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Financial crises: International
dissemination and consequences in
historical perspective

Editors

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Table of contents

INTRODUCTION.....	5
Introductory remarks.....	8
Two centuries of international financial crises — Crises types, patterns and significance.....	9
Prudential supervision and international cooperation on the financial market since 1965 and its consequences for debt crises.....	16
The development of international financial centres and financial crises	27
Comments and discussion.....	36

INTRODUCTION

MATS LARSSON & JAN OTTOSSON

The role of financial crises in history has been a matter of considerable debate since the occurrence of the crisis of 2007/2008. Since Professor Howard Davies concluded that over 30 different explanations were at hand, various explanations have passed in the scientific debate. Certainly, financial crises and their aftermaths are still — even as we write — present. In Europe, for example, the developments in Greece are still a matter of on-going concern; this recent financial crisis has certainly not been fully explained in contemporary research. Therefore, an increasing amount of research within the field of economic history has proven useful in the broad understanding of such crises. We can also see an increasing interest in historical explanations certainly due to the problematic nature of lacking explanations within some fields of macroeconomics.

Of course, the seminal works by Charles Kindleberger regarding the occurrence of financial crises as well as the consequences, for example, has been at the centre of approaches within economic history. 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. Furthermore, new approaches to earlier financial crises have also been a matter of recent research. The role of the crises in early nineteenth-century Great Britain might especially be mentioned in this respect. Therefore, the rapidly

increasing on-going research within the field of financial and economic history, in this respect, is perhaps one of the most visible tendencies currently. The tradition within the subject of economic history, of course, is long and numerous.

There is a recent growing interest in studying not only earlier crises, but also attempting to gain a better understanding of the historical processes leading up to the troubles of 2007/2008. The period of various monetary regimes after the Second World War has been a matter of special interest from this perspective. 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.

In this respect, the Swedish research regarding the role of financial crises has been one important strand during recent decades. The research environment at the Department of Economic History, Uppsala University, Sweden, has examined various aspects of the development within the field of financial and business history. International collaboration has been one of the centrepieces of this approach for many years.

Therefore, we arranged an international seminar in June 2015, entitled Financial crises — international dissemination and consequences in historical perspective. The international scholars present at this seminar were also part of the grading committee, with Professor Richard Roberts as the opponent, of the doctoral dissertation of Eduardo Altamura, a collaboration between University of Geneva and Uppsala University. The discussion during the seminar was documented and edited before publication. We would like to thank those involved in this seminar for their collaboration, especially Professor Richard Roberts, King's College, London, Professor Catherine Schenk, Oxford

University, former Glasgow University, and Professor Youssef Cassis, European University Institute, EUI, Italy. Further, Dr Sarah Linden Pasay has checked the language, we are most grateful for the efforts.

The Seminar

KEY

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

Introductory remarks

Mats Larsson

ML: 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

RR: Thank you. What I am going to present is really a grand picture — a tour de raison — of financial crisis over two or more centuries. And, as the author Charles Kindleberger put it, 'financial crises are a hardy perennial.' In fact, drawn 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 also the question of why have there been so many, or why they continue. Leaving that behind 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; debt crises in two forms: 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 actually an additional type as well. Traditionally, the oldest type of financial crisis was what was known as a panic or a commercial crisis, occurring in the seventeenth and eighteenth centuries. These are 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, for example, are easy to identify. 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 qualifications; one is sample size. Much of the 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 are 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 reckoned 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 to 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. Those 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 U.S. 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?

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 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 as 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, 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 banking crises literature. The absence of banking crises in these years stemmed from official controls on banks imposed during the depression and the war, and on the post-war practice of financial repression to prioritize government's management of 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 liberalize banking with a view to better financial provision.

Britain led the way with the introduction in 1971 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 wholesale markets, which had been newly liberalized, to lend to commercial real estate developers. The outcome, predictably enough, was the secondary banking crisis of 1973 to 1975.

