

ILO Century Project

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The financial crisis in the autumn of 2008 triggered a huge demand for history. Economists and politicians, international organisations, the media, students – everyone seemed to feel the urge, or I would even go so far as to say the need, to place the crisis in a historical perspective. Two questions came up time and time again. First, how serious is the current crisis compared with earlier ones, particularly the 1929 Crash? And second, can we learn lessons from earlier crises, and particularly the 1929 Crash, in order to recover from the current crisis and prevent new crises in future?

Referring back to history in this way is nothing particularly new. What is strange, though, is that the reference point is always 1929. The question has been raised every time there has been a major upheaval: in 1974, for instance, with the onset of “stagflation” following the first oil crisis; in 1982, when Mexico defaulted on its sovereign debt; and in 1987, when the New York Stock Exchange lost over 22% in one day, on 19 October, considerably more than in October 1929, when it lost 12.8% on Monday the 28th and 11.7% on Tuesday the 29th. I could mention other examples.

It all seems as if we have been anxiously but resignedly expecting a repeat of 1929 since the end of the War, or at least since Bretton Woods ended and the world economy was opened up in the early 1970s. Yet the more time passes, the less likely it is that 1929 will be repeated – and in any case, history never repeats itself.

So what can we learn from the experiences of past crises, and particularly 1929? The first thing we need to do is to make sure we are comparing like with like. What are the most relevant comparisons if we want to try to understand the 2008 financial crisis?

Without going into the detail of events that are still fresh in our memories, the first point I would make is that this was a banking crisis. It officially began, as it were, on 9 August 2007, when the French bank BNP Paribas suspended one of its three investment funds, saying that it was impossible to value the fund's assets accurately. The BNP Paribas announcement marked the start of what has become known as the "credit crunch", in other words the banks' increasing reluctance to lend each other money.

As we know, this interbank market freeze was due to the sub-prime crisis in the USA, where the real-estate bubble – prices more than doubled between 1995 and 2006 – finally burst following the increase in interest rates, resulting in defaults on mortgage payments. The collapse of the mortgage market was exacerbated by two factors: first, the very high levels of debt and low levels of solvency of borrowers, and second, the securitisation of these debts by Mortgage-Backed Securities, the value of which rocketed during the first few years of the 21st century.

We all know what happened next. The alarming rise in bank losses – 380 billion dollars for the 100 biggest banks in May 2008, including 43 billion for Citigroup, 39 billion for UBS and 37 billion for Merrill Lynch. The run on the Northern Rock building society in the UK in September 2007, the first run on a British bank for more than a century. The problems faced by America's fifth-biggest investment bank, Bear Stearns, bought out by JP Morgan Chase on 17 April 2008 with the help of the Federal Reserve: its market capitalisation had fallen from 18 billion dollars in April 2007 to 240 million on the day it was bought.

The situation deteriorated further in late summer 2008. On 7 September, the two mortgage companies Freddie Mac and Fanny May were taken over by the US Government. Their failure was seen as too big a risk for the financial markets in the USA and the rest of the world. A different line was taken with Lehman Brothers, America's fourth-biggest investment bank, which filed for bankruptcy on 15 September. On the same day, Merrill Lynch, one of the three biggest investment banks on Wall Street, announced that it was being bought by Bank of America.

The fall of Lehman Brothers marked a turning point, the transition to an acute crisis – you might even call it the transition from crisis to panic. The entire banking system appeared to be contaminated by billions of toxic assets, not just Mortgage-Backed Securities, but all sorts of structured products – Asset-Backed Securities (ABS), Collateralised Debt Obligations (CDO), Credit Default Swaps (CDS) – that might now be worthless. No bank, whatever its size or reputation, seemed safe from failure. This did not turn out to be the case, however, and Lehman Brothers would remain the only major victim of the crisis.

Governments intervened directly or indirectly to save banks and prevent the financial system from collapsing. There was increasing talk of “nationalisation”. On 16 September, the Federal Reserve came to the rescue of AIG (American International Group), the world’s largest insurance company, offering to lend it 85 billion dollars in return for an 80% stake in its capital. In the next few months more than 30 banks in the USA and Europe, including RBS in the UK, Citigroup in the USA, UBS in Switzerland and Commerzbank in Germany, to name just a few of the best known, were bailed out by their governments in various ways, usually through direct loans or equity injection. The governments’ intervention proved effective and the worst of the financial crisis seemed to be over by the start of 2009.

There are actually not all that many historical parallels with the 2008 financial crisis, and 1929 is not the first that springs to mind. If we focus on three factors – a crisis in the banking sector, a crisis that starts from the core rather than the periphery, and a crisis with very serious systemic risks – I can mainly think of three precedents, leaving aside 1929, which had other special features and which I will deal with separately in more detail.

