This Time is Different: Behavioural Aspects of Financial Crises

By Bruce Grantier[1]

This is an article in the Brandes Institute series, "What is Risk?" Here, I review a recent economics text, This Time is Different: Eight Centuries of Financial Folly, *by Carmen M. Reinhart and Kenneth S. Rogoff*[i]*. The authors point out that inherent human traits seem to be present in many financial crises*[ii]*. I begin with 1) a discussion of the "this time is different syndrome," including models of crises, and 2) a review of some examples of behavioural traits in financial crises and finally 3) a summary of the main types of crises. I would like to express my thanks to my colleagues at the Brandes Institute and the authors, Professors Carmen Reinhart and Kenneth Rogoff, for their great support and helpful comments in writing this.*

This Time is Different includes financial crises of all sorts, going back to the 1300s – debt defaults (sovereign and domestic), hyper-inflation, currency crises, and stock market crashes. While much has been written on financial crises and the behavioural aspects of investing, this book stands out in that it abundantly illustrates the surprisingly high repetition of financial crises and the equally surprising nature of participants who believe this time is different. In doing so the book provides an invaluable reminder to investors of the frequency and nature of financial crises.

1) This Time is Different Syndrome

The phrase "this time is different" was chosen by the authors since, "More money has been lost because of these four words than at the point of a gun."[2] The authors discuss how different financial frenzies have remarkable similarities and also discuss the arguments which prevailed at the time and caused observers to exhibit the this time is different syndrome.

Behaviourists and economists both refer to a well-accepted model by economist Hyman Minsky[iii] describing "The Five Stages of Bubbles:"

1. **Displacement:** Considered an exogenous shock which triggers new profit opportunities.
2. **Credit Creation:** Sometimes caused by credit demand to finance assets, sometimes by monetary easing due to economic stress, sometimes by the optimism of banks and eagerness to lend to new opportunities.

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[2] Reinhart, Carmen M. and Rogoff, Kenneth S. *This Time is Different: Eight Centuries of Financial Folly,* Princeton University Press, 2009. Page xxxvii.

3. **Euphoria:** Speculation for price increases in excess of fundamental investment values – e.g., "greater-fool theory" or the popular consensus that "making money was never so easy."

4. **Critical Stage/Financial Distress:** Could be insiders selling, rising price of credit, or initial failures of over-leveraged investors. Generally, it is the first awareness that the bubble may not continue.

5. **Revulsion:** Wide recognition of losses, scared investors, capitulation, and panic.

Behaviourists have identified many forms of bias to which our minds are inherently susceptible. According to James Montier, author of behavioural finance books, there are some 22, which generally fall under four basic sources: self-deception, simplification, emotion, and social interaction, of which the most important are:

1. **Overoptimism:** people overestimate their ability.

2. **Overconfidence:** people feel more confident than they should be.

3. **Self-attribution:** people take credit for their skill for good outcomes, and blame bad luck for bad outcomes.

4. **Hindsight:** people forget or overlook what they knew and when they knew it.

These biases are evident in Montier's discussion of the predictability of bubbles and forecasting in general. He notes that bubbles are often not the "black swans" popularized by Nassim Taleb. The so-called "black swan events" are more often recognized and denounced.

As Reinhart and Rogoff put it very clearly:

> *…The "this time is different syndrome" is simple. It is rooted in the firmly held belief that financial crises are things that happen to other people in other countries at other times: financial crises do not happen to us, here and now. We are doing things better, we are smarter, we have learned from past mistakes. The old rules of valuation no longer apply. The current boom, unlike the many booms that preceded catastrophic collapses in the past (even in our country), is built on sound fundamentals, structural reforms, technology innovation, and good policy. (page 15)*

2) Examples of the Behavioural Aspects of Crises

The authors illustrate the this time is different syndrome throughout the book with many examples.

1. The U.S. financial crisis of 2007/8

While much has been written on this, the following points out a repeat of past excesses and a reluctance to deal with the ensuing problems, even as they were recognized. Housing prices in real terms doubled over 1996 to 2006 and equity markets soared, all fuelled by record

trade and current account deficits. Thinking at the time included many of the "this time is different" sentiments:

> *...Everything is fine because of globalization, the technological boom, the superior U.S. financial system, better understanding of monetary policy, and the phenomenon of securitized debt ...Fed and Treasury officials often argued that financial innovations such as securitization and option pricing were producing new and better ways to spread risk, simultaneously making traditionally illiquid assets, such as houses, more liquid... hence higher and higher prices for risky assets could be justified... Fed and Treasury officials also argued that the gaping trade deficit was to a significant extent, simply a reflection of a broader trend toward global financial deepening that was allowing countries to sustain much greater current account deficits and surpluses than in the past. (page 20)*

2. The Crash of 1929

An advertisement (see Exhibit 1 on the following page) from *The Saturday Evening Post* dated September 14, 1929[iv] by Standard Statistics Inc., points out that the 1719 panic-stricken frenzy of the Mississippi venture need not occur today (1929). Quoting the advertisement:

> *History sometimes repeats itself – but not invariably ...Today it is inexcusable to buy a "bubble"... every investor...has at his disposal the facts...which as far as humanly possible... eliminate the hazards of speculation and substitute in their place sound principles of investing.*

EXHIBIT 1: Saturday Evening Post Advertisement, September 14, 1929 (Reprint)

Source: *This Time Is Different,* page 16.

