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Mats Larsson & Jan Ottosson

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Foreword

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Editors

Mats Larsson is a Professor in Economic History, Uppsala University and Head of Uppsala Centre for Business History (UCBH). He is the principal investigator in UPIER work package 3, Regulatory traditions and legislative homogenization mats.larsson@ekhist.uu.se

Jan Ottosson is a Professor at the Department of Economic History, Uppsala University jan.ottosson@ekhist.uu.se

Financial crises— international dissemination and consequences in historical perspective.

Abstract

This paper is a documentation of a seminar on financial crises held I Uppsala, Sweden. The three presenters at this seminar were all distinguished Professors in economic history with previous research within the field of financial crises. Professor Richard Roberts from King´s College, London gave a broad presentation of the typology and development of financial crises during the last two centuries and how crises can be connected to different financial regimes. Professor Catherine Schenk from Oxford University focused on the development of financial crises after 1965 and especially the role of the expanding international financial market for the development of debt crises. Finally, Professor Youssef Cassis from the European University Institute (EUI) in Florence focused on the role of financial centres in the development and transmission of financial crises from one place to another, but also on the role of financial crises in the rise and fall of financial centres. The seminar ended with a discussion.

Introduction

Mats Larsson and Jan Ottosson

The role of financial crises in history has been of central concern since the crisis of 2007- 2008. Professor Howard Davies concluded that over thirty different explanations for this crisis were currently doing the rounds a number of explanations have been put forward in scientific debate. Certainly, financial crises and their aftermath are still – even as we write – a feature of the world we live in. The developments in Greece remain a matter of ongoing concern: this financial crisis has certainly not been fully examined in contemporary research. But an increasing amount of research within the field of economic history is helping us to develop a broader comparative understanding. Moreover, we are witnessing a period of mounting interest in historical analysis due to the problems caused by the lack of explanations for economic crises within certain fields of macroeconomics.

Of course, the seminal works by Charles Kindleberger, regarding the occurrence of financial crises, as well as their consequences, has been at the centre of approaches within economic history for some time. Additionally, recent contributions by Barry Eichengreen and Kevin O'Rourke, have compared the development of the Great Depression with the events of the crisis of 2007- 2008. On top of this, new approaches to earlier financial crises have begun to emerge, such as the role of the crises in early nineteenth century Great Britain, for example.

There is a new growth of interest in studying earlier crises in order to achieve a better understanding of the historical processes leading up to the troubles of 2007- 2008. The period that witnessed the introduction various monetary regimes after the Second World War has been a matter of particular interest. The historical background of the international financial markets, the role of international actors, as well as the changing regulatory regimes all deserve to be mentioned here as well.

In this respect, Swedish research on the role of financial crises has been one important strand during recent decades. Research at the department of Economic History at Uppsala University in Sweden, has examined various aspects of the development of crises within the field of financial and business history. International collaboration has been central to this and, in June 2015, we arranged an international seminar entitled 'Financial Crises — International Dissemination and Consequences in Historical Perspective'. The seminar presentations and discussions were documented and edited before publication. We would like to thank those involved in this seminar for their collaboration, especially Professor Richard Roberts from King´s College, London, Professor Catherine Schenk from Oxford University (formerly Glasgow University) and Professor Youssef Cassis from the European University Institute (EUI) Italy. Finally, Dr Sarah Linden Pasay has checked and edited the transcriptions. We are most grateful for her input.

The Seminar

KEY

ML:	Mats Larsson
CS:	Catherine Schenk
YC:	Youssef Cassis
RR:	Richard Roberts
Q:	Audience questions

Introductory remarks

Mats Larsson

A warm welcome to this seminar on the development of financial crises, and of course a special welcome to Professor Catherine Schenk from Glasgow University, Professor Youssef Cassis from the European University Institute in Florence, and Professor Richard Roberts from King's College in London. You are all very well-known and your research on financial crisis has been read by several of those in the audience today. You have published frequently within this field. But you have never been here in Uppsala and presented your research before, so we are very happy that you could visit us today and we are really looking forward to the presentations and the discussion afterwards.

This seminar will begin with the three guests making presentations about specific problems connected to financial crises, and after that we will have a general discussion, including questions and remarks from the audience. We will begin with Richard Roberts talking about two centuries of international financial crisis, crisis types, patterns, and significance. Please Richard, begin.

Two centuries of international financial crises — crises types, patterns and significance

Richard Roberts

What I am going to present is really a grand picture — a tour de raison — of financial crisis over two or more centuries. As the author Charles Kindleberger put it, 'financial crises are a hardy perennial.' In fact, drawing from various literature surveys, I have counted 1,097 financial crises over the last two centuries. That is a lot of crises. It tends to surprise people that there have been so many. Of course, there is then the question, why have there been so many, or why they continue. Leaving that aside for now, I am going to outline how we get to these crisis points.

In the literature, there are essentially six different types of financial crises: banking crises; currency crises; external sovereign debt and domestic debt crises; inflation outbursts such as hyperinflation (generally defined as inflation above 25 per cent per annum); and stock exchange or asset-stock exchange crashes.

There is an additional type as well. Traditionally, the oldest type of financial crisis was what was known as a panic, or a commercial crisis. It occurred in the seventeenth and eighteenth centuries. These were not really banking crises because you did not have a banking system, but then they morph, at some point, into a banking crisis.

A characteristic of most of these types of crises is some form of a run. Runs on banks are easy to identify. But there are other types of runs as well. A stock exchange crash is essentially a run on securities. Currency crises are a run on a currency; people want to sell rather than buy or retain it. So, what is the pattern from this collection of 1,097 crises, amassed from Reinhart and Rogoff and, more recently, IMF papers? The distributions are as follows: banking crises are 27 per cent; currency crises 30 per cent; debt crises of both sorts are around 20 per cent, and stock exchange crashes are around 20 per cent.

We can subdivide these into two eras of crises using the literature. There is a period of essentially 170 years, from 1800 to 1970, followed by a second era from 1971 onwards. This final period is essentially the breakdown of the Bretton-Woods system. Both time frames have about 430 crises. For the stock exchange crashes, however, a breakdown is not provided in the literature, so they cannot be allocated by sub-period. If we divide those two sub-periods of the 865 crashes in the two locatable sub-periods, we get an average of 2.5 crises a year from 1800 to 1970, and 11.5 crises a year from 1971 to 2008.

These numbers require some qualification; one is sample size. A primary reason for the increase in the number of crises since 1970 is accounted for by an increase in the number of countries in the data sets.

The pre-1970 data typically comprised twenty to thirty countries; the post-1970 data sets comprised sixty, seventy, or more countries. Before 1870, most of the crises involved advanced economies; after 1970 most of the countries are emerging markets. Generally speaking, it was believed that emerging markets were more prone to crises than advanced economies. In other words, economic and financial sophistication means that countries emerge from, and grow out of, financial crises; this was held to be true until 2008, which was obviously a crisis of advanced economies.

There are also composite financial crises; many are multi-type crises. Thus, these crude crisis counts exaggerate the number of episodes. A well-known crisis-composite type is a banking plus a currency crisis, which is known in the literature as a ‘twin crisis’. These were particularly common in the crises of the early 1930s, and in the Asia crisis of 1997 - 1999. There are also triple crises, comprising banking, currency, and debt crises. Argentina in 2001 managed to score a quintuple crisis, suffering every single form of financial crisis simultaneously, which may or may not be a record, but if you read the accounts of Argentina in those years it is quite staggering.