The first parallel was the Baring crisis in 1890, which only experts will remember, though some of you may still recall the second Baring crisis in 1995, which led to the bank’s demise. In 1890, Baring Brothers was one of the two biggest investment banks in the City, and therefore in the world. It had over-committed itself in Argentina, where a serious crisis broke out in 1889-90. It was saved from failure at the eleventh hour by the London banking community, under the leadership of the Bank of England. A major international financial crisis was averted, but the shock was followed by several years of economic stagnation.

The second parallel was the panic that gripped the financial markets in August 1914, at the outbreak of the First World War. Immediately, the stock markets fell, interest rates went up, there were massive withdrawals of funds from the banks, the banks demanded repayment of loans, and there were widespread risks of non-payment. The entire financial

system, both in the countries fighting in the war and in the neutral countries, threatened to collapse. Only exceptional measures requiring State intervention saved the day – a moratorium on the settlement of debts, the partial or total suspension of payments, closing the stock exchanges, and compulsory exchange rates.

The panic in August 1914 had similar symptoms to the panic in September 2008, but different causes – the War, not an uncontrolled financial boom – and effects – it was followed not by an economic crisis, but by all-out war.

The third parallel was the international debt crisis in 1982. From the mid-1970s to the early 1980s, international capital movements were dominated by loans from commercial banks to Third World countries. These loans were fed by deposits from the oil-exporting countries, “petrodollars”, income from which rocketed after the two oil shocks in 1973 and 1978. Panic broke out in August 1982, when Mexico unilaterally declared a three-month moratorium on payment of its debt principal. A number of major banks, primarily American, were seriously exposed and even risked failure if there were defaults, threatening the financial system with paralysis or even collapse.

A major banking crisis was averted when agreement was reached between the banks and the Latin-American countries. The banks rescheduled the debt and agreed to new loans; the Latin American countries accepted the International Monetary Fund’s restructuring programmes; and the US monetary authorities acted as mediator and offered the banks guarantees. The similarities with September 2008 are striking. The risk that the financial system would implode was very real, even though the financial crisis turned out to be more potential than real and was not followed by an economic crisis. On the other hand, it heavily penalised the Third World countries, whose standard of living took a decade to return to pre-crisis levels.

As I said a moment ago, 1929 was both similar and different. First of all, the financial crisis that broke out in October was a stock market crisis, not a banking crisis. The New York Stock Exchange had soared after 1925, largely because of the progress of the American economy and particularly the rationalisation of production and the introduction of new management methods. The top-performing shares of the period, such as RCA (Radio Corporation of America) or General Motors, reflected the companies’ profitability and growth prospects. However, a bubble was clearly forming from 1928, especially in the new technologies. Public confidence started to be shaken in the summer of 1929 by increasingly

clear signs of an impending recession, and share prices started to fall in early October. One thing then led to another. The brokers were overwhelmed by the volume of sales, there were more frequent margin calls, and the ticker tape fell further and further behind the transactions. Without constant information on the share price levels, traders lost track of their positions and panic gripped the Stock Exchange on Thursday 24, Monday 28 and Tuesday 29 October. The New York banks, supported by the Federal Reserve, increased their loans and managed to prevent a lack of liquidity and a series of bank failures. Having lost 30% since its peak in August, the New York Stock Exchange stabilised in the first few months of 1930, as did the production and employment indices.

The Wall Street Crash of October 1929, we now know today, was not the cause of the “Great Depression”, whereas the banking crisis of September 2008 was very clearly the cause of what has come to be known as the “Great Recession”.

The causes of the Great Depression lay elsewhere, firstly in the international monetary system of the time, the gold standard, which was a fixed exchange rate system, and secondly in the monetary policies that this system generated. As Barry Eichengreen has clearly shown, the first symptoms of the crisis were seen as early as 1928, and were mainly the result of the Federal Reserve’s decision to raise interest rates from spring 1928 in order to curb the wave of speculation on the New York Stock Exchange. That decision led to the interruption of America’s capital exports and forced the central banks of countries dependent on that capital to equilibrate their balance of payments, adopt restrictive policies to defend their currency’s parity, and become more deeply entrenched in the crisis. This was typically the case with Germany, as well as other non-European countries such as Australia and Argentina. In the USA, the economic downturn reflected in the fall in industrial output in August 1929 became a deep depression not because of the Wall Street Crash, though this did not help, of course, but because of the restrictive policy adopted by the Federal Reserve from 1930 and, in particular, 1931.

