1 Financial Crisis: A Hardy Perennial

There is hardly a more conventional subject in economic literature than financial crises. If few books on the subject appeared during the several decades after World War II, following the spate of the 1930s, it was because the industry of producing them is anticyclical in character, and recessions from 1945 to 1973 were few, far between, and exceptionally mild. More recently, with the worldwide recession of 1974–75 and the nervous financial tension of the 1980s and 1990s, the industry has picked up. When it first appeared in 1978, this work thus reflected a revived interest in an old theme, a theme that became increasingly salient in the decades that followed.

Financial crises are associated with the peaks of business cycles. We are not interested in the business cycle as such, the rhythm of economic expansion and contraction, but only in the financial crisis that is the culmination of a period of expansion and leads to downturn. If there be business cycles without financial crises, they lie outside our interest. Isolated financial crises that prove so manageable as to have no effects on the economic system will also be neglected to an extent. The financial crises we shall consider here are major both in size and in effect and, as a rule, international in scope.

The issues to be probed are several. Are markets so rational that manias—irrational by definition—cannot occur? If, on the other hand, such manias do occur, should they be allowed to run their course without governmental or other authoritative interference—at the risk of financial crisis and even panic that may spread through propagation by one means or another to other financial markets at home and possibly abroad? Or is there a salutary role to be played by a “lender of last resort,” who comes to the rescue and provides the public good of stability that the private market is unable to produce for itself? And if the services of a lender of last resort are provided nationally, by government or by such official institutions as a central bank, what agency or agencies can furnish stability to the international system, for which no government exists?

The reader is owed an immediate confession. In an earlier work, The World in Depression, 1929–1939, I reached the conclusion that the 1929 depression was so wide, so deep, and so prolonged because there was
no international lender of last resort. Exhausted by the war and groggy from the aborted recovery of the 1920s, Great Britain was unable to act in that capacity and the United States was unwilling to do so. This interpretation of the Great Depression has not gone unchallenged. The present work is nonetheless an attempt to extend the analysis more widely in time and space.

Speculative excess, referred to concisely as a mania, and revulsion from such excess in the form of a crisis, crash, or panic can be shown to be if not inevitable, at least historically common. And the role of the lender of last resort is fraught with ambiguity and dilemma. Commenting on the behavior of the Bank of England in the crisis of 1825, Thomas Joplin said, “There are times when rules and precedents cannot be broken; others, when they cannot be adhered to with safety.” Of course. But breaking the rule establishes a precedent and a new rule, which should be adhered to or broken as occasion demands. In these circumstances, intervention is an art, not a science. General rules that the state should always intervene or that it should never intervene are both wrong. This fact is abundantly demonstrated by recent questions of whether, or how, to rescue Lockheed, Chrysler, New York City, the Continental Illinois Bank, the Orange Country treasury in California, and Baring Brothers. It is evident as well in the questions of how to cope with continuing or new problems presented by Third World syndicated bank loans or the trauma of ailing thrift institutions in the Southwest of the United States that suffer from disintermediation, this on top of a bout of ill-advised lending for oil exploration, office buildings, luxury condominiums, and shopping malls. The list of questions emphasizes that the problem of financial crisis is still very much with us despite what the world has learned about economic stability from Keynes, so amply put into effect in the years up to about 1965.

By no means does every upswing in business excess lead inevitably to mania and panic. But the pattern occurs sufficiently frequently and with sufficient uniformity to merit renewed study. What happens, basically, is that some event changes the economic outlook. New opportunities for profits are seized, and overdone, in ways so closely resembling irrationality as to constitute a mania. Once the excessive character of the upswing is realized, the financial system experiences a sort of “distress,” in the course of which the rush to reverse the expansion process may become so precipitous as to resemble panic. In the manic phase, people of wealth or credit switch out of money or borrow to buy real or illiquid financial assets. In panic, the reverse movement takes place, from real or
financial assets to money, or repayment of debt, with a crash in the prices of commodities, houses, buildings, land, stocks, bonds—in short, in whatever has been the subject of the mania.