Financial crises are not evenly distributed over time; they occur in clusters. The reasons for this are common macro-economic and political fundamentals, plus the phenomenon of international crisis contagion. Based on Reinhart and Rogoff, ten principal international crisis clusters can be identified. These show the years that they identify as global banking crises. Three of these clusters of crises occurred in the 1990s, giving rise to the perception, at the US treasury and the IMF, that crises were becoming more frequent. This prompted the deputy treasury secretary to pose the question: is the crisis problem becoming more severe?

The financial historians Michael Bordo and Barry Eichengreen took up the challenge and they put together a new data set of historical financial crises, spanning the years from 1880 to 1997. In the years 1880 to 1971, it comprised twenty-one countries, and from 1972, fifty-six countries. They focused on banking crises and currency crises. They published their findings in 2001, and they reported that the crisis frequency since 1973 was double that of the Bretton-Woods era, and the classical gold standard era. It even rivalled that of the crisis-prone interwar years. They explained the growing frequency of crises in the post 1973 era as a result of a combination of capital mobility and the widespread adoption by emerging markets of pegged exchange rates, and sometimes Bretton Woods Two, that accounted for the large number of currency crises.

They also examined the duration and output losses arising from these crises. They reported that there was little evidence that crises had grown longer or that output losses had become larger. Overall, they concluded, and I quote: ‘crises have grown more frequently and more frequent, but they have not grown more severe’. Their study, perhaps inevitably, was immediately followed by a very low frequency of financial crises in the years after 1900, 1990, and 1997. When crises resumed in 2007, it was with extreme severity.

A notable feature is the disappearance of banking crises in the quarter century from 1945 to 1971. This has been called the ‘Quiet Period’ in the literature of banking crises. The absence of banking crises in these years stemmed from official controls imposed on banks during the Depression and the Second

World War, and on the post-war practice of financial repression to prioritize the ability of governments to manage high levels of indebtedness. The Quiet Period demonstrates that it is perfectly possible to abolish banking crises with extensive controls; however, the controls and banking cartels came at a cost as regards financial inefficiency and resource allocation. As levels of national indebtedness fell, along with confidence in bureaucratic allocation, so it became desirable to introduce competition into the banking sector. Thus, the 1970s and 1980s saw a move to liberalise banking with a view to better financial provision.

In 1971 Britain led the way with the introduction of a new policy called Competition and Credit Control. This was followed by a credit boom in which the principle beneficiaries were a group of so-called secondary banks, which borrowed short-term in the newly liberalized wholesale markets, to extend loans to commercial real estate developers. The outcome, predictably enough, was the secondary banking crisis of 1973 to 1975.

Many other banking liberalisations have also ended with financial crises, for instance in Sweden, Norway and Finland in the 1980s and early 1990s. Banking crises are often preceded by a credit boom; in many cases this has fueled a real estate boom that ended in a bust. A common feature of Britain's secondary banking crisis, the Nordic banking crisis, the crisis of 2008, and other banking crises, was losses from real estate lending. In fact, it appears that most of the banking crises of the past century or so, certainly since the 1920s and beyond, were the outcome of real estate lending, either residential or commercial.

What about the long-term, enduring, consequences of financial crises? All financial crises have adverse consequences for somebody. Inflation outbursts are ruinous for holders of financial assets, and those on fixed incomes. As Weimar Germany demonstrated, inflation can be socially and politically disastrous. Stock exchange crashes are obviously bad for investors. Currency crises are particularly and potentially toxic for banks and governments. However, as regards general welfare, expressed by the level of GDP, these types of crises are probably less damaging.

The literature on the cost of crises focuses mostly on the cost of debt and banking crises. The foremost cost of a crisis is calculated as the deviation of GDP from the onset of the crisis to a subsequent point. On this basis an IMF study of debt crises in 154 countries over the period 1970 to 2008, reported that they resulted in a 10 per cent output loss after eight years. As regards banking crises, another IMF study reported that, for the period 1970 to 2006, an estimated average negative deviation of GDP, four years after the onset, was 20 per cent. As for the banking crisis of 2007 to 2009, the estimated output loss was even higher: 25 per cent.

All in all, the verdict of the literature is that it is banking crises that do most damage. And among banking crises the two most devastating episodes are the banking crises of the early 1930s and that of 2007 - 2009. Banking crises of the early 1930s blighted the United States, Germany, Austria, Central Europe, and Latin America. But not Britain, Canada or ten other developed countries. Britain had a currency crisis, and a political crisis, in 1931, but there was no banking crisis. So why did some countries have banking crises in the 1930s while others did not?

There seem to be three key factors. First, the structure of the commercial banking: countries with more extensive branch networks and a greater concentration were less prone to crises than countries with unitary banking systems. Second, countries with universal banking models were hit by the depreciation of the value and solvency of industrial investments in the Depression. And third — macroeconomic policy, especially in relation to exchange rate policy — and political willingness to abandon the gold standard. And this included Britain.

So finally, what about British financial crises? Over the last two centuries Britain has experienced numerous financial crises. As regards currency crises, it saw five devaluations in 1931, 1949, 1967, 1972, and 1992, as well as at least half a dozen lesser crises. With the benefit of hindsight, the devaluations appear to have relieved economic problems rather than exacerbated them. Stock market crashes— well there have been a number of those, notably in October 1987. But they left almost no trace in the economic history of the era. Inflation hit 25 per cent a year in the First World War, being part of wartime financial and economic disruption. It was up there again at 25 per cent in 1975, contributing to the crisis that engulfed the Labour administration in 1976. Debt crises; well Britain's 1976 crisis was really a sovereign debt crisis that resulted in resort to the IMF, and I think until recently, until Greece, this was the last time an OECD country had gone to the IMF. And the banking crises, Britain saw at least eight major or minor banking crises between 1825 and 2008. Now, according to a new book by financial historian John Turner, who is something of a banking crisis sceptic as regards negative impact on GDP, only two of them, those of 1825 and 2008, registered large falls in GDP during or immediately after the crisis. In 1825, the GDP decline was 4.2 per cent but it then quickly rebounded. And the other was 2007 -2008, in which the peak to trough fall in GDP was 6.6 per cent. This was the most severe of any of the UK banking crises and we have only recently overtaken the pre-crisis level of GDP.

ML: Thank you. This opens several questions, but we will have all the presentations first, and then have an open discussion. I will give the first word to Catherine.

Prudential supervision and international cooperation on the financial market since 1965 and its consequences for debt crises

Catherine Schenk

Thank you for the invitation to speak, and thank you, Richard, for setting the scene in a coherent and systematic way. My presentation will perhaps be slightly less systematic in the sense that it is a bit more specific. What I am particularly interested in is the relationship between regulation and supervision on the one side, and financial crises on the other, since banking crises are my area of interest. And of course, there is a two-way relationship between regulation and crisis; because when crises happen, as we have seen in the last few years, there is suddenly a kind of collective gulp and a reaching into the drawer trying to find some kind of regulatory response.

On the other hand, regulation itself can create increasing fragilities; it can push things off the balance sheet; it can make banks and other financial investors misprice risk, and it creates moral hazards in ways that contribute to financial instability and can prompt crisis. So, I'm looking at this sort of tension in the period in the run up to the Latin American debt crisis of 1982, particularly the innovations in financial regulation that happened through the 1970s, and how national, supranational and multilateral agencies dealt with financial innovation in this period which is marked by the extremely rapid internationalization of banking structures as offshore markets developed through the 1960s.

This is part of a bigger project that I am working on. It is an archive-driven project, which makes it fairly complex and slightly more detailed. I am looking at the records at the International Monetary Fund, the Bank for International Settlements and the Basel Committee; the national central banks, the Federal Reserve Bank, the Bank of England; the Hong Kong agencies; and also the archives of the commercial banks that were involved in the market, and what their ideas and opinions were about what was happening in the run up to the crisis, and why they accepted all this country risk.