Many other banking liberalizations have also ended with financial crises, for instance in Sweden, Norway, Finland in the 1980s and early 1990s. Banking crises are often preceded by a credit boom; in many cases this has fuelled 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, long run 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 they 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, as expressed by the level of GDP, these types of crises are probably of least consequence.

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 in trend 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 estimated average negative

deviation from trend 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 to 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, I think until recently, until Greece, 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 to '08, 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 for several questions but we will have all the presentations first, and then have an open discussion. I will give the word to Catherine.

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

Catherine Schenk

CS: Thank you for the invitation to speak, and thank you to 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 is my area of interest. And of course there is a two-way relationship between regulation and crisis; when crises happen as we have seen in the last few years there is suddenly a kind of a 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; can push things off the balance sheet; can make banks in particular and other financial investors misprice risk and that sort of thing, and create moral hazard 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 with the internationalization, very

rapid internationalization, of the 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 more 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 Fed, 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 and how 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, as we were just saying, 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 drawing on Keynes, in the animal spirits of markets and talking about 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 that you kind of get the system that you deserve.

Speaking as a Canadian, the contrast is probably along a fulcrum between the United States, with repeated financial crises and a 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; they look from a political economy approach.

I am particularly interested in the regulation of international banking so I will restrict myself to international banking. 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. That information and their ability to monitor their customers and those to whom they lend their funds make their margin. So they have to be having information about their creditors. They need to know their customers; they need to know that information; they need to be able to price it so 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 when 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. That their willingness to give up that information as part of the supervisory structures is a kind of a difficult trusting and a delicate relationship and it is difficult to share that information then more broadly.

So trust is important. Linked to that is that the supervision and regulation of your national banking system is going to be a jealously guarded prerogative of central banks and national regulators because of its importance to the operation of monetary policy and monetary supervision, and it has been proved very, very difficult to overcome that kind of national perspective. Even in the European context, the Single Supervisory Authority, a lot of the operational aspects and a lot of the supervision of non-SIFIs is delegated back to the national authorities.

I always talk about financial regulation as an agency reaching into a bowl full of jelly, in that it squeezes out between the fingers. So regulators capture a little bit of it but it also creates other kinds of incentives. Financial innovation in particular happens very, very quickly and 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 to 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 simply and quickly move onto 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 realizable collateral in that case, so there are risks that are really difficult to quantify. The sovereign debt that I am talking about in the 1970s, however, was a banking debt. That was where it differs from current markets, which tend to be bond markets. There are reasons for that and the 1982 crisis has important implications for why that change in the market happened.

But in the 1970s it is banking debt; so banks are lending to sovereign borrowers. And again remember that the kind of advantage of banks 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 these borrowers that had defaulted and defaulted and defaulted over again, and we've heard about Argentina but other borrowers were also serial defaulters.

Now is it that the bankers had really short memories or were markets not working or the country risk wasn't appropriate or was it a big surprise to them in 1982 when they woke up in August and Mexico suddenly defaulted and all the country risk came 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.

Global imbalances where the creditors, the OPEC countries, because their distribution of income and other kinds of aspects, they ended up with a lot of cash and that cash is then 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 arise so there are other debtors and those that are trying to smooth over their current account balances, and so the sovereign borrowers then move into the market. It is a time when there is recession in a lot of advanced economies so opportunities for profit in advanced economies aren't so great and suddenly these Latin American countries look pretty good and it is a whole range of developing countries that enter the market.

This was called recycling, occurring initially in 1973/74 when the OPEC crisis struck. This was the market resolving global imbalances. This is the market acting like it should to smooth us over a crisis and to resolve these kinds of issues. It fit in also to an increasing conservatism in the United States as the 1970s went forward, and the privatisation of aid and trying to get that into the private markets. And there was (kind of like in the 2000s) a sort of heroic idea that, well the market is going to solve it for us, isn't it? And isn't this fabulous. And in the literature, it suggested that this view extended through the 1970s.