The monetary aspects of manias and panics are important, and later we shall examine them at some length. A monetarist view of the matter—that mania and panic would both be avoided if only the supply of money were stabilized at some fixed quantity, or at a regularly growing level—is rejected. In one monetarist view, a distinction should be made between “real” financial crises, which involve a shrinkage of the money base, or high-powered money, and “pseudo” crises, which do not. “Pseudo” strikes me as overkill. The New Shorter Oxford English Dictionary defines “pseudo,” inter alia, as “false, pretended, spurious, intellectually pretentious, meaningless.” It is legitimate to distinguish financial crises in which monetary change early or late in the process occurs from those in which the money supply is not greatly affected, but for monetarists to call the latter pseudo is rather like a cardiologist finding a cancer patient only pseudosick. Monetarists who insist on the distinction do so because of a strong prior belief in monetarism more than on empirical differences, and the speculators and investors who were wiped out in 1873, 1929, or 1987 would take little comfort from the thought that their experience was unreal. While better monetary policies would moderate mania and panic in all cases, and doubtless eliminate some, I contend that even optimal policies would leave a residual problem of considerable dimensions. Even if there were exactly the right amount of liquidity in the system over the long run, there would still be crises, and need in crisis for additional liquidity to be provided by a lender of last resort. This view can be generalized to commodity markets. Markets generally work, but occasionally they break down. When they do so, they require government intervention to provide the public good of stability.

The first edition of this book failed to include a definition of financial crisis, as Raymond Goldsmith pointed out, though it may be that the genus is like pretty women (in our culture): hard to define but recognizable when encountered. Goldsmith’s pithy definition is “a sharp, brief, ultracyclical deterioration of all or most of a group of financial indicators—short-term interest rates, asset (stock, real estate, land) prices, commercial insolvencies and failures of financial institutions.” He specifically excludes foreign-exchange difficulties as a necessary feature. Michael Bordo, a monetarist, defines financial crisis in terms of ten key elements or links (of which reduction in the money supply is number 6): a change in expectations, fear of insolvency of some financial institution,
attempts to convert real or illiquid assets into money, and so on. The first edition made its way without trying to define and limit the concept of financial crisis, but I recognize that there are people who are more comfortable when provided with a definition.

The position that markets generally work but occasionally break down is widely at variance with the views at either of two extremes: that financial and commodity markets work perfectly in all times and places, or that they always work badly and should be replaced by planning or governmental assignments. On the contrary, I contend that markets work well on the whole, and can normally be relied upon to decide the allocation of resources and, within limits, the distribution of income, but that occasionally markets will be overwhelmed and need help. The dilemma, of course, is that if markets know in advance that help is forthcoming under generous dispensations, they break down more frequently and function less effectively.

In the earlier versions of this book, I started with the South Sea and Mississippi bubbles of 1719–20, largely out of ignorance. With wider reading, I am now ready to begin with the sixteenth century and to include especially the Kipper- und Wipperzeit, a monetary crisis from 1619 to 1622 at the outbreak of the Thirty Years War, and the much-discussed “Tulipmania” of 1636–37. The reader perhaps deserves another warning, that there is a strong and insistent voice preaching that there are no manias or bubbles, and that the tulip episode in the Dutch Republic was a natural consequence of the fundamental fact that rare specimens of tulip are difficult to breed, but once bred are easy to propagate.

The early historical treatment is largely on Europe, and comes down to the London crisis of the fringe banks in 1973. Appendix B lists the major crises dealt with insofar as they can be fitted into a standard format. I know European financial history better than American, and both far better than those of Latin America and Asia, which occupy stage center today. To the extent that an abundance of work in secondary sources accurately reflects its importance in the international financial system, as it largely does, major attention to Britain is appropriate for the nineteenth century, if less so for the early eighteenth, when Amsterdam matched or outstripped London in financial power. Inability to read Dutch has cut me off from most of at least once frequently cited monograph on the crisis of 1763, but there is a considerable literature on Amsterdam in this period in more accessible languages, notably English.