So, looking at regulation of financial crises we have Reinhart and Rogoff and we've heard quite a lot from them, and many historians are critical because their data is not fully reliable. The more you know about financial crises the more their research seems slightly flawed. But their conclusion is that financial crises are frequent and perhaps inevitable. We have Schiller and Akerlof, who draw on Keynes, who refers to 'the animal spirits of markets' and they talk about the irrational exuberance in animal spirits. Maybe these markets, in that framework, cannot really be regulated; they can only be herded in more benign directions. We have Calomiris and Haber's great book which is about the structures of regulation and suggests that you get the system that you deserve.

Speaking as a Canadian, the contrast is probably along a fulcrum between the United States, with its repeated financial crises and its complex, multi-layered and opaque regulatory and supervisory system, and Canada, with its more stable system which is more tightly controlled. So, for Calomiris and Haber, financial regulation in a national context, at least, is sort of a game of bargains when seen from a political economy approach.

I am particularly interested in the regulation of international banking, so I will restrict myself to international banking here. The difficulties and the obstacles are clear from our current perspective. The way that banks operate is that information is probably their most important asset. This information, and their ability to monitor their customers and those to whom they lend their funds, is how banks make their margin. They need information about their creditors; they need to know their customers; they need to know that information, and they need to be able to price it to ensure they are charging the proper interest rate. They need to know whether they're going to get repaid; they need to know what the value of that collateral is over time. And it is that margin that is essentially the source of their profits. And information of course, if it is private and valuable, is difficult to share and this makes it more difficult to supervise. So even in a national context we see a lot of different models of the relationship between the national supervisor, which might be the central bank but might not, and the individual banks themselves. The willingness of commercial banks to yield their information to support supervisory oversight involves a difficult degree of trust. It is a delicate relationship, and this means it is difficult to share information between creditors and customers more broadly.

So, trust is important. Another factor is that the supervision and regulation of the national banking system is the jealously guarded prerogative of central banks and national regulators because of its importance to the operation of monetary policy and monetary supervision, and again it has proved to be extremely difficult to overcome that kind of national perspective. Even in Europe, where there is a Single Supervisory Authority at the European Central Bank, a lot of the operational aspects and a lot of the supervision of non-SIFIs (i.e. the non-systematically important financial institutions) is delegated back to the national authorities.

I always talk about financial regulation as a form of agency reaching into a bowl full of jelly that is squeezed out between its fingers. Regulators may capture a little bit of it, but the work of regulation also creates other kinds of incentives. Financial innovation, in particular, happens very fast and it spreads very quickly. So that's another kind of obstacle. The increasing complexity of financial institutions has also proved a barrier, and it is related to the problems of information. Of course, in the global context, we have the problem of regulatory competition at the lowest common denominator, in that banks and financial organizations, or their business at least, are quite mobile and can move to places where there will be an advantage.

I am going to move on to sovereign debt because sovereign debt has its own particular characteristics. Rationally and economically nobody would prefer to lend to a foreign government. There's absolutely no way of predicting when a country will default. It is very difficult to define some kind of realisable collateral in these circumstances, so there are risks that are really difficult to quantify. The sovereign debt in the 1970s, however, was a banking debt. It occurred in a market that differed from current markets, which tend to be bond markets. There are reasons for this, and the 1982 crisis has important implications for why this change in the market came about.

But in the 1970s we are talking about banking debt: banks are lending to sovereign borrowers. And again, remember that the kind of advantage banks' have over you, as an individual investor in a bond, is their ability to monitor the countries to which they lend. It is this big failure that leads to the Latin

America debt crisis. Looking back to 1973 or 1975 it just seems incredible that banks lent so much to borrowers that had defaulted and defaulted and defaulted time and again. We've heard about Argentina, but other sovereign borrowers were also serial defaulters.

How do we account for this? Is it the case that the bankers had really short memories, or were markets not working, or was the country risk assessment inappropriate? Was it really a big surprise when they woke up in August in 1982 and found that Mexico had suddenly defaulted, and all the country risk had come to land? No, it was not. We had the OPEC oil crisis and the accumulation of future surpluses, for example, so there was an era of global imbalances, which is how we used to talk about the late 2000s as well.

In the 1970s global imbalances occur where the creditors, the OPEC countries, because of their distribution of income and other factors, end up with a lot of cash which is deposited in banks, mainly in the City of London, but also in the offshore euro-dollar banking market. And then of course as these creditors emerge so there are other debtors, and those that are trying to smooth over their current account balances, and this is when the sovereign borrowers move into the market. The 70s is a period when there is recession in a lot of advanced economies, so opportunities for profit in advanced economies are limited, and suddenly these Latin American countries seem attractive and a range of developing countries enter the market.

This was termed recycling, and it initially occurred in 1973-74 when the OPEC crisis struck. This was a market based on resolving global imbalances. This was the market acting like it should to smooth us over a crisis and to resolve these kinds of issues. It fitted with the increasing conservatism in the United States as the 1970s progressed, together with the privatization of aid and the attempt to get that into the private markets. And there is a parallel here with what occurred in the first decade of the millennium because there was a heroic idea that the market is going to solve it for us, isn't it? And isn't this fabulous. And from studying the literature you can see that this view persisted for the 70s as a whole.

But when you look at the archives, you see that as early as September 1974 the IMF is extending a warning to its executive board, in effect saying this is a really dangerous thing that is accumulating. So, even in September 1974, the executive board is very worried about the capital adequacy of the banks; there are early warnings. In response the banks say that they are opening subsidiaries; that they are involved in consortium lending instead of building up their capital adequacy for this lending; so, they are spreading their risk rather than being more precautionary. And in September 1974 the IMF says, we must stop this recycling, we cannot stop it altogether, or else several countries will be made to default, but we need to taper it off and find other ways of smoothing over the global imbalances.

But the banks respond by saying, it is not our job, it is your responsibility as central banks and as regulators of your national banking systems. Now, in the summer of 1974 a series of international banking failures take place. During the 1960s, there was a very rapid expansion of international bank branches and subsidiaries as banks tried to deal with European integration, the increased opportunities in offshore dollar markets, the freeing up from capital controls and the opportunities this presented.

Remember that it is in the spring of 1973 that the Bretton Woods pegged-exchange rate system comes to an end, and because of the sudden exchange rate volatility there are new risks. To find an equivalent period of floating exchange rates, prior to 1973, you have to go back 40 years. This means that bankers and foreign exchange traders working in the market have no experience of volatile exchange rates like this. And they get caught out, and in 1974 there's a series of banking failures, big banking failures, and there's a series of near failures, and there's quite a lot of forbearance and liquidity pumped in to the market. It is this crisis in 1974, this apparent fragility in international banking, that leads to the launch of the Basel Committee in 1975.

You have the IMF, and now you have the Basel Committee: two agencies. The Basel Committee is tasked by the G10 central bank governors with developing an early warning system that will allow greater understanding of the dangers of contagion, and of the increasing risk from cross-border banking. The dangers have not only been demonstrated by the Herstatt crisis, where the Herstatt Bank was closed by the German authorities in Germany while the American markets were still open, and left a large liability at the other end, but also by smaller banking crises. One that is not looked at much is the Israel-British bank that collapsed in London. It was a subsidiary of an Israeli bank and nobody was supervising it. It came to light that the Bank of England was not supervising any foreign branches or subsidiaries of banks in its territory, nor did it supervise the foreign branches of British banks, because it did not regard this to be its business. So, what is happening in the summer of 1974 is that there are these gaps in supervision that are increasing the fragility of the market.