But when you look at the archives already in September 1974 the IMF warns its executive board: this is a really dangerous thing that is

accumulating. So even in September 1974 they were very worried about the capital adequacy of the banks, forms of early warnings. They say that they're opening subsidiaries; they're involved in consortium lending instead of building up their capital adequacy for this lending. So they're sort of spreading their risk rather than being more precautionary. And in September 1974 the IMF says we have to stop this recycling. We cannot stop it altogether or a bunch of countries are going to default, but we need to taper it off and find other ways of smoothing over the global imbalances.

They say, however, that it is not our job, that it is you as central banks and as regulators of your national banking systems. That is your job. Now in 1974, in the summer of 1974, there is a series of international banking failures. During the 1960s, there was a very rapid expansion of international bank branches and subsidiaries as banks tried to deal with European integration but also the increased opportunities in offshore dollar markets, the freeing up from capital controls and there are new opportunities there.

Remember that in the spring of 1973 the Bretton Woods pegged exchange rate system ends and suddenly there is exchange rate volatility so we've got two new risks. From 1973 to find a period, an era of floating exchange rates you have to go back 40 years. So there is no banker in the market, no foreign exchange trader in the market who's ever had experience with volatile exchange rates like this. And they get caught out, and there's a series of banking failures, big banking failures, and there's a series of almost failures, and there's quite a lot of forbearance and liquidity pumped in to the market in 1974. It is this crisis in 1974, this apparent kind of fragility in international banking that leads to the launch of the Basel Committee in 1975.

Here, you have the IMF, and now you have the Basel Committee, two agencies. The Basel Committee was tasked by the G10 central bank governors with developing an early warning system that will allow greater understanding of the dangers of contagion; of the increasing risk from cross border banking, and this arose from the Herstatt crisis, where 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 so 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 out that the Bank of England was not supervising any foreign branches, or subsidiaries of banks in its territory, and it did not supervise the foreign branches of British banks because that wasn't its business.

What happened in the summer of 1974 is that there were gaps in supervision that was increasing the fragility. The Basel Committee were tasked with developing an early warning system. The Basel Committee was chaired by George Blunden from the Bank of England, who arrived at the first meeting and said we are not having an early warning system. What they agreed instead is that they would meet monthly and exchange gossip, and that's the word they used for that, 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, which everybody seems to think set out who was responsible and what 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 we haven't moved a huge amount beyond that by 2008.

Now moving back then to the accumulation of this sovereign debt in 1974 and 1975; you have the IMF already warning in 1974/75. I then

looked at the commercial bank archives to see if they're worried or they're accepting, or there's any evidence of moral hazard that they would be expecting to 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 the IMF from 1975 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 said, 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, and their foreign officer was a former IMF staffer, and he 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 was a lack of transparency in the market so that banks were unable to price their risk. They were just developing their ideas about country risk, and there's no data on which to do that because the banks aren't sharing between themselves and the regulators and supervisors who know the exposure aren't sharing amongst themselves either.

Now you think this is a big lapse and why did not they do something about it; they did try. And there's a series of initiatives through the 1970s to try to increase transparency in the market. Thinking back to 1982 nobody knows the total indebtedness of any of those countries that defaulted. So each bank knows what it owes, it might know what it

owes through a consortium because it feels it has shed some of its risk that way, but it doesn't know what else this country has borrowed.

The IBRD (the World Bank) tries to develop some information and it collects tombstone stuff from the newspapers and other sorts of data; so it publishes some with a long time lag. The Bank for International Settlements and the G10 central banks published consolidated country data for their banks but it is very slow and very consolidated so it is also very out of date; so it is not really market information. The IMF is keen also to speed things up and allow greater transparency in the market, but they're really pushed back by Basel. They want to go to the Basel Committee and just have a discussion about how you increase transparency in the market and they're told they cannot come, for example. So there's quite a lot of tension and what I am seeing as emerging is quite a lot of competition amongst the agencies about who owns this information; who is allowed to give the information, as well as between the banks and the supervisors themselves.