This book is an essay in what is derogatorily called today “literary economics,” as opposed to mathematical economics, econometrics, or
embracing them both) the “new economic history.” A man does what he can, and in the more elegant—one is tempted to say “fancier”—techniques I am, as one who received his formation in the 1930s, untutored. A colleague has offered to provide a mathematical model to decorate the work. It might be useful to some readers, but not to me. Catastrophe mathematics, dealing with such events as falling off a height, is a new branch of the discipline, I am told, which has yet to demonstrate its rigor or usefulness. I had better wait. Econometricians among my friends tell me that rare events such as panics cannot be dealt with by the normal techniques of regression, but have to be introduced exogenously as “dummy variables.” The real choice open to me was whether to follow relatively simple statistical procedures, with an abundance of charts and tables, or not. In the event, I decided against it. For those who yearn for numbers, standard series on bank reserves, foreign trade, commodity prices, money supply, security prices, rate of interest, and the like are fairly readily available in the historical statistics. My thesis does not rest on small differences in quantities, however—or so I believe. It seemed to me to bog the argument down, as well as to involve an inordinate amount of work with greater costs than benefits. The result is an essentially qualitative, not quantitative, approach.

Chapter 2 provides the background to the analysis. It consists of a model of speculation, credit expansion, financial distress at the peak, and then crisis, ending in panic and crash. It is patterned after early classical ideas of overtrading, followed by revulsion and discredit, as expressed by Adam Smith, John Stuart Mill, Knut Wicksell, Irving Fisher, and others, but most recently by the late Hyman Minsky, a monetary theorist who held that the financial system is unstable, fragile, and prone to crisis. It is not necessary to agree with him about the current monetary system of the United States to recognize that his model may have great explanatory power for past crises in this country and especially in Western Europe.

The analysis itself, with copious historical illustration, begins with Chapter 3, which focuses on speculation, the mania phase of the subject. The central issue here is whether speculation can be destabilizing as well as stabilizing—whether, in other words, markets are always rational. The nature of the outside, exogenous shock that sets off the mania is examined in different historical settings: war, the end of war, a series of good harvests, a series of bad harvests, the opening of new markets, innovations, and the like. A particular recent form of displacement that shocks the system has been financial deregulation, or liberalization. This has
been an especial stimulus to monetary expansion, foreign borrowing, and speculative investment in East Asia, encouraged by attacks on government direction of bank activity or repression by Ronald McKinnon and Edward Shaw as early as 1973.9

Objects of speculation are listed: commodity exports, commodity imports, agricultural land at home or abroad, urban building sites, new banks, discount houses, stocks, bonds (both foreign and domestic), glamour stocks, conglomerates, condominiums, shopping centers, office buildings. Moderate excesses burn themselves out without damage. A difficult question to answer is whether the euphoria of the upswing endangers financial stability only if it embraces two or more objects of speculation, a bad harvest, say, along with a railroad mania or an orgy of land speculation.

Chapter 4 deals with the monetary dimensions of both manias and panics. We shall note occasions when boom or panic has been set off by monetary events—a recoinage, a discovery of precious metals, a change in the ratio of the prices of gold and silver under bimetallism, an unexpected success of some flotation of a stock or bond, a sharp reduction in interest rates as a result of a massive debt conversion, or a mistake in monetary policy. A sharp increase in interest rates may also cause trouble through disintermediation, as depositors flee banks and thrift institutions and leave them with long-term assets that fall in price. Innovations in finance, as in productive processes, can shock the system and lead to overtrading. A 1986 report of the Bank for International Settlements stated that financial innovations are often underpriced and hence overused.10

More fundamentally we shall stress the difficulty of getting the monetary mechanism right at any one time and the impossibility of keeping it right. Money is a public good; as such, it lends itself to private exploitation. Banking, moreover, is notoriously difficult to regulate. Modern monetarists insist that much, perhaps most, of the cyclical difficulties of the past are the consequences of mistakes of understanding. That such mistakes were frequent and serious cannot be denied. The argument advanced in this chapter, however, is that even when the supply of money was neatly adjusted to the demands of an economy, and mistakes were avoided, the monetary mechanism did not stay right very long. When government produces one quantity of the public good, money, the public will proceed to make more, just as lawyers find new loopholes in tax laws as fast as legislation closes up old ones. The evolution of money from coins to include bank notes, bills of exchange, bank deposits,
finance paper, and on and on illustrates the point. The Currency School might be right about the necessity for a fixed supply of money, but it is wrong about the possibility of achieving it.

In Chapter 5 we consider swindles and defalcations. It happens that crashes and panics often are precipitated by the revelation of some misfeasance, malfeasance, or malversation (the corruption of officials) engendered during the mania. It seems clear from the historical record that swindles are a response to the greedy appetite for wealth stimulated by the boom. And as the monetary system gets stretched, institutions lose liquidity, and unsuccessful swindles are about to be revealed, the temptation to take the money and run becomes virtually irresistible. It is difficult to write on this subject without permitting the typewriter to drip with irony. An attempt will be made.