The Basel Committee is chaired by George Blunden from the Bank of England, who arrives at the first meeting and says, we are not going to have an early warning system. What they agree instead is that they will meet every month and 'exchange gossip', that's precisely the expression they use, to 'exchange gossip' about their banks. So, there's quite a lot of debate about that. They go on to develop the Basel Concordat later on in 1975. Nowadays everybody seems to think that this set out who was responsible for oversight and the appropriate form of jurisdiction for international banks, international branches and subsidiaries, but if you read it, it just says, well it is really difficult and we cannot really agree a rule for this so we just need to communicate very closely together. I'd say that by 2008 we still hadn't moved beyond that significantly.

Now, moving back to the accumulation of sovereign debt in 1974 and 1975, and the way the IMF has already extended early warnings, I decided to look at the commercial bank archives to see if they are worried, or whether they are accepting this advice, or whether there is any evidence of moral hazard that they would be bailed out should there be a default. And there's quite a lot of frank discussion in the archives of the relationship between national regulators and the commercial banks, and the IMF and commercial banks. I should say that from 1975 the IMF starts going around on world tours to meet commercial bankers from around the world to get market intelligence and different ideas. A lot of the evidence comes from that. There is clear evidence of moral hazard, a couple of examples, from 1977; Irving Trust, which is a big international bank, says we were all kind of worried about Turkey and everybody knew they were likely to default but nobody wanted to be the first one to stop lending.

On the other hand, there is Deutsche Bank in 1977, whose foreign officer was a former IMF staffer, who tells the IMF when they come to visit, yes well, we can lend as we want because we know the IMF is going to bail us out. So, there are very clear and explicit ideas of moral hazard developing here. The crisis happens in August 1982, and part of the problem is a lack of transparency in the market which means that banks are unable to price their risk. They are just developing their ideas about country risk, and there are no data for them to do this because the banks are not sharing information between themselves, and the regulators and supervisors who know the exposure are not sharing information amongst themselves either.

Now, this may strike one as being a big lapse which ought to have been addressed; and they did try. There are a series of initiatives through the 1970s to try to increase transparency in the market. But by the time we get to 1982 we are still in a position where nobody knows the total indebtedness of any of the countries that defaulted. So, each bank knows what it owes, it might know what it owes through a consortium because it feels it is has shed some of its risk that way, but it doesn't know what else this country has borrowed.

The International Bank for Reconstruction and Development (i.e. the World Bank) tries to collate information. It collects information on bank failures from tombstone pieces in the newspapers and it collects other sorts of data which it publishes after a long delay. The Bank for International Settlements and the G10 central banks publish consolidated country data for their banks, but it is very slow, and very consolidated, so it is also very long term; so, this is not really market information. The IMF is keen also to speed things up and allow greater transparency in the market, but they're stalled by the Basel Committee. They want to go to the Basel Committee in order to hold a discussion about the way to increase transparency in the market, but they are told not to come. There's evidence of a lot of tension, and what emerges is quite a lot of competition between the agencies about who owns this information and who is allowed to share the information, both between the banks and the supervisory bodies themselves.

In 1981 the IMF writes to the head of Basel Committee to suggest that their supervisors should be helping the banks with calculating country risk. And they get a letter back saying it is up to the banks themselves to do this. In 1982, three days after the Mexican default, there are internal documents which show that the IMF is getting their data on indebtedness from Reuters, the news agency. In November 1983 I've got letters to Margaret Thatcher from the British officials who are going to negotiate the bail-out of Brazil, or the debt rescheduling for Brazil. They show that when the negotiator arrived, they found out that it was not 2.5 billion, it was 3.8 billion dollars that they owed; but this sort of gap is not so unusual.

We blame the banks for mispricing their risk and not understanding what was going on but the lack of transparency is more than their responsibility. One of the outcomes of the 1982 debt crisis was that it provides a wakeup call for the Basel Committee, and prompts the first attempt to standardize, or set thresholds for, capital adequacy. I am quite critical of the whole Basel process – Basel 1, Basel 2, Basel 3, Basel 3A, Basel 4 – because it is clear that this a process that always seems to be running to keep up.

Basel 1 is all about sovereign debt risk and while that's the big risk at the time, the market quickly turns to bonds, and it was already trying to get to bonds by 1983-84. Basel 2 is after the Asian financial crisis and the emerging market financial crises. It also starts with building some retrospective measures. And here we have the quite heavy reliance on delegating monitoring to credit rating agencies like Moody's and Standard & Poor's, and they rate mortgage debt — coming back to your real estate thing — at A+ or A. Of course, then we have the next crisis rising up, and so we have Basel 3, and so it goes on.

The problem with the Basel process is that it is very backward-looking, and it is very slow; it occurs after years of consultation with the banks themselves, so there's an element of capture that happens over the course of that. The rules become increasingly complex and increasingly expensive to implement, and I think this was a big problem with Basel 2, the expense and the inability of countries to implement it. And then of course it develops perverse incentives for different kinds of accounting and financial innovation in order to escape the sort of restrictions that are there, and we see this happening between Basel 1 and Basel 2.

To conclude, the relationship between financial regulation and financial crises – and here I am talking about mainly banking crises – is two-way. What happens in 1982 is not a surprise – it was well predicted – and I have highlighted what the IMF, for example, was saying already in 1974. But even in 1977 the Bank of England tells its banks to stop lending to these countries. Yet they are unable to rein them in, and there is an element of moral hazard that is clearly evident, and also lack of transparency in the market. It is clear that the supervisors and the regulators failed to create transparency in the market. But that's what regulation is for: it is meant to overcome market failures, and this is a market failure in the financial market.

The development of international financial centres and financial crises

Youssef Cassis

My talk falls between the two papers you have just heard. It is more specific than the survey of 200 years of financial crisis and it is a bit less specific than 1982 and regulation. The topic was kindly suggested to me by the organizers when they conceived of this seminar. They asked me to talk about the influence of financial crisis on the development of financial centres. It was very kind of them to ask me to talk about my last two books, one on the financial centres, Capitals of Capital, and the next one on financial crisis, Crises and Opportunities. I put the two together. If you know them well, you know what I am going to say.

Financial centres are a grouping together of a certain number of financial services, always in a city, in a given urban space. And there are reasons for these groupings, which I will not explain in detail now; basically, it is what is called external economies. You find financial centres at national levels; every single country has its financial centre. It is a movement that Kindleberger described very well in a famous article a long time ago. It also exists at a regional level. I mean here by regional, region of the world, Europe or Asia, or North America, or whatever. And then you have a few centres that are global in the sense that they operate throughout the world, providing a global centre that acts as financial centre for the entire globalized integrated economy.

Because of this variation you have a hierarchy of financial centres and this hierarchical order has been a topic of interest. People like ranking, and tables, and ranking number one, is it London or New York? Or is it going to be Hong Kong? So, it is quite a popular topic. You can talk a lot about the criteria for ranking. But, in order to discuss the link with financial crises, whatever criteria you use, you reach a similar conclusion. Here I am concentrating on the leading rankings that are global. You have London followed by Paris, then Berlin and New York and Brussels, before 1914. Then you have London and New York followed by Paris and then a few lesser centres, Berlin, Amsterdam and others in the interwar years. Then you have New York, followed by London and then Zurich in the Golden Age. Then you have New York, London, and Tokyo in the last part of the 20th century. Followed by Frankfurt, a bit behind, and a few others. Then finally, prior to 2007, and up until now actually, you have London and New York, and you have Tokyo too, although this has lost some ground; Hong Kong and Singapore are emerging quite strongly, and Shanghai. So, this is the global picture.