The banking crises in the early 1930s were more significant than the stock market crash in 1929. Unlike the 2008 crisis, however, they were the consequence and not the cause of the economic crisis, even though they helped to exacerbate the situation. It is also significant that despite the global nature of the Great Depression, the banking crises did not affect all countries simultaneously. Some, like the UK, escaped them altogether. In others such as France, the crisis was protracted (just under 700 local and regional banks disappeared

between October 1929 and September 1937) but never very severe, although one major bank, the BNC, was orderly liquidated in 1932 and reconstituted the following year as the BNCI – the forerunner of today's BNP Paribas.

The most serious banking crises occurred in the two countries where the economic depression was most severe, the USA and Germany. Four banking crises broke out in the USA and more than 10,000 banks disappeared between autumn 1930 and spring 1933. The American banking system was gripped by real panic early in 1933, and all the country's banks had to be closed for a week, during which the new President, Franklin Roosevelt, announced a series of measures designed to restore confidence – the Emergency Banking Act. The banking crisis in America was primarily due to panic among depositors anxious to change their deposits into cash. The banks affected were mainly small local banks, and none of the large ones were really in danger – a situation explained by the extremely decentralised structure of the American banking system, itself the result of the ban on banks opening branches outside the state in which they were registered. The banking crisis nevertheless had serious consequences for the real economy, as Ben Bernanke has clearly demonstrated, through the rationing of credit, which hit small and medium-sized businesses in particular.

Germany's banking crisis in July 1931 had more similarities with the events of September 2008, in that this time it was the country's major banks that stood on the edge of the abyss. The crisis started on 13 July when Danat Bank, one of the country's four biggest, weakened by the collapse of the Nordwolle wool trust, closed its doors. Its failure triggered a run by depositors on the other major banks, which more or less suspended payment. The German banks were certainly imprudent in using short-term foreign capital to finance long-term investments, and they were severely affected by the interruption to the inflow of American capital. But they also had to face massive withdrawals of capital, particularly foreign capital, because of the protracted crisis and international tensions, especially about the payment of reparations. Finally, in July 1931, they were no longer able to obtain refinancing from the Reichsbank, whose gold and currency reserves had been dwindling steadily, after it had failed, faced with conditions imposed by France, in its attempts to replenish them by means of a foreign loan, bringing the gold cover for banknotes below the statutory minimum.

Government intervention only just managed to recover the situation. The Chancellor, Heinrich Brüning, immediately ordered all banks to close for two days, during which another

major bank, the Dresdner Bank, declared itself bankrupt. He introduced exchange controls on 15 July and, with the Reichsbank, obtained credit for the commercial banks and savings banks. Lastly, he reorganised the German banking system: the government recapitalised the major banks in return for 35% to 90% of their capital, depending on the bank concerned. They would be privatised a few years later under the Nazi regime.

To sum up, the parallels between 1929 and 2008 are not obvious, particularly in how the various crises – in the banking sector, on the stock markets, in the economy – were linked. The parallels are no more obvious with the other banking crises that have affected the advanced economies over the last century or more.

In this respect, the 2008 financial crisis can be seen as the most serious in history. Never before have so many of the leading banks – in terms of both size and reputation – in so many advanced countries found themselves, at almost exactly the same moment, requiring State intervention to save them from failing.

Why was the 2008 crisis so severe and on such a global scale? Generally speaking, the global economy at the start of the 21st century is not the same as it was at the start or even the end of the 20th century. The transition to a post-industrial society from the 1980s onwards has gone hand in hand with massive growth in the tertiary sector in general and the financial sector in particular. The globalisation of the world economy has also reached unprecedented levels, even compared with the pre-First World War period.

This huge growth in the financial sector has been made possible by a series of financial innovations that have emerged in the last thirty years or so, the most important of which may be grouped under the overall title of derivatives. Some people have blamed the financial crisis on these innovations, stressing their increasingly opaque nature based on extremely complex mathematical formulae which few bankers can really understand and therefore few can assess the risks involved. Warren Buffett famously referred to derivatives as “weapons of mass destruction”. It is useful to point out here that financial crises have often been blamed on the destabilising effects of certain innovations. In his famous book on the 1929 Crash, John Kenneth Galbraith described investment trusts as “the most notable piece of speculative architecture of the late twenties”. The lack of regulation of Euromarkets was linked to the 1982 debt crisis.

One considerable difference between investment trusts and euromarkets on the one hand and derivatives on the other is the derivatives’ degree of complexity. Investment trusts

and euromarkets were still traditional products, not so different from 19th century financial practices. Derivatives mark a new era. The packaging of structured products incorporating a number of mortgages with different levels of risk, the price of which is fixed by mathematical formulae, is something radically different and radically new.

