# Carmen Reinhart

## On twin financial and currency crises, the future of the dollar, and sovereign debt


IMAGE: COURTESY MARTHA STEWART

**Carmen Reinhart is a leading authority on financial crises in both advanced and emerging economies thanks to timely and groundbreaking research like her acclaimed 2009 book, *This Time is Different: Eight Centuries of Financial Folly*, with frequent co-author and fellow Harvard University economist Kenneth Rogoff. Yet despite the influence she has had on the profession, she wasn't drawn to economics until later in life.**

**"In high school, I would have been shocked if someone had told me I'd become an economist," she says. "I wanted to study fashion design."**

**Fortunately for everyone who has benefited from her research over the years, she hated her college courses in fashion merchandising and was instead drawn to her principles of economics class. Once she made the switch, international topics became an early focus. After completing her master's degree at Columbia University, she went to work for Bear Stearns in March 1982. About five months later, Mexico defaulted on its debt, engulfing numerous Latin American countries and U.S. banks in a crisis and solidifying Reinhart's interest in international economics.**

**"My research has always been very influenced by real-time events," she says.**

**She became Bear Stearns' chief economist in 1985 before returning to Columbia University to complete her Ph.D. in economics under future Nobel laureate Robert Mundell. Afterward, she served as an economist at the International Monetary Fund (IMF) until 1996, when she joined the faculty of the University of Maryland. She has held top positions at the IMF, the World Bank Group, and the Congressional Budget Office Panel of Economic Advisors, among other institutions. Since 2012, she has been the Minos A. Zombanakis Professor of the International Financial System at Harvard's Kennedy School. In addition to her work on financial crises, she has studied international capital flows, the effects of government debt, the costs of default, and exchange rate systems, among other topics.**

**Tim Sablik interviewed Reinhart in April.**

**EF: You were born in Cuba and immigrated to the United States with your parents at the age of 10. Did your childhood experiences shape your economic research interests?**

**Reinhart:** I think they did in two ways.

One is not specific to economics, but my experiences instilled in me the value of education. I remember my parents telling me that education is what you take with you. We were refugees. My parents had to leave all their worldly possessions behind — we came to the United States with just three suitcases. My parents' human capital was really all they had, so the importance of education was driven home for me from an early age.

In terms of the economic dislocations I saw in Cuba — the default, the collapse of the currency, the embargo — I did not realize it at that time because I was very young, but in hindsight I think those definitely played a role in my interest in international crises.

**EF: Was that interest in international issues what led you to the IMF early in your career?**

**Reinhart:** After I finished my field exam at Columbia, I convinced myself that I could work full time at a brokerage firm and do my dissertation. Needless to say, that did not happen.

I went to Wall Street in March 1982, and Mexico defaulted on its debt in August. I remember [Fed Chair] Paul Volcker talking about the exposure U.S. banks had to Mexico and Latin America, and we were all watching the dominos start to fall. It reinforced my already strong interest in international economics. Those were very volatile years, but also quite formative.

It was around this time, too, that the IMF's involvement in the developing and emerging market world really began in earnest. In its early years, a lot of the IMF's programs were focused on advanced economies like the U.K. or even the U.S. Of course, Argentina was one of the first clients of the fund. But this was the first time the IMF faced widespread issues, balance of payments crises, and debt crises. It wasn't just confined to Latin America; the Philippines were also having a debt crisis. I became very intrigued by the work the IMF was doing. So, after about four years at Bear Stearns, I went back to do my dissertation at Columbia. I did it in nine months because I really knew what I wanted to write about.

My advisors, Bob Mundell and Ron Findlay, wanted me to go into academia, but I was determined to go to a policy institution. I chose the IMF, and it was an excellent experience. Being in the research department offered me the combination of a policy and an academic position. I was exposed to what the institution was doing with its lending programs in various countries. At the same time, I was in a very academic setting and, as a young person, having time to do research is invaluable at that stage in your career. I was very fortunate that Guillermo Calvo, who had been at Columbia and had been my professor, was there as a senior advisor in the research department. Jacob Frenkel was the research director and chief economist, and it was a very good environment for a young person to land in.

**EF: You wrote one of your seminal papers around this time with Graciela Kaminsky exploring the idea of "twin crises," which refers to the propensity of banking and currency crises to occur together and amplify one another. The topic got a lot of interest after the Mexican peso crisis of the mid-1990s and the Asian financial crisis a few years later. Are twin crises limited to emerging market economies, or could a similar style crisis happen in the United States?**

**Reinhart:** The U.S. is not a particularly good example. Twin crises have occurred in advanced economies, and some were included in our study, but what has made the U.S. different historically is the dollar's reserve currency status. You can see this clearly during the global financial crisis of 2007-2009. The subprime mortgage problems started evolving in the U.S. first before spreading to other countries. Despite that, people were running to the dollar and to Treasuries. Vincent [Reinhart] and I wrote a piece at that time in which we observed that it's not often that you see people running into a burning building! But that was what was happening.