How has this shifted? Has it moved, or has it been moved, has it been influenced by financial crises? What are financial crises? We have had a definition, although not really a definition. It is very difficult to give a definition, so I have to rely on the not very politically correct definition of Charles Kindleberger who after all died a few years ago, he was born in 1910. He said, and I quote, that 'financial crises are like pretty women: hard to define but recognizable when encountered.'

It is not true, and perhaps in 2015 it is not correct to quote it, but it is true it is hard to define. But you do see them. Whether it is like a pretty woman or not doesn't matter, you recognize one. So, as I speak third, I don't have to repeat what has already been said. Dick has told us a number of categories of financial crises as defined by economies: banking crises, currency crises, twin crises, debt crises, stock exchange crises, inflation and so on.

I have put in my notes that hundreds of financial crises had broken out across the world since the mid 19th century. I hadn't suspected it would be as high as 1,097, which is enormous. But the question is do you need a database? Because for a database the more financial crises we have the better, you know, because database needs lots of data. Or do you want to see which ones really mattered? I would say that out of 1,000, or even 500, a lot of them did not matter. So, what you do with them is another discussion we could have. If you look at the unreliable list of crises in Reinhart and Rogoff, most of the financial crises in all categories, up to about 75 per cent seem to take place in the nineteenth century (with the exception of the interwar years) and they take place in emerging economies.

Now, do you have to put these crises together with crises in advanced economies? In my view they are different types of crisis: they have different causes; they have different consequences; they are always much bigger in emerging economies; think of the 1982 crisis, for example. You have to distinguish between crises in advanced economies and crises in emerging economies. In the same way you have to distinguish between major, global, systemic financial crises, and minor ones. Now, what do I call a minor financial crisis? Is the failure of a big bank in a big country a financial crisis? Is the failure of Crédit

Lyonnais in 1993 a financial crisis? It is listed in the databases. But in my view, it is not. It was a hard moment, but the French government dealt with it; it did not have much effect in the end, so I would not list it.

Now, were the financial crises which broke out in the Nordic countries in the early 1930s, severe financial crises? Yes, they were severe for the countries where they occurred in, but they were not global financial crises. They had a limited effect. That is the fate of being a small country; small countries have less effect, whether in the north or the south, on the world economy. In the end, many financial crises which have broken out since the end of Bretton-Woods, have been either in emerging economies (the vast majority of them), or they have consisted of a single bank failure in a big country, or in a smaller country, such as Spain.

I have identified 8 major global systemic financial crises from the late 19th century, much less than 1,097. There would have been more if I had gone back further in time instead of starting at 1890. There are crises that did not actually even break out, but I will return to them. So, my list is made up as follows: there is one, the Baring Crisis of 1890; two, the American Panic of 1907; three, the financial crisis of July–August 1914; number four could be divided up into several individual crises but I have chosen to group them together as the banking crisis of the Great Depression of the 1930s. This encompasses all the banking crises that occurred in the early 30s, especially in Austria, Germany, the United States as well as in other central European countries, such as Switzerland. Then I have attempted to find a different umbrella term for what I call five, the financial instability of the early 1970s and the ensuing bank failures, to which Catherine has referred. At number six, there is the international debt crisis of 1982. Number seven is the Japanese banking crisis of 1997–1998. This is possibly a contentious: should you call this the Asian financial crisis, or just the Japanese one? They intersect. As I wanted to limit myself to advanced economies, I call this the Japanese crisis, because it was quite serious actually. And surprisingly even though Japan was at the time the second largest economy in the world, the Asian crisis in Japan did not have as much effect on the world economy, or the world financial system, as the banking crisis in the Nordic countries a few years earlier. And finally, at number eight, we have the most severe of all, the financial debacle of 2007–2008.

So, my idea was to take my chronological list of leading financial centres beginning with London, Paris, Berlin and Frankfurt, then after the Second World War, New York, Amsterdam, Brussels, Zurich, Hong Kong, Singapore, Shanghai which is currently growing in strength, and compare it with the timeline of financial crises in order to ask three questions. First, have financial centres been responsible for the outbreak of financial crises? Second, have financial centres been responsible for assisting the transmission of financial crises from one place to another? And finally, third, have financial crises contributed to the rise and fall of financial centres? The first question is easy to answer, so long as one focuses on the eight major crises I have enumerated above, because they all take place in major financial centres since this is where there is a concentration of very large, systemically important financial institutions. In order to have a global systemic crisis, you must have the failure of at least one, but usually more than one, SIFI.

So, this is one reason. Although the originating cause of the crisis might lie elsewhere, say in Argentina or in Mexico, the crisis will remain confined there unless there is a link between Argentina and London or New York. The scale of the international debt crisis of 1982 is because all the world's largest banks were up to their neck with loans to countries which couldn't repay. Now, the surprising point is that you would expect these financial centres to have translated the crisis from one centre to another because of the integration of the world economy and globalization, but we do not find much evidence of this kind of transmission taking place.

First, as we've just seen, in my analysis at any rate, global crises have been infrequent, and they are often less global than assumed. If I take my list of eight, six of the selected financial crises remained confined to a single financial centre, including the banking crisis of the Great Depression. But in the end, the banking crisis of the Great Depression led to subsequent banking crises that broke out separately within a few months or even year of the event. Crisis was transmitted from Vienna to Berlin with the failure of the Creditanstalt and was followed by the German banking crisis. Of course, the devaluation of sterling and Britain leaving the gold standard had an effect on America, and on the fragility of the finance system, because of doubt concerning the dollar and so on.

However, it was not an immediate transmission, one bank failure here leading to another one, apart from, perhaps – and even here there are doubts about that – the impact of Creditanstalt. So, there are not that many global crises. The only two which really come to mind as an example of global transmission between one centre to another was 1914. It is interesting, that it was only when people started to work on financial crises that they realised that one of the strongest parallels with the financial crisis of 2007–08 was 1914. And it is true that in 1914 and in 2007-2008 you see this rapid transmission taking place.

One of the reasons for this absence of transmission between financial centres is that some of these crises were contained, and a solution was found before the crisis actually broke out. That happened in 1890, with Baring Brothers; it was one of the largest banks and a family partnership with unlimited liability. It was, in terms of size, one of the largest banks in the world and its failure could have generated mayhem across all the financial centres. But this was avoided. It was avoided because of the Bank of England organized a bank consortium to rescue Barings Bank. In the same way, in 1982 there wasn't actually a crisis. There was a risk of a crisis, but with the IMF organizing all the leading bankers in discussions with the IMF and the American Federal Reserve, they established a scheme to prevent default by renewing lending to Mexico and rescheduling the loans.

So, two of the most important crises were actually prevented, and I would argue that the concentration of financial power in leading financial centres actually helped to do that, whether in London in 1890, or New York and Washington, so that in 1982 you had the possibility to organize the banking financial actors and protagonists and find a solution. This worked again in the American Panic of 1907, when there was a run on certain trust companies which were actually solvent but had a liquidity problem, and Pierpont Morgan himself took all these bankers into a room to discuss what to do. So, no, this did not happen in New York, which was not yet the leading financial centre, but was on its way to it.

Rather than facilitating or causing a spread of crises, the concentration of financial power in leading financial centres had the opposite effect: it prevented major crises to break out. This failed in September 2008 when no solution was found for Lehman Brothers. Barclays couldn't or wouldn't buy it, and then they thought they could let it fail, and can the younger members here remember what happened after that?

Now to my third question, whether financial crises have been responsible for the rise and fall of financial centres. Here again, the answer might appear surprising and disappointing, but I would say that financial crises have had very little effect on the destiny of financial centres. If you take the two most severe crises of the 20th century, the banking crisis of the Great Depression and the financial debacle of 2008, they have hardly led to any change in the hierarchy and the position of international financial centres.

