

Carmen Reinhart: Putting the Sub-Prime Crisis in Perspective and the Risks that Remain



Carmen Reinhart is a Professor of Economics at the University of Maryland, and co-author, with Kenneth Rogoff, of the paper "[Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historical Comparison](#)," which was discussed in a previous [article](#) in Advisor Perspectives. Professor Reinhart is a Research Associate in the [National Bureau of Economic Research](#) and serves on the editorial board of the [American Economic Review](#). She has held positions as Vice President at the investment bank [Bear Stearns](#) and more recently, as Deputy Director at the Research Department of the [International Monetary Fund](#). Her areas of academic research include capital flows to developing countries, capital controls, inflation stabilization, balance of payments and banking crises, and contagion. She recently testified before Congress on the causes and cures for the sub-prime crisis.

We spoke with Professor Reinhart on March 19, 2008.

Your paper makes a strong case for a two- to three-year period of economic recovery from the sub-prime crisis, based on historical precedent. Have any of the recent events, including the failure of Bear Stearns and the most recent Federal funds rate cut, changed your opinion about the severity of the crisis or the projected recovery period?

The idea that it takes two to three years to recover is not unique or new. After going through a crisis of this order of magnitude, you do not have willing lenders. Lenders are reluctant to make loans of any kind, irrespective of quality. That is the definition of a credit crunch, and it is not overcome in three to four months; it takes a while. The good news, if it can be considered good news, is that we are six months into the crisis period.

None of the historical examples cited in your paper involved the securitization of debt, which spread the risk of default across a wide range of holders of debt. How important a role does securitization play in differentiating the US crisis from your historical examples?

This is a very sophisticated question. The securitization that took place with Brady bonds was similar. [Editor's Note: Brady bonds were created



in 1989 as a mechanism for mostly Latin American countries to securitize their debt that had gone into default in the 1980s.] Most run-of-the-mill crises do not involve securitization, except in the case of Brady bonds. The current crisis is more unique. As I noted in my testimony to Congress, these sub-prime loans are no better than what would be made to a banana republic. The borrowers were not credit worthy.

I wish I could offer a better answer to this question. It could be that sub-prime debt ends up being repackaged through another round of securitization.

Do the actions taken by the Fed resemble the ways other governments (especially the “big five”) dealt with their crises? What regulatory actions, both in the short term and the long term, have proven to be most successful in dealing with the historical crises you have studied? Should the Fed have let Bear Stearns go bankrupt – and avoid the “moral hazard” dilemma?

The Fed has been really good in terms of how quickly it has acted, but really bad in the way it has acted. The Fed had to reduce interest rates in a hurry, and it acted perfectly in this respect. But doing it in “panic mode” does not instill confidence. One of the big problems Japan had was that it dragged its feet, mostly through indecision with respect to dealing with inflation versus easing credit. We should not worry about inflation now; we can worry about that later. As long as the Fed acts symmetrically, and raises interest rates as swiftly as it has lowered them, it will stem inflation. Our first concern is mitigating the recession associated with the credit crunch.

My opinion of the fiscal stimulus package resembles that of our monetary policy. It is good that we are doing it. It will minimize extent and severity of the crisis, but it will not avoid it.

Looking at Japan in particular (since that is the most industrialized of the “big five” and would seem to be the closest parallel to the US), how close does Japan’s crisis parallel ours? What are the chances that we could be headed for a “lost decade”?

Japan does not resemble others in the “big five.” Norway, Sweden, Finland, and Spain had fixed exchange rates, and Japan did not. These four countries [excluding Japan] did not have the leeway the Fed has. As I mentioned, Japan’s problem was that it sat and waited. Malaise,



inaction, and an unwillingness to admit the problem existed was Japan's downfall. The Fed actions are unparalleled in any of the "big five" crises. What's looking a little scarier, relative to Japan, is that we're getting to lower and lower interest rates, with not much farther to go. I hope - more than think - we are more forthcoming in our willingness to admit the size of crisis. With Bear Stearns, we did not know the size of its losses. Until you pinpoint the problem you do not know the solution, and that is a similarity between the US and Japan. But I am seeing more readiness by our authorities to admit problems, as compared to Japan.

