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Article

Financial crises in historical perspective: Parallels between the past and present

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ABSTRACT

The outbreak of the financial crisis in 2007 has increased the interest in the study of financial history and, mainly, from compared studies on international financial crises. To this end, Investigaciones de Historia Económica-Economic History Research has set out to publish a special issue, welcoming the research on past financial crises into its pages. This issue consists of five papers, summarized in this introduction, that revolve around three large topics: the significance of sources and their use to understand the origin of financial crisis as well as their regulatory consequences; comparisons between major crises, and the study of financial crises' causes and the measures taken to rise to their challenges. The articles presented here delve into the lessons offered by past crises and provide a good example of Economic History's ability to contribute to a better understanding of past and present economic phenomena.

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Las crisis financieras en perspectiva histórica: paralelismos entre el pasado y el presente

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RESUMEN

El estallido de la crisis financiera en 2007 ha incrementado el interés por el estudio de los antecedentes financieros y, sobre todo, por los estudios comparados sobre las crisis financieras internacionales. Con este fin, Investigaciones de Historia Económica - Economic History Research publica este número especial, dedicado a la investigación sobre las crisis financieras del pasado. Este número consta de 5 artículos, cuyo resumen se encuentra en esta introducción, y que giran en torno a 3 grandes temas: la importancia de las fuentes y su uso para entender el origen de las crisis financieras, así como sus consecuencias regulatorias; comparaciones entre las grandes crisis; y el estudio de sus causas y las medidas adoptadas para enfrentarlas. Los artículos que aquí se presentan profundizan en las lecciones ofrecidas por las crisis del pasado, y constituyen una buena muestra de la capacidad de la Historia Económica para contribuir a una mejor comprensión de los fenómenos económicos pasados y presentes.

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When the financial crisis broke out in 2007, few analysts would have foreseen its profound impact. After two decades marked by stability and growth – a period dubbed by some as a stage of "Great Moderation" – the world's economy succumbed to an extraordinarily severe crisis that expanded quickly from the United States to the rest of the world, rapidly turning into a global crisis that, while financial in origin, fiercely swept the real sector in its wake. Despite, as Marichal has pointed out (2010), a strong financial

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instability in 1977–2000 that translated into over a hundred financial crises in 93 countries, this crisis seemed to take everyone by surprise. Yet, many studies were published in the 1980s and 1990s – a large number focusing on emerging economies – pointing to the threats associated with capital market globalization and increasing financial liberalization.[1] From a historical perspective, the works by DeLong et al. (1999), Bordo et al. (1998), Bordo et al. (2001), or Goodhart and Delargy (1999) all revealed a growing vulnerability in financial markets as a result of the globalization process initiated in 1971, relying on the historical evidence from the first globalization (1870–1913) to draw parallelisms and dissimilarities.

In spite of these warnings and potential red flags, neither political powers nor agencies in charge of financial market regulation and oversight took any steps. The confidence in markets' self-regulatory capability and the ability to measure risks made it hard to believe that a systemic, worldwide crisis could actually unleash. As a result, the beginning of the crisis not only spurred a host of studies on its causes, impacts and the economic policies required to put an end to it, but also challenged the very usefulness of Economics and fueled an academic and professional debate on the prevailing research methodology and economic activity, especially in financial markets, as well as on how Economics is taught at universities.[2]

Against this backdrop, History emerged as a basic reference to read into the facts. According to Stephen King, HSBC's Chief Economist, "the global financial crisis can be more easily interpreted and understood by someone who has prior knowledge about the 1929 crash, the Great Depression and, for that matter, the 1907 crash" (Coyle, 2012). Moreover, the knowledge of past experiences soon became an instrumental guide to face a situation that seemed to escape analyses based on more conventional models. Clearly, the more or less unorthodox reactions in the early months of the crisis were largely influenced by the Great Depression experience. Thus, from the very beginning, the crisis triggered a great interest in gleaning some insights from the study of financial histories and, mainly, from compared studies on international financial crises. This crisis has been "a good crisis" for Economic History, as argued by Barry Eichengreen in 2011. Studies based on a historical standpoint have risen to the top of international research agendas. Works by Bordo (2008), Reinhart and Rogoff (2009), Eichengreen (2008), Eichengreen and O'Rourke (2009, 2010), Felton and Reinhart (2008), Collyns, 2008, Marichal (2010), or Crafts and Fearon (2013), among others, prove a growing interest to find in history the keys to understand the causes of financial crises, to explore their major macroeconomic effects, or to examine how effective economic policies are.

The issue we are presenting here intends to delve into this line of research, contributing not only to the understanding of the current situation but also to the search for valid formulas to find solutions. To this end, *Investigaciones de Historia Económica-Economic History Research* has set out to publish a special issue, welcoming the research on past financial crises into its pages. This issue consists of five papers that revolve around three large topics: (1) the significance of sources and their use to understand the origin of financial crisis as well as their regulatory consequences; (2) comparisons between major crises, and (3) the study of financial crises' causes and the measures taken to rise to their challenges.