3. Post-Crash Emerging Market Defaults

Following World War I, the major combatant countries had built up enormous debts. These appeared isolated and explainable in contrast to regions such as Latin America and Asia, whose public finances (mistakenly) seemed reasonable. Additionally, from post-WWI into the 1920s, there developed a period of relentless global optimism, led by global peace and the sentiment that WWI would not be soon repeated. Thinking at the time included:

> *...There will never be another world war; greater political stability and stronger global demand will be sustained indefinitely; and debt burdens in developing countries are low. (page 15)*

The 1929 global stock market crash, however, destroyed this confidence and led to the Great Depression and the largest wave of defaults in history.

4. The Debt Crisis of the 1980s

A generation after the above-noted aftermath of the Great Depression, lending to emerging countries had resumed and indeed was viewed as quite profitable. The early 1970s brought a world-wide commodity boom, real interest rates were unusually low and Latin American defaults were fading from memory. Thinking at the time included:

> *...There are skilled technocrats in government, money is being used for high return infrastructure investments, and bank loans are being made instead of bond loans as in the post WW I period. With banks actively lending there will be an incentive for information gathering and monitoring to ensure the monies are well spent and loans repaid. (page 17)*

The 1970s build-up ended in steeply higher interest rates and a collapse in commodity prices (70% from their peak), causing Mexico's most notable default in 1983 and dozens of others including Argentina, Brazil, Nigeria, the Philippines, and Turkey.

5. The Asian Debt Crisis of the 1990s

Foreign capital flowed into Asia in the mid-1990s, based on high household savings rates, strong government fiscal positions, and quasi-pegged currencies to the U.S. dollar. Thinking at the time included:

> *...The region had a conservative fiscal policy, stable exchange rates, high rates of growth and savings, and no memorable history of financial crises. (page 18)*

Overlooked was the weakness of the currency pegs, which were implicit rather than explicit and masked governments' inability to intervene to stem foreign exchange losses. Thailand, Korea, and Indonesia were all forced into gigantic bailout packages by the International Monetary Fund.

6. The Latin American Debt Crises of the 1990s and 2000s

Despite recent memory, international creditors again poured funds into the Latin American region, based on: (ironically and perversely) using bonds instead of bank debt, spreading loans across a broad array of bond holders, assuming that a shift from dictatorship to democracy was much more stable, and (again) Argentina was not risky because of its "immutable" peg of its exchange rate to the U.S. dollar. It was believed that Mexico was not a problem as it would now be under the North American Free Trade Agreement ("NAFTA"). This time is different thinking included:

> *Bond debt is now safer than bank debt... Many more bond holders are involved...Countries will now be reluctant to default because renegotiation would be so difficult. (page 19)*

Mexico led the way to collapse in December 1994, the year it entered NAFTA. Shortly thereafter, Argentina's $95 billion default was the largest in history at that time, later accompanied by Brazil and Uruguay.

3) Summary of the Book

This Time is Different represents a significant collection of data on financial crises. Both authors have written about this in numerous preceding papers.[v] The data collection is notable in its long history and broad geopolitical scope.

The massive, hitherto unassembled collection of data on financial crises dates back to the 1300s and covers up to 66 countries.[vi] The very early financial crises (Europe: 1300 to 1600) were mainly external debt defaults. For example, England defaulted on debt in 1340, 1472, and twice in 1594. These were not due to behavioural traits, but monarchs simply defaulting (sometimes executing their creditors). Exhibit 2 shows historical defaults in Europe.

EXHIBIT 2: The Early External Defaults, Europe 1300-1799

Country	Years of Default	Number of Defaults
Austria	1796	1
England	1340, 1472,1594*	2*
France	1558,1624,1648,1661,1701, 1715,1770,1788	8
Germany (Prussia)	1683	1
Portugal	1560	1
Spain	1557,1575,1596, 1607,1627,1647	6

Sources: Reinhart, Rogoff, and Savastano and sources cited therein, MacDonald, 2006. (Page 87 in *This Time is Different.*)
* denotes authors' uncertainty at the time as to whether England's default was on domestic or external debt.