Chapter 6 describes the crisis stage, with the emphasis on domestic aspects. One question is whether manias can be halted by official warnings—moral suasion or jawboning. By and large, the evidence suggests that they cannot, or at least that many crises followed warnings that were intended to head them off. One remark, widely noted in financial circles, was that of Alan Greenspan, chairman of the Federal Reserve Board, who stated on December 6, 1996, that he thought the New York stock market was “irrationally exuberant.” This was at a time when the Dow-Jones industrial average was 6,400. It subsequently rose over 11,000. A similar warning had been issued in February 1929 by Paul M. Warburg without slowing for long the stock market’s upward climb. The nature of the event that ultimately produces a turning point is discussed: some bankruptcy, defalcation, or troubled area revealed or rumored, a sharp rise in the central-bank discount rate to halt the hemorrhage of cash into domestic circulation or abroad. And then there is the interaction of falling prices—the crash—and its impact on the liquidity of the system.

Chapter 7 deals with domestic propagation. It was mentioned just now that a financial crisis may be more serious if two or more, rather than just one, good or asset is the subject of speculation. History seems to show that a boom in one market spills over into others. When and if a crash comes, moreover, it may seize up the banking system and, quite apart from any change in the quantity of money, lead banks to ration credit all around. The connections between the stock and commodities markets were especially strong in New York in 1921 and 1929, and those linking shares and real estate again in 1929, and in 1987, and notably in Japan and Scandinavia in 1988 to 1990.

In Chapter 8 we turn to international contagion of manias and crises.
Connections run through many linkages, including trade, capital markets, flows of hot money, changes in central bank reserves of gold or foreign exchange, fluctuations in prices of commodities, securities, or national currencies, changes in interest rates, and direct contagion of speculators in euphoria or gloom. Some crises are local, others international. What constitutes the difference? Did, for example, the 1907 panic in New York precipitate the collapse of the Società Bancaria Italiana via pressure on Paris communicated to Turin by withdrawals? There is fundamental ambiguity here, too. Tight money in a given financial center can serve either to attract funds or to repel them, depending on the expectations that a rise in interest rates generates. With inelastic expectations—no fear of crisis or of currency depreciation—an increase in the discount rate attracts funds from abroad and helps provide the cash needed to ensure liquidity; with elastic expectations of change—of falling prices, bankruptcies, or exchange depreciation—raising the discount rate may suggest to foreigners the need to take more funds out rather than bring new funds in. The trouble is familiar in economic life generally. A rise in the price of a commodity may lead consumers to postpone purchases in anticipation of the decline, or to speed them up against future increases. And even where expectations are inelastic, and the increased discount rate at the central bank sets in motion the right reactions, lags in responses may be so long that the crisis supervenes before the Marines arrive.

One complex but not unusual method of initiating financial crisis is a sudden halt to foreign lending because of a boom at home. This occurred in Germany and Austria in 1873 and contributed to the difficulties of Jay Cooke in the United States; in the Baring crisis in 1890, when troubles in Argentina led the British to halt lending to South Africa, Australia, the United States, and the remainder of Latin America; and in the spring of 1928, when the start of the stock market boom in New York cut off lending on bonds to Germany and Latin America, causing them to slide into depression. A halt to foreign trading is likely to precipitate depression abroad, which may in turn feed back to the country that launched the process. Chapter 8 is especially enlarged from earlier editions to make room for the manias and crises of Latin America, East Asia, and Russia, a form of contagion that started locally and in due course spread widely over oceans.

Crisis management at the domestic level is treated in Chapters 9 and 10. The first of these is devoted to no management on one hand and to a host of miscellaneous devices on the other. No management is the
remedy of those who think that the market is rational and can take care of itself; according to one formulation, it is healthy for the economy to go through the purgative fires of deflation and bankruptcy because these get rid of the mistakes of the boom. Among the miscellaneous devices are holidays, bank holidays, the issuance of scrip, guarantees of liabilities, issuance of government debt, deposit insurance, and the formation of special institutions like the Reconstruction Finance Corporation in the United States (in 1932) or the Istituto Ricontruzione Italiana (IRI) in Italy (in 1933). The Italian literature calls the process the “salvage” of banks and companies; the British in 1974–75 referred to saving the fringe banks as a “lifeboat” operation.