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Thinking about other advanced economies, the U.K. had a twin crisis. The eurozone is much more difficult to categorize, but the euro did crash against the dollar around the time of the global financial crisis. It's not really appropriate to say Ireland had a twin crisis, because Ireland doesn't have its own currency anymore, but Iceland certainly did. And there were twin crises in Sweden, Norway, and Finland in the early 1990s, which were included in our study. Those were subsequently seen as role models for how to handle a twin crisis. But in the U.S., it has played out differently because of the dollar's reserve currency status. Historically, when there is a global crisis, we see a flight to the dollar. Now, I have to say, we've experienced some global turbulence in recent weeks, and we haven't seen that flight to the dollar this time. So things might be changing, but that remains to be seen.

**EF: On the topic of the dollar's special status, in a 2019 *Quarterly Journal of Economics* article with Ethan Ilzetzki and Kenneth Rogoff, you wrote that "the dollar remains dominant in the twenty-first century and by some measures is even more central to the international monetary system than in the heyday of the Bretton Woods system." Do you still feel that way?**

**Reinhart:** That's a question I've been getting more and more these days.

When we talk about the dollar's dominance, it's important to first remember that central banks and investors are not buying greenbacks, they're buying Treasuries. And it is the unmatched liquidity of the Treasury market that supports the role of the dollar. Ethan, Ken, and I wrote a companion piece to the paper you mentioned titled, "Why Is the Euro Punching Below its Weight?" When the euro came into being, for a while it looked like, while it might not replace the dollar, you could have a situation with dual reserve currencies. Before the global financial crisis, investors tended to view all European debt — whether it was French debt, German debt, Greek debt, or Irish debt — as close substitutes. Of course, the global financial crisis completely destroyed that perception. What it boils down to is that you have very fragmented debt markets in the eurozone that don't offer the liquidity of the U.S. Treasury market. The euro is a unified currency, but there is no unification of the underlying assets that support the currency.

Others have argued that the Chinese renminbi could be a contender to replace the dollar. I've never really entertained that possibility because, as Rudi Dornbusch used to say, people only go to a party if they think they can leave whenever they want to. China has capital controls, which directly impacts the liquidity of their debt market. How could you have as a reserve currency an underlying asset that in a time of need you can't sell? So, our argument about the dollar's dominance as a reserve currency in the 2019 article rested on a lack of alternatives.

Now, let's fast forward to today. There's a lot of economic and policy uncertainty and, contrary to other moments of global stress, the dollar has depreciated rather than appreciated. Is this the end of the dollar era? Let's not jump the gun. The dollar has had numerous crashes in the postwar era without losing its reserve currency status. The breakdown of the Bretton Woods system saw the dollar depreciate more than 50 percent against the German deutsche mark, for example.

Another thing that some people worried about the dollar's status have pointed to is the fact that reserve accumulation of dollar assets around the world has slowed and even begun to decline. That is true, but I think it is overstated. If you look at the Federal Reserve's balance sheet, the rest of the world has bought fewer Treasuries but more repurchase agreements. So there has been a substitution but not away from the dollar. It is a substitution between two different dollar assets.

Having said all this, are there new developments that could allow another currency to compete with the dollar? I think so. I mentioned that the eurozone has fragmented, comparatively illiquid debt markets, and the German market, which is the most desirable from a reserve currency point of view, is small compared to the United States. The Germans have not been issuing a lot of debt, but more recently we've seen increased German willingness to provide fiscal stimulus and thus issue more debt. We've also seen efforts to start thinking about a common eurozone debt instrument. Both of those things are not going to happen overnight, but the development of deeper markets would be supportive of the euro gaining more ground. Still, it's too early to tell, and I don't think we should interpret the fluctuations of the dollar's value as necessarily telling us anything about its future as an anchor currency.