In his article "Historical Reflections on the Causes of Financial Crises: Official Investigations, Past and Present, 1873–2011", Carlos Marichal sets out to open new paths for historical research, underscoring the use of official documents produced in the course of investigations conducted by several commissions and committees created to look into the causes underlying some financial crises. With this goal in mind, as he briefly reviews major crises until World War I, Marichal analyzes the 1873 and 1907 crises, lingering over the leading reports issued in the United States and Great Britain about the Great Depression. Finally, he takes a look at the current financial crisis, which has led to the creation of many commissions, committees and think-tanks in several countries, with their key findings published in a myriad reports, studies and papers that are readily accessible, as the author highlights, as a result of new information technologies.

As noted in this article, it was pressure from a public opinion distraught by the magnitude and effects of financial wrongdoing that propelled the creation of those commissions. Documents have proven useful largely as a result of the efforts made by committee members to collect information from as many and diverse sources as possible to offer a thorough view of the causes underlying these problems. While, as shown by the comparison drawn here, these reports largely determined that poor management and even fraud were among the key causes, "unscrupled businessmen" rarely took any legal responsibility. On the contrary, report conclusions did help to justify and legitimize reforms and steps taken later, by offering a demonstration of the diagnosis that led to regulatory reactions. Future historians will have plenty of materials to show whether these regularities are followed by this crisis as well.

A fruitful research avenue has hinged on historical comparisons among the current crisis and past crises – primarily a comparison between the present Great Recession and the 1929 Great Depression (Eichengreen and O'Rourke, 2009, 2010; Fernández de Córdoba and Kehoe, 2009, or Bordo and James, 2010, among others). Foreman Peck's article, "Great Recessions Compared", compares the Great Depression to the Great Recession in the United States, Great Britain, France, and Germany. This author discusses the impact of both crises, using several metrics (GDP, employment changes, trade, etc.) and argues that today's crisis has been less severe – either as a result of differing shocks or dissimilar economic policies. While he looks into the different natures of these shocks, Foreman Peck zeroes in on the ties between the current crisis' lower impact and applied economic policies – specifically, an anti-cyclic monetary and fiscal policy combined with efforts to prevent an international trade collapse. As opposed to what happened in 1929, this time both the U.S. Federal Reserve and Europe's Central Bank have lowered discount rates (though this expansive monetary policy has not come hand in hand with a credit recovery), and present governments have turned to an expansive fiscal policy that has buffered the impact of the current crisis (albeit less effectively than expected). On the downside, government and sovereign debts have risen. In addition to these measures, governments have also striven to avoid policies that might compromise trade, and, in fact, commerce has remained relatively buoyant throughout the current crisis, largely as a result of the World Trade Organization's efforts, but also partly because trade has a lower weight on these countries' national income at present.

For Foreman Peck, however, these economic policy decisions do not only reflect the fact that we have learned from past experiences but also reveal the influence of pressure groups. As the author points out, the severity of the 1929 crisis drove a massive regulatory reform: in 1933, the United States enacted the U.S. Banking Act, not only introducing the federal Deposit Insurance to prevent

[1] For instance, Krugman (1998), Sachs (1996), Radelet and Sachs (1998), and Stiglitz (2000) insisted on the dangers associated with capital market globalization as well as short term capital streams' high volatility and pro-cyclic nature.

[2] See, among many others, the "Dismal Soothsaying" forum at *Project Syndicate* blog on Economics (http://www.project-syndicate.org/focal-points/dismal-soothsaying), or the debate on "What's the use of Economics" at Voxeu.org's blog (http://www.voxeu.org/debates/what-s-use-economics), with contributions from economists like Howard Davies, Richard Baldwin, Dani Rodrick, Andrew G. Haldane, Robert Skidelsky, and Barry Eichengreen. The need to change the way in which students are taught at Schools of Economics was extensively discussed, for example, at a seminar funded by the Bank of England and the British Government's Economic Office, leading to the publication of *What's the Use of Economics? Teaching the Dismal Science after the Crisis* (Coyle, 2012).

future crises but also incorporated other provisions, known as the Glass-Steagal Act, that limited commercial banks' activities. Yet, in the current crisis, large banks have supported the application of anti-cyclic policies with a very clear goal in mind: preventing a significant regulatory reform that would certainly go beyond higher capital requirements. The anti-cyclic policies instituted have lessened the impact of the crisis, but they have also reduced pressures for a greater regulatory reform that would prove instrumental if we wanted to lower the likelihood of future crises.

