Rethinking the *Rogoff-Reinhart* Thesis

BY BERNARD CONNOLLY

This time, things may not be different…from the 1930s.

Economic historian Niall Ferguson has written of *This Time Is Different: Eight Centuries of Financial Folly,* by Carmen Reinhart and Ken Rogoff, that "This single marvelous volume is worth a thousand mathematical models." That might be considered an instance of damning with faint praise, but it was certainly not intended—nor should it have been, for the book is indeed marvelous. But while the book itself is extremely valuable, what have become known as the Reinhart-Rogoff theses popularly derived from it are a decidedly mixed blessing.

Popular (and policymaker) discussion of the book has erected two propositions. First, that since the Reinhart-Rogoff research shows that output and employment have always had a hard time recovering after a banking crisis, the slowness (or absence) of recovery in many countries now is a function of the state of the banking system and that regulatory or organizational reform of that system is necessary for stronger recovery to be possible. Second, because it seems that growth may have been adversely affected in countries where the public debt ratio exceeds 90 percent, "austerity" aimed at ensuring ratios below that level is a necessary and sufficient condition for faster growth.

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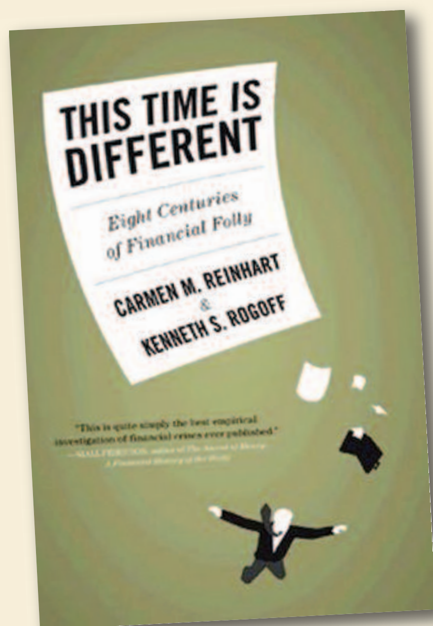

Kenneth Rogoff

Carmen Reinhart

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—B. Connolly

Now it is undoubtedly true that the world would be in better shape if its banking system were healthier. And it is equally true that high public debt ratios are indicative of something that has gone badly wrong. The problem is that both the banking mess and worryingly high public debt are symptoms of an underlying problem. Because the Reinhart-Rogoff book is largely an exercise in measurement rather than theory (while many of the data in the book are new, little or none of the theory is), it can give rise—and has given rise—to dangerously misleading popular interpretations of the data which its authors have so painstakingly assembled.

Reinhart and Rogoff themselves sometimes fall into the trap of simply asserting a direction of causation. This can be dangerous when thinking about the present problems of the world and of the U.S. economy in particular. Thus, for instance, they assert that, "[T]he rise in asset prices [in the United States before the crisis] was being fueled by a relentless increase in the ratio of household debt to GDP, against a backdrop of record lows in the savings rate" (p. 212). But might it not have been the rise in asset prices (or an expectation of continued increases in asset prices) that allowed an accumulation of debt and depressed saving ratios rather than the other way around? Similarly, Reinhart and Rogoff seem to assert (p. 207) that U.S. current account deficits in the pre-crisis 2000s were caused by capital inflows. But might it not have been the other way around? Since the current account is "stickier" than the capital account, this might seem a reasonable question.

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But to answer such questions one needs to set the data within a theoretical framework. Unfortunately, the macroeconomics industry as a whole shies away from doing that. The reason for its reluctance is straightforward. The world, or at least the United States, became dynamically inefficient in the second half of the 1990s (perhaps for the first time since the "roaring twenties"): the real interest rate tended to be less than the expected trend real growth rate. The culprits? Fed Chairman Alan Greenspan, European monetary union, the academic macroeconomics industry as a whole with its worse-than-useless DSGE models, and central banking theology as a whole with its dangerous inflation-targeting obsession. (See my article, "Origins of the Credit Crisis," *TIE,* Fall 2008.) Over-financialization and

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excessive risk-taking by financial institutions were the consequence of this mess, not its cause.

As Rogoff and his co-author Maurice Obstfeld put it in the magnificent, awe-inspiring *Foundations of International Macroeconomics* (ironically, it was published in 1996, just as dynamic inefficiency was taking hold in the United States), "The behavior of dynamically inefficient economies wreaks havoc with much of our intuition about the laws of economics." Put more bluntly, dynamic inefficiency makes a large part of macroeconomics worthless. Financial markets are in a sense ahead of academic macroeconomics in responding: traditional "fundamentals" have now largely been transformed into one overarching "fundamental": the assessment of solvency. As a result, markets are exhibiting binary behavior ("risk-on" or "risk-off"). Mathematically, dynamic inefficiency, bubbles, and Ponzi games are linked very closely together. The world economy has become a collection of Ponzi games. And which country's assets constitute a "safe haven" is largely a question of whether one country's Ponzi game can attract new participants (or even hold on to existing ones) longer than another's. In the case of the EMU Ponzi game, the crisis has arisen because only one conceivable new participant can prevent collapse: the German taxpayer (and German demographics mean there will be fewer German taxpayers in the future, even if current taxpayers were to accept the role of "bigger fool").

