsky<sup>3</sup> which forms the basis of Kindleberger's "Manias, Panics, and Crashes: A History of Financial Crises"<sup>4</sup>, that is frequently cited throughout the book. Similarly, the book lacks the mention of Montier's work<sup>5</sup> on identified biases to which are

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<sup>3</sup> Minsky (1975) in his renowned model, describes five stages of bubbles. In his model, an exogenous event causes new profit opportunities (displacement), increased credit demand and eagerness to lend also accompanied by monetary easing (credit creation), which is followed by speculation for price increases in excess of fundamental investment values (euphoria) before insiders and over-leveraged investors start to sell assets, sending first signals that the bubble may not continue (critical stage/financial distress), and ends with the wide recognition of losses, scared investors, capitulation, and panic (revulsion).

<sup>4</sup> Kindleberger's "Manias, Panics, and Crashes: A History of Financial Crises" on speculative stock market bubbles was first published in 1978, and became popular again in 2000 after the dot-com bubble in the US.

<sup>5</sup> Montier (2007) identifies four behavioral biases in characterizing financial crises. These are *overoptimism*: people often believe they can extricate themselves on a timely basis from whatever bubble or extreme conditions exist, *overconfidence*: people often believe that conditions are different for them and better than for

minds are susceptible, even though this work is extremely relevant to this time is different syndrome.

The adopted view by the book to analyze financial crises is along the lines of mainstream economics, and so, presuming a capitalist economy, where on the other hand, alternative views could have at least been mentioned when spanning such a wide array of centuries and countries. Also, the book fails (or does not intent) to explain the role of monetary policy and regulatory institutions in fueling bubbles, and rather than being analytical, the book takes on a narrative approach in relating the conduct of monetary policy by Federal Reserve to the sequence of events that preceded the latest financial crisis. In the meantime, conduct of monetary policy in other advanced economies and emerging markets, which certainly paved the way for the recent crisis, is entirely overlooked. Similarly, the significance of financial stability and its interaction with monetary policy, the choice of exchange rate regime and the monetary policy framework are completely ignored.

#### **4. Conclusion**

*This Time Is Different: Eight Centuries of Financial Folly* is truly an important addition to the literature of economics and financial history. The book offers significant insight into understanding financial crises by continually emphasizing the role "this time is different syndrome" plays in instigating a crisis. Providing with ample empirical evidence, the book also stipulates many directions for new research as it leaves the reader with more questions than answers.

The book is timely published and wisely constructed fully convincing the reader that the validity of the "this time is different syndrome" will never expire. Having compiled distinctively enormous data, the book rightfully compels that while financial crises come in different varieties, they do not mysteriously happen, but instead, they can be spotted and even controlled especially if politicians and regulators can be immuned to the syndrome.

Finally, this book is likely to affect policy decisions for a long time to come. Even if this time will never be different, as we are now fully convinced, "it's too late to undo the bad forecasts and mistaken policies that have marked the aftermath of the financial crisis, but it's not too late to do better" (Rogoff, 2011).

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others, adverse events will happen to others, not them; *self-attribution*: people take credit for their skill in good outcomes and blame bad luck for bad outcomes and *hindsight*: people forget or overlook what they knew and when they knew it even if it is quite recent.

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