It is hard to summarize the entire literature on crisis causes or drivers, but, roughly, a distinction can be made between two large groups: on the one hand, studies linking financial crises to macroeconomic instability (current account imbalances, public deficit growth, etc.), and on the other, studies viewing financial nuisances as characteristic of financial systems. Anna María Cerro and Osvaldo Meloni, in their article entitled, "Making Explosive Cocktails: Recipes and Costs for 25 Argentine Crises from 1823 to 2003", intend to identify the ingredients that often combine to build a crisis. Their goal would be to design a sort of "warning" mechanism to prevent future financial crises. This study draws from a very widespread debate on financial crisis drivers, although most empirical studies are panel data studies based on a large country sample. Cerro and Meloni, however, concentrate on Argentina's financial crises, and their single-country, long-term focus offers a different perspective than those other studies. With an econometric analysis based on a non-standardized classification technique, they have found three possible recipes, with certain ingredients combining to increase the likelihood of a more severe crisis. The first combination or "recipe" for a more likely and severe financial crisis features high public spending associated with strong current account deficit. The second combination, leading to frequent, less severe crises, involves a moderate public deficit with an overvalued exchange rate and high interest rates abroad. The third "recipe" – with intermediate effects – combines moderate public spending, overvalued exchange rate, and moderate international interest rates with falling banking deposits and a growing M2/international reserve ratio. Thus, the purpose of this article is to show how knowing about these "explosive recipes" may help anticipate future crises and to lessen their impact.

With a different approach, Matthew Holloway and Jari Erolanta look at the 1990s' Asian crisis from Minsky's standpoint in their article, "Stability Breeds Instability?" A Minskian Analysis of the Crisis of the Asian Tigers in the 1990s". Explaining what Bordo (1986) calls "financial fragility" is a key element Minsky's Keynes-inspired work (1977, 1992). According to Minsky, financial instability does not come as a consequence of external shocks; rather, it is an inherent phenomenon in the financial realm. As noted by Torrero (2010), Minsky views financial liberalization and competition as causing a cycle with growing risk and vulnerability leading to a financial crisis. The central hypothesis in this article attributes the 1997 Asian crisis to a strong investment growth fueled by highly speculative foreign funding and very deficient local financial institutions. The article's uniqueness lies in its attempt to show how the mechanisms that Minsky views as triggering a financial crisis specifically came together to pave the way for Asia's financial crisis in the 1990s. To this end, it describes the vulnerability of some countries – namely, Indonesia, Malaysia, South Korea, Thailand, and the Philippines – as a result of their weak financial systems. Starting in the mid 1990s, these countries embarked on an economic liberalization process, including interest rate deregulation, the elimination of capital controls, and lacking banking regulations, that enabled financial institutions to grow to extraordinary levels, capturing foreign savings to support domestic investments. As the authors highlight, this rapid growth of foreign investment was driven by the fact that these countries had pegged their currencies to the U.S. dollar, building an artificial sense of security, as the exchange rate risk seemed eliminated. In turn, this also fostered the emergence of complex financial instruments that further contributed to this growing bubble.

Unlike the preceding two, the article written by Sebastián Álvarez and Juan H. Flores, "Trade Finance and Latin America's Lost Decade: The Forgotten Link", discusses ways to exit a crisis. Specifically, it analyzes the links between foreign trade financing and Latin America's import behavior in the 1980s' crisis. It draws two primary conclusions: first, the fact that imports fell more strongly in Latin America than in the other groups of developing countries studied may be attributed to the lack of trade credit, and second, the prompt recovery of this flow was influenced by debt negotiations and the agreement to terms imposed by international agencies. Thus, the article characterizes trade recovery as a mandatory requisite to exit a crisis. As shown by this study, starting in the 1970s, trade credit was used to finance a significant share of the trade with developing countries. When Latin America succumbed to the 1982 crisis, the trade credit was clearly stricken by stopped flows to crisis-affected countries, and imports plummeted in these nations. However, the recovery proved relatively quick, as all the parties had a lot riding in a swift return to normalcy. On the one hand, as capital imports were believed to be crucial for Latin America's economic growth, both debtor countries and international agencies were keen on reinstating trade funding as a means to jumpstart the recovery of these economies. On the other hand, the banks and credit agencies involved were interested in ensuring Latin American countries' ability to repay their loans. As a result, trade credit played a key role in debt negotiations, and it was reestablished as soon as debt agreements were signed with debtor countries. If these flows had not been promptly reinstated, Latin American imports' recovery would have taken much longer. As these authors put it, "the lost decade would have proven even worse."

As we have noted elsewhere (Martín-Aceña et al., 2013) recently, learning more about previous experiences does not prevent us from suffering new crises, but if we ignore the past, we may overlook warning signs about specific problems, and we may risk errors in the judgments that serve as a basis for actions and choices to deal with a new scenario. The articles presented here delve into the lessons offered by past crises and provide a good example of Economic History's ability to contribute to a better understanding of past and present economic phenomena.

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