## Carmen Reinhart

**PRESENT POSITION**

Minos A. Zombanakis Professor of the International Financial System, Harvard Kennedy School

**SELECTED PAST POSITIONS**

Senior Vice President and Chief Economist, World Bank Group (2020-2022); Professor, University of Maryland School of Public Policy and Department of Economics (2000-2010); Senior Policy Advisor and Deputy Director, International Monetary Fund (2001-2003)

**EDUCATION**

Ph.D. (1988), M. Phil (1981), M.A. (1980), Columbia University; B.A. (1978), Florida International University

**EF: The U.S. and many other countries took on a lot of debt in their response to the COVID-19 pandemic. You became the chief economist at the World Bank in June 2020, in the middle of that crisis. What are your thoughts on the fiscal and monetary policy responses to the pandemic? What lessons should policymakers take away from that episode?**

**Reinhart:** When Ken and I wrote *This Time is Different*, we focused on the histories of a broad swath of economic crises — banking crises, sovereign debt crises, currency crashes, inflation, and so on. But a health crisis? You have to go back to the influenza epidemic of 1918. This wasn't the sort of crisis that fit the pattern we described in the book: a period of increased leverage leading to asset price bubbles and then a crash. So, I was one of the people during the COVID-19 pandemic saying that this time really was different! This was not the time to worry about debt accumulation.

We faced a massive global shock that led to the most synchronous decline in global per capita GDP in over a century. In the World Bank's 2022 *World Development Report*, we have a chart that shows the share of countries globally that experienced a decline in their annual per capita GDP going back to 1900. The share during COVID was close to 90 percent, which was higher than during both World Wars and the 1930s.

That said, one can be critical of specific aspects of the fiscal response. My colleagues Jason Furman and Larry Summers have both been very vocal about the U.S. having done too much stimulus. Certainly, we were at the top of the distribution. But I think the relatively swift moves toward monetary and fiscal stimulus helped mitigate the fact that economic activity came to a screeching halt. In countries like the U.S., greater fiscal and monetary capacity allowed the governments to respond swiftly and strongly to the crisis.

Another lesson that became a sort of mantra when I was at the World Bank was the importance of building resilience. We all learned the importance of paying attention to supply chains for crucial goods like food and medicine. In the case of fiscal stimulus, it suddenly became important to think about how you can disburse transfers rapidly. This was a particular concern for countries with poor levels of digitization, but it was also a question that came up in the U.S. So, we need to pay more attention to resilience building. These types of shocks, which we thought were long gone, are still with us.

**EF: What are the costs of sovereign debt accumulation on economic growth?**

**Reinhart:** For countries with over 90 percent debt-to-GDP, average growth is about 1 percent slower per year. While the idea of a "debt threshold" at which growth slows down has been a bit overdone, certainly there are past and modern examples of advanced economies that have had a perceived debt overhang for some time and much slower growth.

In recent years, there has been more concern about debt in the U.S. and other advanced economies. I've been concerned about debt accumulation for a long time, but until recently, there was a lot of complacency around sovereign debt that stemmed in part from the fact that, since the global financial crisis, we have had a stretch of time where real interest rates were negative. In the case of Europe and Japan, even nominal rates were negative. In that environment, it is very easy for growth rates to exceed interest rates. I never shared that complacency, though, because interest rates move. Some people began to think that low for long meant low forever.

**EF: Are you concerned that U.S. debt is approaching a level where it might start to weigh on growth?**

**Reinhart:** The recent surge in U.S. debt has outpaced many other advanced economies. Since the end of the pandemic, we've had ample opportunity — with a very tight labor market — to deliver more balanced budgets that would not continue to add to our debt, but we haven't done so. Am I worried? Yes. Debt servicing has become more costly. Additionally, in the recent past when inflation and interest rates were low for long, volatility was suppressed. Now we have a combination that is much more difficult to manage: very high levels of debt, higher interest rates, and higher volatility. This is a scenario that many people had discounted prior to the inflationary shock that came at the tail end of COVID.

The issue that I've always highlighted in my work is that there's no silver bullet for dealing with high levels of public debt. Many countries might wish they could grow out of their debt, but that's aspirational. Japan has been aspiring to grow out of its debt for decades. This is complicated by the fact that, as we discussed, growth is slower in periods of high debt burdens. That finding is based on long historic averages. If you look at Greece's recovery from the global financial crisis, their per capita income in recent years was still below what it was before the crisis. So, there are no easy ways of delivering debt reduction. Growing out of the debt is unlikely if growth is slowing. Fiscal tightening is difficult. Inflation as a means of debt reduction is very unappealing. Debt restructuring, which is another term for defaulting, is also very unappealing.

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**EF: In aftermath of World War II, the U.S. and other countries reduced their debt burden through a variety of policies that you and others have called "financial repression." This includes things like capping interest rates or requiring domestic financial institutions to hold government debt. Do you think financial repression could be used to address current debt levels?**

**Reinhart:** I think we've already been doing some of that, perhaps without being so aware of it. Going back to 1900, there have only been four periods of sustained, negative real short-term interest rates: World War I, World War II, the 1970s, and the last and longest was following the global financial crisis. Each of those periods drove inflation higher. And, especially around World War I and in the aftermath of World War II, financial repression played a big role.