A note on stock markets: Reinhart and Rogoff's early data begins around 1300 – well before today's stock markets were developed. Joint-stock limited liability-companies first appeared around 1600 as precursors to today's publicly held corporations and were bought through private subscriptions which traded informally. The first, more formal or regular stock exchanges appeared in London in coffee houses in the so-called "Exchange Alley" around 1690.

Published in 2009, the book also examines the recent 2007/2008 sub-prime crisis, which the authors call the "Second Great Contraction." They propose a new index, the banking, currency, debt, and inflation ("BCDI") index (described below) which allows comparisons of different types of crises over the long term.

This Time is Different: Behavioural Aspects of Financial Crises

The book is organized around six main types of crisis:

1. Sovereign Debt Defaults
   - External debt defaults in Europe from 1300 to 1800, as mentioned, which includes the era of Florentine city-states, the Napoleonic Wars, and Spain's numerous defaults due to inflation and debasement of its currency associated with New World silver and gold discoveries.
   - Default and rescheduling from 1800-onward in the emerging economies of Asia, Africa, Latin America, and to a lesser extent Europe (due to World Wars I and II).
   - The concept of "graduation," whereby now mature/wealthy economies have had no recent sovereign debt defaults. For example, the last defaults that occurred were for the United Kingdom in 1594, Spain in 1647, and France in 1778.

2. Domestic Government Bond Defaults
   - Defaults on domestic debt are on a far smaller scale than sovereign defaults (70 domestic vs. 250 sovereign since 1900) but nonetheless surprising when one considers that domestic debts are really debts to the country itself.
   - This latter aspect engenders a discussion of the political tradeoffs governments face when they are faced with the prospect of domestic defaults.

3. Banking Crises
   - While "graduation" may apply to mature economies, no such phenomenon applies to banking crises. Rich and poor are equally susceptible to banking crises and indeed housing crises as well, which are often the cause of a banking crisis.
   - This section covers the proportion of countries with banking crises since 1900, plus real housing prices in the United States since 1900.

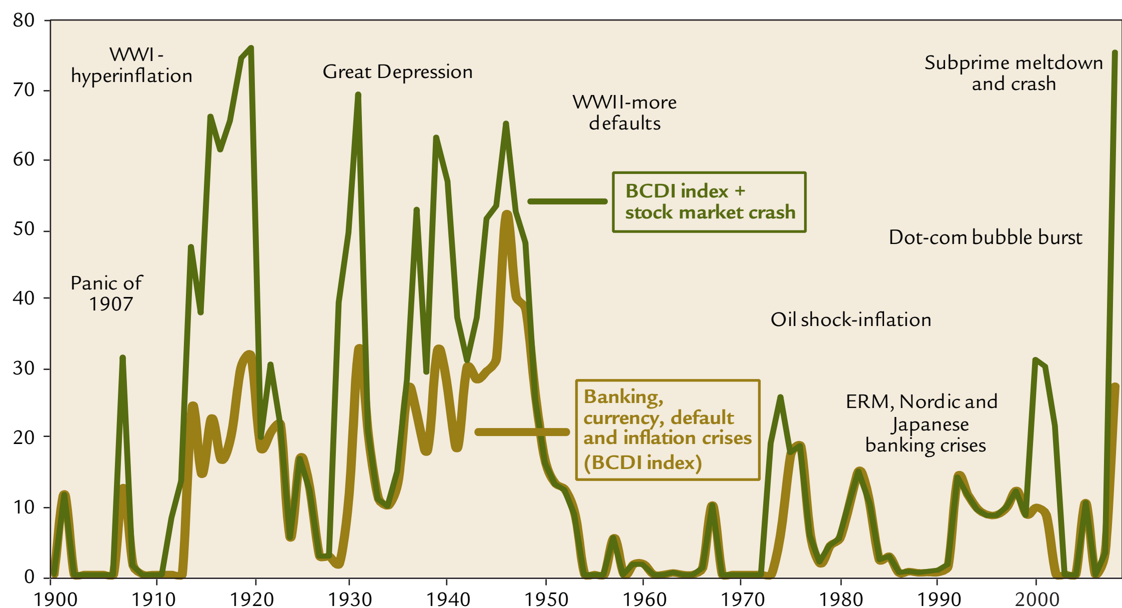
4. Currency Crises
   - A long history of expropriation through currency debasement in Europe is addressed (mid-1200 to 1800), including a decrease in silver content of currency during the Napoleonic Wars.
   - High inflation in Asia, Africa, and the New World (1500 to 1800) are discussed, as well as in Europe, Latin America, North America and Oceania since 1800, concluding with a summary of major currency crashes 1800 to date.