The fact remains that financial innovation is a means, not an end in itself. It is not financial innovation but how it is used and regulated that generates risk. Derivatives are certainly complex, but recent generations of bankers are highly trained enough to handle this complexity. It is risk supervision both by the regulators and within firms themselves that all too often seems to have been lacking.

Low interest rates during the boom years and the oversupply of capital on the financial markets led to excessive risk-taking in order to obtain higher yields. Much of this can be put down to the accommodating policy of the central banks and widening global imbalances since the start of the 21st century – between countries with a balance of payments surplus and those with a deficit; between excessive saving in the former, primarily China, and a worrying level of debt in the latter, primarily the USA; and through the accumulation of enormous currency reserves in the emerging economies, mainly invested in American treasury bonds. This macro-economic climate unquestionably favoured the triggering of a financial crisis, especially when coupled with unregulated markets, inadequate supervision and the total failure of the credit rating agencies.

In this respect, regardless of its specific characteristics, the 2008 crisis involved the standard mechanisms identified by Charles Kindleberger in his classic work on the history of financial crises. There was undoubtedly what he calls a “displacement”, an exogenous shock caused by the financial innovations, which offered new ways of making a profit. The boom and the speculative frenzy that started in 2002 led in 2007 to “euphoria”, again using Kindleberger’s term. This was followed by a phase of “financial distress” from August 2007 to September 2008, when insiders started to sell, but many traders continued to buy; the “crisis” proper was marked by a strong signal, in this case the fall of Lehman Brothers; that was followed in turn by “panic”, which was ended by the intervention of a lender of last resort.

While we might already regard 2008 as the worst financial crisis in history, it is much too early to judge the severity of the economic crisis that followed. Its effects on the real economy were soon felt. GDP in the OECD countries fell by 2% in the fourth quarter of

2008 and by 2.1% in the first quarter of 2009, then bottomed out (-0.02%) over the second quarter. The unemployment rate went up from 5.6% in April 2008 to 8.2% in June 2009, before stabilising over the next few months. These trends were, initially, comparable with those observed in 1929-1930. On the other hand, the expansionist policies pursued by the political and monetary authorities, in contrast to the deflationary policies of those in charge in the early 1930s, seem to have had a positive effect and prevented the “Great Recession” from becoming a “Great Depression”.

So the lessons of the 1930s have certainly been learnt. But are these history lessons or economics lessons? It all depends on how you interpret Keynesianism, which may have been shaped by the experiences of the Great Depression, but which is above all an advance in economic theory. For historians, the lessons of history are of a different order, and involve observing not just similarities, but also, and perhaps above all, differences. Of course, the idea is to avoid repeating past mistakes. But these mistakes are actually quite easy to identify because people are forever harking back to them, sometimes obsessively, as we can see from the constant references to 1929.

It is clear that 2008 was not 1929. The financial crises were different, as were the economic crises. The 2008-2009 economic crisis was probably the worst for 80 years, but history will tell us whether the most relevant comparisons are with 1929 or with the post-war recessions – 1974, 1980, or 1990 – even if the global economy should fall back into recession in the short term. But 1929 and 2008 were also different politically. Leaving aside the rise of extremism and the emergence of totalitarian regimes, one of the main political consequences of the crisis in the 1930s, which might also be viewed as having helped to resolve it, was State intervention in the economy, which continued until the 1970s. This was particularly found in the financial sector, before deregulation took over in the 1980s and 1990s, to be replaced by massive State intervention again in the rescue plans of autumn 2008.

The Glass-Steagall Act, which has been much discussed recently, clearly reflects this development. Adopted by the US Congress in 1933 as part of the New Deal reforms, it ordered that the activities of commercial banks should be completely separate from those of investment banks. Its abolition in 1999 was regarded by many as one of the main causes of the 2008 crisis, and its reintroduction is currently being considered. The question of the regulation of the financial system, in order to prevent a disaster that could be more serious than 1929 the next time, is not straightforward. The scale of the State intervention that

followed the Great Depression was not just down to the severity of the 1929 crisis. It was part of a much wider phenomenon, the “Thirty Years War” of the 20th century, to use Arno Mayer’s expression – the years 1914-1945, which saw two world wars and the worst economic crisis in history. The Glass-Steagall Act was dictated by political reasons as much as by economic ones and probably played only a secondary role in the financial stability that marked the 1950s and 1960s. This does not mean that it should not be reintroduced today. But it should be for the right reasons.

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