Framing of Financial Crises: Some History

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"Are we ready for the next financial crisis? Lessons yet to be learned"

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Financial Technologies

- Finance is a technology for transferring resources backward and forward in time.
- Like other technologies, financial technologies can be used for good purposes, or abused.
- Finance is a network technology, with positive and negative network externalities.
- Economic growth is a positive network externality of finance.
- Crises are negative network externalities of finance.

Three centuries of crises (a partial list)

- 18th century:

- Mississippi and South Sea Bubbles, 1720
- Ayr Bank (Scotland), 1772
- Wall Street's first crash, 1792

19th-century crises (partial list)

- US, 1819 (aftermath of War of 1812)
- Britain, 1825 (Latin American investments)
- US and Britain, 1837-1842 (Andrew Jackson)
- British railway mania, mid 1840s
- US, 1857 (railway related)
- Britain, 1866 (Overend Gurney)
- US, Europe, 1873 (Jay Cooke)
- UK, 1890 (Barings, Latin American investments)
- US, 1893 (gold standard, JP Morgan to the rescue)

20^{th}-century crises

- US, 1907 (trust companies as shadow banks; JP Morgan again to the rescue)
- Europe, UK (1931)
- US, 1930-1933 (bank failures, debt deflation)
- US, Europe, 1982ff (LDC debts)
- US Savings & Loans, late 1980s
- Asia, 1997
- Russia-LTCM, 1998

21st-century crises

- US, Dotcom bubble and crash, 1997-2002 (a crisis? Perhaps not, because banks were not much involved or hobbled.)
- US, 2007-2009 (subprime mortgage loans, shadow banks, toxic assets spread to world via financial networks)
- Next one???????????

How and why crises occur: Kindleberger, et al. on the build-up to crises

STAGES	UNDERLYING PROCESS
DISPLACEMENT	
BOOM	
SPECULATION	MONEY CHASES ASSETS
MANIA	

Crisis and its aftermath: Kindleberger, et al. continued

DISTRESS

REVULSION

PANIC/CRASH

ASSETS CHASE MONEY

DEPRESSION?

LENDER OF LAST RESORT?

Network technologies have strong association with crises

- Finance itself, and canals, railways, electricity, telecommunications, electronic/IT/Internet networks at center of many crises.
- Network technologies stimulate investment booms, and financial networks facilitate and sustain the booms via credit/debt creation, until they don’t. Positive network externalities.
- In a crisis, credit and liquidity disappear, just when market participants need it most, and asset values plummet. Economies may suffer great recessions and depressions. Negative network externalities.

Why are crises misunderstood?

- Most people don’t grasp the concept of network externalities, especially negative ones.
- Memories of the last crisis fade over time; in 2007-2009, hardly anyone alive had experienced or remembered the 1930s crisis.
- In the build-up to a crisis, the Cassandras of the world and financial historians are shooed away and told, “This time is different.” Folks making money don’t like to be told to stop doing what seems to be making money.

Why crises will occur again.

- Human nature is both speculative and interested in increasing one's wealth.
- New technologies, especially network technologies, will continue to get our speculative juices flowing, leading to booms, crashes, and bank failures.
- New financial technologies, history indicates, will continue to facilitate credit/debt creation and destruction.
- "Banks," by whatever name they are called, have incentives to increase financial vulnerabilities and make end-runs around financial regulations,

The bank balance sheet: the incentives of bankers can lead to crises via financial networks

• Assets		• Liabilities
• Loans & Investments (earning assets)		• Funding (deposits, market, e.g. commercial paper)
• Cash reserves		• Capital (including surplus)
• Total assets	=	• Total liabilities

But … can crises be good?

- If they are not wasted, some say.
- In the recent crisis, some did not waste it—”The Big Short”, John Paulson, et al.
- Lesson is that if one understands the pattern of a financial crisis, it may present an opportunity to increase one’s wealth.
- The crisis pattern may advance the development of new technologies faster than would happen without crises.
- But often there are too many innocent victims of the fallout from crises, and populist backlashes against finance. So while we can’t put an end to crises, we should probably try to minimize their occurrences and their negative effects by increasing our understanding of crisis management.