5. Inflation Crises
   - Median Inflation rates using 5-year moving averages since 1500 are calculated, plus the incidence of inflation rates above 20% in Asia, Africa, Europe, and Latin America, since 1800.

6. The Subprime Crisis

- Global crises since 1890, including global stock markets during global crises and (ir)relevance of country credit ratings are examined.
- Sequences of prototypical crises are identified, including inflation, growth in debt, trade deficits, and banking crises. Excessive debt is a consistent recurrent feature of the model.
- The BCDI is used to compare the Second Great Contraction with the Great Depression. The BCDI, as noted, is a composite index of crises of five types: banking, currency, sovereign default, inflation, and stock market crashes. (If all five occur the country gets a "5" for that year). The scores for 18 large economies are then summed and weighted by their share of world GDP. The results are shown in Exhibit 3 for 1900 to date, indicating the severity of the recent financial crisis.

EXHIBIT 3: The Subprime Meltdown in Historical Context



Source: *This Time Is Different*, page 254.
Past performance is not a guarantee of future results.

Concluding Remarks

James Montier's top four behavioural biases seem quite appropriate in characterizing financial crises.

1. **Overoptimism:** people often believe they can extricate themselves on a timely basis from whatever bubble or extreme conditions exist.
2. **Overconfidence:** people often believe that conditions are different for them, and better than for others; adverse events will happen to those others, not them.
3. **Self-attribution:** people take credit for their skill for good outcomes, and blame bad luck for bad outcomes. Prior to the crisis, people took credit for turning packaged subprime loans into AAA-rated mortgage-backed security tranches. After the crisis they blamed the bad misfortune of a six-sigma event on the widespread defaults and write-downs.
4. **Hindsight:** people forget or overlook what they knew and when they knew it – even if quite recent.

This last trait is, indeed, reflected in the subtitle of the book itself: *Eight Centuries of Financial Follies*.

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[i] Reinhart, Carmen M. and Rogoff, Kenneth S. *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009. From their respective websites:
Carmen M. Reinhart is Professor of Economics and Director of the Center for International Economics at the University of Maryland.
Kenneth S. Rogoff is Professor of Economics, and Thomas D. Cabot Professor of Public Policy, Harvard University.

[ii] Literature on financial crises, their economic causes, and, in some cases, their human behavioral aspects:

Montier, James. *Behavioural Investing: A Practitioner's Guide to Applying Behavioural Finance*, Wiley Finance, 2007.

Ferguson, Niall. *The Ascent of Money: A Financial History of the World*, Penguin Press, 2008.

Chancellor, Edward. *The Devil Take the Hindmost: A History of Financial Speculation*, Plume, 2000.

Kindelberger, Charles. *Manias, Panics and Financial Crises: A History of Financial Crises*, Palgrave MacMillan, 2005.

Mackay, Charles. *Extraordinary Popular Delusions and the Madness of Crowds*, New York, 1932.

Green, Stephen. *Good Value: Reflections on Money, Morality, and an Uncertain World*, Allen Lane, 2009.

[iii] Minsky, Hyman, *John Maynard Keynes*. Columbia University Press, 1975.

[iv] From *This Time is Different*, p. 16.The authors thank Professor Peter Lindert for sending this advertisement.

[v] See, for example: Reinhart, Carmen M. and Rogoff, Kenneth S. *The Aftermath of Financial Crises, American Economic Review* 99, May 2009.

Reinhart, Carmen M. and Rogoff, Kenneth S. *Banking Crises: An Equal Opportunity Menace*, manuscript, University of Maryland, December 2008.

Reinhart, Carmen M. and Rogoff, Kenneth S. NBER Working Paper 13946, April 2008.

[vi] For example, Reinhart and Rogoff cite Niall Ferguson's *The Ascent of Money* for its excellent discussions of the defaults of the Florentine city states in the 13th century and Spain's defaults in the mid 16th century due to huge newfound wealth in New World gold and silver.

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Bruce is retired from Scotiabank, where he was Managing Director, Pension Assets, responsible for investment policy, asset allocation, manager selection, and alternative assets for Scotiabank pension funds. Previously he was involved in policy, strategy, and fixed income portfolio management for Scotia Investment Management. He earned his BASc at the University of Toronto and MBA at York University. He is a CFA and CAIA charter holder and member of the CFA Institute and Chartered Alternative Investment Analyst Association. He has written articles and reviews for investment industry publications such as the *Journal of Investment Management*, the *Financial Analysts Journal*, and *Benefits and Pension Monitor*. In addition to his role as an Advisory Board member of the Brandes Institute, he serves on the Queen's University Investment Committee, the Toronto Archdiocese Investment Committee, the Board of Governors, Catholic Missions in Canada, and is a director of the Provenance Life Insurance Company.

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