London, in my view at any rate, had a slight edge over New York in the 1920s, and although the crisis may have strengthened its advantage, this was not so significant in the 30s because there was a big decline in international capital flows. Paris looked strong in the early 30s when Britain left the gold standard, but it was not enough to enable Paris to regain the position it had before 1914. So, there were some changes, but what really changed was the big decline of international financial transaction.

And if you look at the ramifications of the 2007–2008 crisis, London and New York remained the leading financial centres in the world, according to all sorts of criteria. I will say that the rise and decline of financial centres has been the result of two main factors, one is the change, or the changes rather, that take place in the world economy especially with respect to the position of the various powers. In other words, at each period in time the financial capital of the major – the leading economic power –is the financial centre of the world.

You had that with Amsterdam in the 18th century, London in the long 19th century, and New York after 1945. But there is a time lag. There is a time lag between the moment when a country becomes the largest economy and the moment its financial capital reaches position of world's financial centre. London was already a bigger commercial centre than Amsterdam in the second half of the eighteenth century, but it took the French wars for London to become the world number one. The United States was already a larger economy than Britain by the late 1870s, but it took another 50 to 70 years for New York to completely establish itself as the financial capital of the world. So, there were discussions taking place in the late 1980s suggesting that Tokyo was going to overcome New York, but it never happened. We will see what will happen with Shanghai.

So, it is a slow process and there is one factor which can hasten this process, and this is another kind of financial crisis: you need a big war. The French wars prompted shifted the centre of power from Amsterdam to London, and the First and Second World Wars shifted the centre of power from London to New York. It happened at a lower level as well, you know, Paris was competing strongly with London during the Second Empire between 1850 and 1870, but then, after its defeat against Russia in 1871, it remained number two, but it lost much of its capacity to compete. Berlin was completely eradicated after the Second World War. So, this could be bad news if there were to be a big change in the hierarchy, but as I say, it is a very slow process, and, well basically, we will all be dead by then.

ML: Thank you for this fascination journey and interesting ending of your speech. I want to begin by asking the three of you if you have any comments on one another

Comments and discussion

RR: Just on Youssef's point about the numerical count: all those crises are taken from other people's surveys. They all have some kind of benchmark metric to them, so it is not just some bank going broke. I mean there are many thousands of those. So, these definitions involve some metric, whether it is looking at some GDP decline, or something like that. They are not just any old episode. Related to Catherine's remarks, I was reminded of the wonderful description of the relationship between regulators and bankers as being that of 'bloodhounds chasing greyhounds.'

CS: Yes, talking about crises, and maybe I am too caught up in banks, but it is that tipping point between liquidity and solvency that is so difficult to predict. We should be paying more attention to these near misses.

It is all resolved, so it is not a crisis. That is quite interesting. If we looked at crises not by bank failures or market failures, but by a tightening up of liquidity or the central bank's balance sheet, or provision of liquidity to the market, we might identify more than half, and maybe that is where Reinhart and Rogoff went. But there's a tendency for forbearance: lies are accepted on a balance sheet; people just hope for the best; more recently we can think about China and other cases like that, where they averted crisis by setting up asset management companies-something that South Korea did as well – and just manipulating the banks' balance sheets in this sort of way to avoid failure. But still, that probably happens at some considerable cost to the economy, and certainly to the tax-payer, and that's maybe an avenue that we need to pay more attention to, and not fetishize the crisis or the failure.

YC: You have undertaken many studies and made sense of them. You have to do both quantitative long-run analyses, like compiling database with many crises and look more specifically at some of them. However, I looked carefully at the appendices of Reinhart and Rogoff, and when I am certain that they have put this crisis in, then I look in the book to see what are they referring to.

RR: Those that are not on the database.

YC: And France in1994 might have been a crisis, so there has to be a level of weighting to gauge what is more important, to create a kind of hierarchy. Also, I call it 800 years and I should have called it 40 years because the database starts in 1970. And I fully agree about including near misses, that's why I put them in my list, because it is true that sometimes they could disappear and not be seen. And for example, in most of the databases the Baring crisis does not appear because it nearly failed, it only appears because of the crisis in Argentina. This is why there is confusion, and these are two very different crises. Regarding the debt crisis, the literature discusses the ten years it took for Latin American countries to get back to their pre-crisis level of GDP per head, and the plan for rescheduling the debt, rather than the actual episode, which you have looked at, and I have been interested in too, which is sometimes passed over in the broad literature.

ML: Yes, thank you. Should we open for comments from the audience?

Q1: I can start. I was surprised by your point Youssef, about the non-impact of the financial, global financial crisis on the behaviour of different financial global centres. I was surprised when you asked how global a financial crisis needed to be, in order to be called *a global financial crisis*. Take Barings, for example. I mean the Nordic countries were not involved at all, so you don't count them; Shanghai was not involved at all; Russia was hardly involved; nor Germany. So, I mean how global does a crisis need to be in order to count as a global financial crisis? That's my first question. The other question is about specific countries. Mexico experienced a crisis; it was a hard crisis in 1982. So, I mean specific people, specific countries or regions, as it were, there are a lot of them experiencing actual crises. Do you agree?

YC: Yes, I agree with you.

Q1: But your point is, and I think you were quite right, that the financial strength, economic strength of a country, the political strength of a country, is more important in the long run if you develop a centre or not.

YC: I don't know if you will agree with this, but it possible that we have never yet experienced a completely global crisis. I mean, with regards to 2007-2008, they say that China was very little affected, and so they helped relaunch in the world economy. 1914 wasn't a complete crisis either. One of the reasons I've made this distinction is that I think what happens in advanced economies when there is a crisis is different than what takes place in an emerging one. And I think the database which we pulled together doesn't make sense, but we were following a trend established by the IMF, and they are the ones who carry influence, not me. But I think it doesn't make any sense. Secondly, I tend to consider that the larger economies, big economic and financial powers, matter more, are more global than smaller ones. But they are never completely global it is true. So, I fully accept your remark and your reservations and doubts about my analysis.

RR: As the global economy integrates you may be able to look forward to a truly global crisis in… however long it may take.

CS: Part of that is driven by the outcome. It is not a simultaneous crisis: Canberra in Australia, for example, is affected a bit further down the line, though not because of their financial structures. I wonder if we could identify financial crises differently if we did not just look for bank failures but were looking for measures of liquidity in markets and that sort of thing. Because what affected the world during the global financial crisis that we have just come out of, *was this sucking sound in international liquidity*. And the banks survived. And as I said, their regulators exercised forbearance, some of them had more resilient structures, like Canada and Australia, that I have just spoken about. But the liquidity in the global market just contracted and finding measures for that would identify where there was convergence in that sort of measure. Certainly, you would see that in the 1930s, like you saw that in the 1970s. In the summer of 1974, the whole clearing house for international payments in New York (which is where all the world's dollar payments went through) was suspended, and then they delayed every payment for twenty-four hours, so that nothing settled in the global dollar economy for months. That was huge, and it never recovered in terms of the size of transactions. Even with inflation on a nominal level, it did not recover.

YC: A question for Catherine. What you suggest is: to take loan financial, as in the case of a financial crisis like 1974, and try to have other measures of the manifestation of a crisis?

CS: I would be trying to track all the liquidity rather than trying to look for episodes of bank failure. Just because you are not seeing bank failures or institutional failures does not mean you are not seeing a crisis happening that could be expensive.