The modern financial repression after the global financial crisis was a milder version of what we saw at the end of World War II. Financial repression is essentially trying to get better financing terms for the government, enabling a country to borrow at a lower cost than it otherwise would have. There are mild and more extreme versions, but what you typically see in financial repression episodes are negative ex-post real interest rates. If you have a negative real return, that's a tax on the bondholder. The question is, how do you ensure bondholders pay that tax? At the end of World War II, the U.S. and everyone else had capital controls. That makes it easier to get banks, firms, households to hold your debt even if returns are negative because they can't hold any other assets from abroad. It immediately restricts the menu of possibilities.

We didn't see anything that draconian after the global financial crisis, but we did see milder versions. Banks were asked to hold higher shares of their portfolio in government securities. Now, one could say that policy was strictly for macro prudential reasons. But the fact is, it generated captive audiences. Besides the macro prudential reasons, how much moral suasion was applied to financial firms? I think it varied from country to country. I remember delivering the Angelo Costa lecture in Rome as the Greek debt crisis was unfolding in 2011, and the dinner conversation revolved around the Italian Treasury twisting the arms of banks to buy government bonds to improve the outcomes of government debt auctions. In Spain, the public pension fund, which was diversified before the global financial crisis, ended up holding practically 100 percent in government paper. That said, we did not see extreme examples of financial repression after the global financial crisis. There wasn't a return to capital controls. At the end of World War II, capital mobility was not the norm as it has been in the modern era.

Looking ahead, I think financial repression of the milder form that I just described was easier to justify and deliver in the decade and a half after the global financial crisis. There was the perception that interest rates would be low forever. There were all kinds of explanations for why real interest rates were negative and would remain low. I think perhaps one explanation that was underweighted in much of that discussion was the fact that central bank balance sheets grew a lot during the global financial crisis. That allowed for ample monetary accommodation without inflationary consequences, and it facilitated low-to-negative real interest rates. With the post-COVID inflationary spike, we seem to be heading into an era with more uncertainty and higher levels of volatility, so I think that sort of mild financial repression will be much more of a challenge to implement.

**EF: As you and many other economists have documented, dealing with debt is generally preferable to default, as the economic costs of defaulting can be substantial. You've recently been studying the social costs of sovereign default. What have you found?**

**Reinhart:** The social costs of default have been overlooked in the economics literature. Typically, when one thinks of all the costs of default, there are the political costs, the fear of retaliation in terms of getting shut out of capital markets, and the economic costs. But related to those economic costs, you could think about the costs for households in terms of nutrition or health outcomes, for instance. And the research on those costs was a blank sheet. So, I wrote a paper with Juan Farah-Yacoub and Clemens Graf von Luckner, former students of mine, trying to quantify those costs.

The results are pretty striking in terms of direction and duration. Life expectancy compares poorly versus the non-defaulters, and there is some increase in infant mortality. But the biggest effect that we see, apart from per capita GDP, is on poverty measures and things like caloric intake. So, the human toll of sovereign default is significant and long-lasting.

**EF: What else are you working on now?**

**Reinhart:** I'm in the process of revisiting the massive database on crises that Ken and I created for *This Time is Different* — expanding the coverage and bringing it up to date. Related to what we've been talking about, globally we've weathered a lot of storms in the last decade. Some classic storms, like the crashing commodity prices for many emerging markets in 2015, and then subsequently the COVID-19 pandemic and the inflation spike that followed. So far, a lot of the dislocations that we saw in the 1980s, the debt crises erupting in many different countries, have been avoided, except for in low-income countries.

A lot of those low-income countries borrow from China. One big area that I have been working on in recent years is China's overseas lending. I recently completed a paper on this topic for the *Journal of Economic Perspectives* with my co-authors Sebastian Horn and Christoph Trebesch. China's overseas lending has outpaced the World Bank and is greater than the IMF and the Paris Club combined. The World Bank's lending only caught up to China's in the last couple of years following the COVID-19 pandemic.

But China now has its own financial problems with a housing market crash and a lot of provincial debt. Adding to those problems is the fact that many of the countries China has been lending to can't repay. This is a topic that is being discussed at institutions like the IMF and the World Bank, and it is something I'm going to continue to work on and see how it plays out. This year, I think tariffs and the prospects of a global recession will take center stage, but this issue of how to resolve the debt problems that have accumulated in lower-income countries is not going away. **EF**