Chapter 10 addresses questions related to a lender of last resort—whether there should be one, who it should be, how it should operate—and the dilemmas posed for the system by the discharge of such a role. If the market is sure it will be saved by a lender of last resort, its self-reliance is weakened. On the other hand, one may choose to halt a panic for the sake of the system today, rather than worry about effects on incentives tomorrow. If there is a lender of last resort, however, whom should it save: insiders? outsiders and insiders? only the solvent, if illiquid? But solvency depends on the extent and duration of the panic. These are political questions, and they are raised in particular when it becomes necessary to legislate to enlarge such devices as the Federal Deposit Insurance Corporation (FDIC) or the Federal Savings and Loan Insurance Corporation (FSLIC) when one or the other runs out of funds to lend to banks in trouble in time of acute stress. The issue was particularly acute in the 1990s in Japan, where the collapse of the Nikkei stock bubble in 1990 uncovered all sorts of bad real estate loans by banks, credit unions, and other financial houses, confronting the government with the neuralgic question of how much of a burden to put on the taxpayer. Particularly troubling was the catatonic state of government in Japan in the 1990s, slow to decide how to meet the crisis and slower to act.

The penultimate chapter moves from the domestic scene, in which there is responsible government, to the international arena where no agency or government has de jure responsibility for providing the public good of monetary stability. U.S. government support for Mexico, first in 1982 and again in 1994 on two occasions, was justified on the grounds, one, that countries of the North American Free Trade Area (NAFTA) should stick together, and second, that in preventing a breakdown of Mexican finance, the NAFTA countries prevented a collapse of
lending to a list of “emerging markets.” This expectation or hope failed to be realized. Following the rescue of Mexico in 1995 under the leadership of the IMF, the crisis spread to Thailand and then ricocheted through East Asia to Indonesia, Malaysia, and South Korea, escaping, however, China, Singapore, and Hong Kong.

A final chapter sums up the argument. In a word, our conclusion is that money supply should be fixed over the long run but be elastic during the short-run crisis. A lender of last resort should exist, but its presence should be doubted. For example, uncertainty about whether New York City would be helped, and by whom, may have proved just right in the long run, so long as help was finally provided, and so long as there was doubt right to the end as to whether it would be. This is a neat trick: Always come to the rescue, in order to prevent needless deflation, but always leave it uncertain whether rescue will arrive in time or at all, so as to instill caution in other speculators, banks, cities, or countries. In Voltaire’s Candide, the head of a general was cut off “to encourage the others.” What I am urging is that some sleight of hand, some trick of mirrors be found to “encourage” the others (without, of course, cutting off actual heads) because monetarist fundamentalism has such unhappy consequences for the economic system.

Let me close this introduction with a word of caution. This book has few new themes. Insofar as it fits into an intellectual pattern, it is against revisionism. A considerable portion of the economic writing of the last fifty years has been devoted to attacking old-fashioned modes of analysis that I happen to believe are valid. The monetarist school of Milton Friedman, for example, holds that there is virtually no destabilizing speculation, that markets are rational, that governments make mistake after mistake. I hope to suggest that such views, although not necessarily wrong, are too emphatic and leave too little room for exceptions. Both Keynesians and monetarists tend to disregard the macroeconomic impact of price changes, on the ground that gains from price changes for producers or consumers are matched by losses to consumers or producers, with no net effect on the system except where there is money illusion, that is, when consumers or producers fail to see that their income has changed when prices change while nominal monetary aggregates remain unchanged. This disregard is often mistaken, in my judgment, as when the decline of prices leads to industrial, mercantile, and investor bankruptcy, financial disintermediation, bank failure, and spreading deflation before the benefits, if any, from lower prices have a chance to make themselves felt. The net effects of rising prices in today’s world
may be limited by offsetting gains and losses, without letting loose
dynamic reactions. I would argue, however, that the pre-Keynesians were
right in paying attention to price movements, now so cavalierly dis-
carded. A study of manias, bubbles, crashes, panics, and the lender of last
resort helps us to move from classical thesis through revisionist antithe-
sis to a more balanced synthesis. Or so I claim.