Q2: Thanks to all three speakers here today. I will start with a question for Catherine. When you start talking about international levels of regulation and supervision how do you see the EU regulations in correspondence to the international level of regulations? Perhaps the most interesting example today is the European troika.

CS: If ever there was going to be a collection of nation states that was going to introduce a single, regulatory environment, you would think that the EU would be the most probable and most likely. They have a single currency. You would think that they would be able to go there before the latest sovereign debt crisis. They did in the 1960s, with their efforts towards harmonization, and the talk about the banking union, which sparked a lot of regulatory changes, and the introduction of regulation in the 1970s, and early 1980s, in a range of European states. But there has never been the willingness – the political, or indeed the economic will – to give up sovereign control of regulating of the banking system. And you see, even today, how different and disparate and distinctive the national banking systems of the European Union members are in a lot of ways, you know with the German system, with the Landesbank, and this kind of thing.

So, what you have with the single supervisory mechanism in the European Central Bank is that they're capturing the SIFIs, these institutions. But the other institutions – they're not even shadow banks, they're savings banks and regional banks – and there's a systemic fragility coming from ignoring them and separating out the SIFIs from the rest. Everybody says, well too big to fail, too big to fail. I am thinking: is there an institution that's too small to take your eye off, on a global level? Because there are systemic fragilities that bleed from those institutions. We saw that in the 1970s, we saw it again in the 1980s, small institutions can generate liquidity crises that then prompt solvency crises further on. And we see this in the literature now, with the Federation of Small Businesses and others, talking about shadow banking and these sorts of dangers. So, I think even in the case of the European Union where the prospects should be the strongest, and where they've been talking about this for decades, there's still this intransigence, or path dependency, or inertia. Youssef was talking about the national structures and the banking systems, and the point is that the regulatory structures match the structure of the banking systems, they are distinctive.

Q3: I was thinking about what you said about regulation and the banks, but also about regulation of financial markets at large, and whether we really learn from history or not.

CS: We would be out of business if they did.

Q3: I was just reading a survey published by the Swedish Central Bank where they look at the Swedish debt markets, and how they know that they're not functioning as well as they used to. They're less liquid than they used to be. And one thing that the market participants define as what they see to be a risk to the function of market is regulation, and in particular, the MiFID II as it is called, the Markets in Financial Instruments Directive, the second one that's not fully implemented yet. But they point out that they see this as a risk, that it will have detrimental effects on the function of the market. That brings us back to history, have we seen this before? Could this be an early warning sign, because the market participants are saying that if this leads to less liquidity in the market then we have a problem?

CS: Yes, definitely. And if there is a decline in liquidity in the market, I would expect the market participants to innovate around those sorts of issues and increase liquidity on their own, on a different kind of scale. If you're talking about non-banks – or other kinds of financial institutions, like stock exchanges, securities markets and hedge funds – until very recently there was a lot of reliance on self-regulation in industry standards, and the use of some sort of non-state collectives and other groups of industry-led organizations to self-regulate. This is because of the complexity and the resources; and the failure to get people that are starting off to regulate on a state salary; these sorts of issues. And there's still an argument for that I suppose, in terms of efficiency, but it leads to recurring problems again. The banks tend to be regulated because of their clear role in the monetary system and because of the need to protect depositors who tend to be more directly involved in those markets than in others. But I have been looking at the British Bankers Association for example, and we know about LIBOR and other things that have been going on, and how those markets are created amongst these groups also effects the liquidity of markets and stability.

RR: There's a great deal of concern among professional bankers about these liquidity problems. At the moment, not just at the level of central banks at the actual level of… I mean, I know senior people at UBS and we've had discussions about this, and there is very much rising concern that, as you say, the unintended consequence of the regulation is that… you know, it is like whack the mole: you hit the mole and it pops up somewhere else. That describes these different types of crises; you regulate and solve one, and then the problem occurs somewhere else.

CS: Well, it seems to me that you shouldn't be walking around with a hammer. Or you shouldn't be reaching into your bowl of jelly. You know that this kind of model of regulation doesn't work because of the nature of the financial markets that it is governing. Partly that it is international and global, but partly that it is very slippery. And so, this is where the self-regulation maybe comes in. But for self-regulation to work it already has to have some skin in the game and they have to be ready to move if they go out. So, it is a complex issue, but I think it is one we haven't resolved, and part of the reason why I am so critical about the Basel Committee is that they take the position that these rigid structures are going to solve it : we'll be able to regulate the whole market and it will all work, if we can just reach far enough. And I do not think that is true.

RR: There is a romantic solution to this in a way, which is partnerships. And if you go back to structures where you largely had partnerships rather than limited liability companies and then all sorts of agency problems…

CS: Then the depositors lost their money.

RR: The partnerships were small enough to be generally non-systemic, Barings possibly being an exception, and the partnerships did not tend…well, if they took an absurd risk, but generally the partners would manage each other, so they would monitor each other so that you did not 'risk shift', as they say in the jargon. It is, I think, entirely romantic as a notion in the modern financial markets but…

CS: Then you get financial repression essentially.

RR: But you know those kinds of structures. I mentioned skin in the game, where there are penalties: two managers, two institutions. Whereas a lot of us, well what one saw in 2007 was that the risks and the penalties were entirely asymmetric, that you got rewarded for taking on risk. Now how do you, institutionally, have better structural arrangements whereby that asymmetry is…that you have the alignment then between the managers and the shareholders and things.

CS: A risk that pays off is called smart. It is only the risks like these world traders and all this other sort of thing, you know, it is 'encouraging risk encourages profit'.

YC: Well I mean I agree about the romance — I mean the romantic idea to have partnerships again. I mean you have to reduce so much. And it was the investment banking that lost. It is true that investment bankers took huge risks and they lost everything.

RR: But they were agents mostly. They did not take any risks at all.

YC: Yes, they did not, but if they lost, they lost a fortune, whereas nowadays the reward is totally commensurate with the risk taken. But still, if you think back to British banking, banks were extremely stable. Since the City of Glasgow Bank in 1878, there has never been a failure, including during the Great Depression. It can work, and without any regulation, because there was hardly any regulation. The fact was that British banks were commercial banks, it was like a rule of the game, which wasn't imposed from above, it was how they conceived banking. So, we know why that changed, but it is still strange that it could have become the worst hit country of all, and all changing in quite a short time, a generation.

RR: Well, 120 years.

YC: No, by the 1970s. So, in Switzerland what happened in this country renowned for great stability it became so unstable in the last phase of the – I mean, we can have lots of explanations – but I'd like just to…

CS: Well, in 1974 of course they bailed the banks through the lifeboat, and Germany too around that time.

YC: Herstatt is a little thing. It is a small private bank. Deutsche and Dresdner, they were not in trouble.

CS: But it increases the incentive for the big banks to be monitoring the rest of the market if they know they are going to have to be involved in resolution, and they were involved in resolution in the 1970s.

RR: John Turner, whose book about crises in British banking I referred to, offers two explanations. One concerns the capital buffers of British banking. There's a wonderful graph— I think it goes down, it lurches down—but it has gone from way over ten per cent to two per cent, or less than two per cent. So, the capital adequacy is being addressed by the reforms while possibly the liquidity is not being addressed sufficiently. The second point is about financial repression, that is, not regulation, but the state controlling credit and interest rates and whatever essentially, which runs all the way from the First World War through to 1971 to this new competitive policy of competition and credit control. And so, you then liberalise at that point and the cost of liberalisation, as you saw in Sweden and the Nordic countries, is the potential for financial crises. You can get rid of financial crises but there is a cost to that, and so there are fashions and sometimes people say, we will pay the price by having a financial crisis because of the better allocative mechanisms. Sometimes, this is a price too big to pay so we need to regulate that out of the system, as we are probably doing now, and creating these other non-intended problems on the liquidity side of things. And, almost certainly, the crisis will crop up somewhere that we do not expect next time.