It is very important, in thinking about the implications of the Reinhart-Rogoff research, to realize that what deters new participants in a Ponzi game is not an accumulation of debt but a destruction of wealth, or more accurately, a realization that the wealth supposedly backing debt is illusory. Thus the Ponzi game in Spain, for instance, provisionally collapsed when markets realized that the "wealth" required to justify debt was non-existent and that the implied reduction in

A World of Ponzi Schemers

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future Spanish consumption, absent the appearance of a "bigger fool" German taxpayer, would mean, within the constraints of monetary union, depression and deflation and thus default.

Unfortunately, if the wealth of debtors is illusory, the wealth of creditors must also be illusory. Someone has to take losses and someone—debtor or creditor or both—has to face reduced consumption possibilities. There is no getting away from that. The political problem concerns the allocation of losses. That allocation may have macroeconomic effects. But no allocation can "put things right" macroeconomically.

Thus the suggestions often put forward (largely driven by interpretations of Reinhart-Rogoff) that debt forgiveness or a "bit more inflation" to reduce the real burden of debts can get the world out of the mess are quite wrong. The underlying problem is dynamic inefficiency, which reduces future consumption possibilities; and this in turn means that much of recent and current fixed capital formation, notably in the United States, has been based on excessively optimistic expectations of future demand. To prevent a hole in demand emerging as today becomes tomorrow, more and more incentives to keep on bringing spending forward from the future have to be given, whether in the form of reduced "risk-free" bond yields, or attempts to ease credit conditions, or fiscal "stimulus." If a shift of consumption possibilities from creditors to debtors via debt "forgiveness" or via inflation combined with financial repression had the effect of increasing consumption today (because debtors are more current income-constrained than are creditors), consumption tomorrow would be reduced. And, worryingly but increasingly obviously, such attempts, however neces-

sary they might be, to bring spending forward and to avoid a near-term collapse simply reduce the (realistically) anticipated rate of return on capital still further, in a vicious downward spiral.

Increased consumption today can bring increased consumption tomorrow only if today's conditions are Keynesian (as they apparently were in the world for six months or so after Lehman). And that is relevant to the second proposition erected on the Reinhart-Rogoff research. One could indeed see the Lehman shock as an exogenous shift in "animal spirits" and in private sector spending propensities (such shifts, supposedly stochastic, being the keystone of the "new Keynesian" DSGE models which, appallingly, dominate central bank thinking). In such a Keynesian disturbance, budgetary action which succeeds in avoiding an incipient fall in income leaves the private sector in a better financial position than it would have been without the Keynesian disturbance. Thus, when the disturbance disappears, the government can subsequently run a budget surplus, without depressing demand, and restore the public debt ratio to "normal."

That happy state of affairs has clearly not been instantiated anywhere. Why not? Keynesians such as Paul Krugman might argue that the budgetary stimuli around the world in 2008–2009 were just not big enough to avoid (or rapidly reverse) a fall in income and that governments failed to grasp the political nettle of nationalizing the banks so as to be able to make the necessary allocative decisions on credit losses. But there was in fact a V-shaped global recovery, at least in trade, from mid-2009 to early 2010, and most of the world was no longer "Keynesian" by the middle of 2009. But the recovery was truncated. The world is in a state of, at best, growth constrained by the consequences of intertemporal disequilibrium—a persistent tendency, as today keeps on approaching tomorrow, for a hole in demand to emerge because previous demand was excessive given realistic assessments of wealth and thus of future consumption possibilities. Thus budgetary stimulus combined with the "automatic stabilizers" (probably the more important element, as Reinhart and Rogoff insist) during the recession raised debt levels with no offsetting subsequent surplus: indeed the budget deficit remains above baseline indefinitely. Since growth is slow at best, the debt ratio rises sharply. But the interpreters of the Reinhart-Rogoff research get the causality wrong: it is the constraint on growth from intertemporal disequilibrium that produces the high debt ratio, not the other way around.

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If the euro crisis produces a Lehman-like shock, the argument for fiscal stimulus will become a valid one again. And the need for a political resolution of the allocation of credit losses will remain: the banks, at least in Europe, are living on borrowed time, politically as well as financially. But Keynesian stimulus starting from today's position could at very best prevent an immediate "liquidation" crisis. It definitely could not produce "recovery" nor even prevent—except possibly for the briefest of periods—a slow downward grind in activity relative even to potential growth rates which seem to be declining almost everywhere. The Greek tragedy that began with the mistakes of central banks, Euro-imperialists, and the macroeconomics industry in the second half of the 1990s is moving towards a grim *dénouement.* What is becoming terrifyingly clear is that, despite a different set of policy responses, this time may not be different from the 1930s. ◆