In Japan's case, I characterize their benign neglect as lying. During their crisis, I was co-author of an IMF report that, in part, pegged losses at three times what was being reported, and it almost cost me my job. Once you recognize the order of magnitude you can act accordingly. The Fed is recognizing our crisis and, in that regard, I am hopeful.

Since exchange rates are an area of your research, I'd like to ask a couple of questions about the value of the dollar. One of the most worrisome aspects of the current situation is the decline of the dollar. Has this been a trend in the other crises you have studied? What are the chances of a precipitous decline in the dollar, which could freeze the financial markets?

The best thing that could happen is for the dollar to tank. The US does not have a commitment to a fixed exchange rate. We do not lose credibility when the dollar depreciates. Look at aggregate demand. Consumption is not going to be good, because wealth has been destroyed due to stock market and real estate market declines. We need to recover growth through exports. Our current account deficit is at record levels, and that needs to be fixed. A weak US dollar is not pretty, but it will fix the problem. The current account deficit is a drag on the economy. Our current account depends on three things - real exchange rates, domestic income, and foreign income. We do not want to fix it by reducing our domestic income; we want it fixed through a relative price change [i.e., through exchange rates].

Commodity prices (another area of your research) have spiked recently. Do you attribute this to the fall of the dollar, hedging against inflation and financial risk, pure speculation, or something else? Are commodity prices now in a bubble?

In 1907 there is a parallel. [Ed. Note: The Bank Panic of 1907 followed a surge in commodity prices, and led to J.P. Morgan bailing out market



participants, a precursor to Morgan's current bailout of Bear Stearns.] In 1907, the emerging markets (with the exception of Mexico) were spared, and I see the same in today's crisis. The commodity markets are bailing out the emerging markets. Commodity prices are in a secular downtrend but cyclically have done well. Before we write off the possibility of crises in emerging markets, we now have the best conditions for these markets: high commodity prices and low exchange rates. Before we get too complacent about how they are doing, let us reexamine that. Commodity prices will come down as Asian markets slow down. Things won't look as good for some of the emerging markets, such as countries like Bolivia and Chile.

Since you worked at Bear Stearns, I'd like to ask a couple of specific questions about that situation. The culture at Bear Stearns has been characterized as one which encouraged risk taking, perhaps to a "cowboy" extent. Is this accurate? Were there inadequate risk controls at Bear? Was a collapse such as this inevitable (for Bear)?

Bear was always a risk taking firm: high risk, high return, and high probability of loss. I was very disapproving of the LTCM bailout, and am similarly worried about this bailout. These are high risk enterprises who know what they are getting into. I am very unhappy about encouraging this type of behavior. I expect to see other collapses as high profile as Bear Stearns.

Most advisors take a long-term view of the markets, and would like to believe that this crisis is similar to many others (e.g., LTCM, dot-com) that the US markets have successfully weathered and which rewarded investors with long-term horizons. Is this crisis any different from other US crises, or are we experiencing something fundamentally different? Have you changed your own asset allocation or investment strategy as a result of the sub-prime crisis or recent events?

It has no comparison to the S&L crisis. That hit in 1984, and the trough in the recession was in November of 1982. The economy was growing in 1983 and 1984 was a record year. That crisis took place against a backdrop of a booming economy, not a tired economy. That crisis was not as systemic as this one; it was more localized. These two factors make for no comparison. That is why the "big five" are the relevant comparisons. LTCM was peanuts. Barings, which collapsed in 1995, was a bigger and better company than Bear ever was. When it collapsed,



the British allowed it to go bankrupt. LTCM was localized; they assumed a mean reversion that did not happen.

I am a low risk investor with a long time horizon, and that hasn't changed as a result of the current crisis. If you really want to avoid something over the next few years, it is the financials, because you don't know what risks are hidden. The banks are not forthcoming. I have looked at crises in every economy - advanced and emerging - and banks are never forthcoming.

I have a long term outlook, and we will ride this out.

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