Q3: Probably, but another point is that since the Swedish Central Bank is buying a lot of bonds at the moment, they're actually contributing to a market that is less liquid. They don't say that themselves though.

RR: This is a completely unknown experiment. What is it doing to asset prices? Nobody knows. But surely there is a crisis to come at the end of it, which may take the form of inflation, although there's not much sign of that at the moment. But there certainly is inflation in asset prices. So that's the latest caper and it is very hard to see that ending without a whole load of unintended unravelling—

without a lot of unintended consequences. At the same time that programmes have been suspended now in the US and Britain, they have recently been started in the EU, as well as Japan and China. But have we returned to normal conditions with normal rates of growth, two per cent? If somewhere between two per cent and four per cent interest rates is kind of what we tend think of as a normal financial scenario. No, we are miles away from it. It is very difficult to see when and how we get there.

Q4: I was thinking about your talk about near misses and near crises and I was wondering if all of you could maybe give your thoughts about periods with no crises. Should we be surprised about these periods, or what is the normal so to say? And should we researchers try to learn from these periods more than fantasising about crisis periods? I mean we can point to forty explanations to the 2007–2008 crisis but maybe we are influenced by the fact that it was a big crisis. I was wondering on your thoughts about the non-crisis periods and what you learned from them.

YC: Yes, I tend to see not that many crises first. I always like to be provocative, so I think the end of Bretton Woods did not make the financial system much more unstable than it was. In the end, okay: there was 1973, but if you talk to people about 1973–75, you would soon be reaching twenty crises. People remember stagflation, the oil crisis, the oil price, the Sunday without a car, and other things like that. But banking crises nobody remembers. So, it is important to rediscover them and to analyse the long run leading to 1982, but in terms of their impact at the time they were fairly minor. 1982 could have been as serious as 2007 but in the end, it was managed, and that was the only instance in history, as far as I know, that banks directly lent to governments. Otherwise, it is always they serve just as issuer, and act as an intermediary between the borrowers and the public. So, if everybody loses money of course it is going to have an effect on demand, and it will probably start a recession, but it is not the same as all the big banks collapsing. So that was very interesting. It is very interesting, I think, to understand why. Nobody had worked much on financial crises until 2007, and sort of suddenly, you know as financial historian, you realise you've got to look at it because there is demand. And I was struck by the fact that there had been very few financial crises in industrialised countries during the 20th century, apart from the 30s, and even the 30s is quite Germany-focused.

So, I want to start talking about the German banking crisis, but it is very peculiar, you trace the connections from the hyper defeat in the War, to hyperinflation, to the currency called the Reichsmark, and the reparations. It is very political as much as economical. So, I think that you could look at it and think that there had been quite a lot of stability in the financial system and then suddenly we had a very, very severe financial crisis. I described it in all that I have written as the most severe ever. Secondly, the way we talk of this concept of financial repression is totally ideological. It is a way of saying, 'You must not'. I have lived and grown up in a country where there was very limited financial repression and no exchange control: Switzerland. But I remember people in France and Britain being in a situation where you could not just take your money for holidays. It was not very pleasant.

CS: I do not remember that.

YC: On the other hand, this was a period with the highest growth rate. We know now that this was because of the War, due to the catching up process, and not just because regulation would help. So, to concentrate only on financial repression during this period, or to suggest that this was the only period when it was stable because of financial repression, is a biased way of analysing reality. It is very ideological, and it is typical of a certain view of the world. I just wanted to share a few thoughts in response to your question.

CS: Partly, I was inspired by Youssef, and I am slightly worried about the division between financial crisis and real crisis, in that everybody remembers having to turn the lights off, for example. But what was financing the ability to import any oil at all was the financial system and the fragility in that. So, that matters, and we should not divorce the banking and financial system from the real economy too sharply. I will go the other direction and say there is always a crisis. It may not be a global financial crisis but there are institutions failing and bubbles bursting all the time. You will not find a period of five years without a crisis somewhere around the world, at some time. What we should learn from those times is the distribution of that cost and looking at the outcomes and resolutions of those crises, and who paid. It is a fool's errand to be thinking that we're are going to prevent financial crises. I sound like Akerlof and Shiller here, but we need to be more deliberate, I think, in focusing more on the outcomes, the distributional cost of this kind of market activity.

RR: The American economist, Hyman Minsky, once proposed something called the financial instability norm. Minsky's proposition was that finance is inherently risky, you can eliminate risk, but the only way you do that is by not doing anything in finance. As soon as you start to have factional banking, or whatever, as soon as you start having time mismatches, currency mismatches, you are taking risks; and some of those risks will be ill-judged, or will go wrong, for some reason that you have no control over. I rather tend to agree with the proposition that finance is, inherently, about the management of risk. Unless you don't do any of it you will never eliminate risk and that means that you will always have some accumulation of risk: and if that goes wrong, we get what we call a crisis. There is another one of these IMF studies that looks at that. It compares financial crises in emerging markets, in countries which are prone to crisis, (they looked at Thailand in particular), and countries which have very few, if any. So, they looked at India which, I think since Independence, has had no financial crises. Then they looked at growth and development. And Thailand, despite having had half a dozen crises, has a — well this was until a few years ago, this is about 2012, I think — a much more impressive growth path, despite all the crises, than India before liberalisation. But the current liberalisation in India will probably mean that they will end up with some financial crisis, like everybody else.

YC: Can I add a tiny thing to what my two friends have said? I would put it slight—I went a bit far the other way, but I think financial stability doesn't mean an absence of crisis. But I think, because of 2008, we've become obsessed with the crisis which risks to completely engulf the entire international financial system. Now, this is what I would call the exceptional moment, but a series of crises—you cannot have business activity, you cannot have financial transaction in a capitalist economy without crisis, obviously. But having crises, in my view, is absolutely normal – they have occurred across the whole of the 19th and 20th centuries – it doesn't mean that you're facing what we've just had. If the regulators want to prevent another one like that this is what we should do, but to prevent a bank from collapsing.

ML: Perhaps the last question now.

Q5: In 1993–1994, Sweden had a very critical situation with soaring debt, like Greece. I was convinced that it would end up in a financial crisis, but it did not, the Finance Minister of Sweden managed to handle the situation. So, how many critical situations end up in a financial crisis? What is the probability? Are we now approaching another financial crisis, or will this situation be resolved in some way?

CS: Historians are very bad at predicting the future, I think, but what we do know a lot about is that institutions and the historical context matter. So, the ability to predict when something will be resolved, when there will be the forbearance, when there will be the global buy-in to support, these are things it is very difficult to predict. Greece's particular institutional context in Europe is a particular institutional context vis-à-vis Germany, and Germany's in its own position in Europe. And there's the kind of moral issues that are being driven by the sort of democratic politics in Germany, as well, which are overshadowing some of the position-taking. So again, it is so very highly contextualised that I am going to say we cannot really predict what's going to be resolved and what won't.

RR: Well if one wanted to take the comparison between Greece and Sweden, if either of those crises was going to be resolved, I would guess that it would be the Swedish crisis rather than the Greek crisis. As far as I am aware, Sweden has never defaulted on its sovereign debt. Greece has defaulted something like twelve times since Independence. That is history giving guidance.

CS: And it defaults and carries on you know; borrows again. Default doesn't seem to push you out of the market. Forever. Forever.

RR: Not forever.

ML: Thank you for your very interesting comments and the good discussion. Most of all, thank you for coming to Uppsala today and giving us a better insight into the development of financial crisis.

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