So in 1981 the IMF writes to the head of Basel Committee and says, don't you guys really think that all your supervisors should be helping your banks with country risk? And they did get a letter back saying, no that's up to the banks themselves. In 1982, three days after the Mexican default, I've got internal documents where 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 who are going to negotiate the bail out of Brazil, or the rescheduling for Brazil. The negotiator arrived there and found out that it was not 2.5 billion, it was 3.8 billion dollars that they owe but that 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 a wakeup call for the Basel Committee, and the first idea of trying to standardize or set thresholds for capital adequacy. I am quite critical of the whole Basel process, the Basel 1, Basel 2, Basel 3, Basel 3A, Basel 4, who knows? But it is a process that is always like running to keep up and that is very clear.

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 building in some kind of backward looking 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 rated 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 onward.

The problem with the Basel process is that it is very backward looking; it is very slow; it is 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 as we saw between Basel 1 and Basel 2 perverse incentives for different kinds of accounting and financial innovation in order to escape the sort of restrictions that are there.

To conclude, the relationship between financial regulation and financial crises, and here I am talking about mainly banking crises, is two way. What happened in 1982 was 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. But also lack of transparency in the market that the supervisors and the regulators failed to create the kind of transparency in the market that really that's what regulation is for is overcoming market failures. And this is a market failure in the financial markets.

ML: This is certainly a very interesting theme and very specific problems. We will have the possibility to discuss this later on.

The development of international financial centres and financial crises

Youssef Cassis

YC: My talk falls between Dick and Catherine. 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, is a grouping together of, always in a city, in a given urban space, of a certain number of financial services. And there are reasons for these grouping together, which I will not go into 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 actually throughout the

world, global centre that act as financial centre for the entire globalised integrated economy.

Because of this variation you have a hierarchy of financial centres and this hierarchical order has been very much an object of interest. People like ranking and tables 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 for a similar conclusion. Here I am concentrating on the leading rankings that are global. If I go as far back as Dick in my survey, 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 inter-war 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 in pre-2007 until now actually, it is still the case, you have London and New York, and then you have also Tokyo has sort of lost some ground; Hong Kong and Singapore coming quite strongly, Shanghai. So this is the global picture.

How has that moved, has it moved, has it been moved, has it been influenced by financial crises is one question I think the organizer wanted me to address. What is this, 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, he 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 recognisable when encountered.'

It is not true but it is perhaps in 2015 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 note 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 one 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 be nineteenth century with the exception of the inter-war years, took place in emerging economies.

Now, do you have to put them together with advanced economies? In my view, they are different types of crises; they have different causes; they have different consequences they are always much higher in emerging economies — think of the 1982 crisis for example. You have to distinguish crises in advanced economies from crises in emerging economies. In the same way, you have to distinguish between major, global, systemic — assume the adjective mostly used — financial crises, and minor ones. Now, what do I call minor ones? 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. 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 but they were not global financial crises. They did not have that much effect because of the fate of small countries. Small countries have less effect, whether in north or south, on the world economy. In the end, many of these financial crises, which have broken out since the end of Bretton-Woods, have been either in emerging economies; the vast majority of them, or one single bank failure in a big country, or in a smaller country including Spain.

I identified eight 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 slightly. I started at 1890. Some of them are crises that did not actually even break out, but I will return to them. Baring Crisis 1890, American Panic of 1907, Financial Crisis of July–August 1914. Then it could be divided into several of them. I have put them into one item: the banking crisis of the Great Depression of the 1930s; all the banking crises that occurred in the early 30s especially in Austria, Germany, United States; other central European countries, Switzerland. Then I called it to find a different way of naming them, what I call the financial instability of the early 1970s and the ensuing bank failures, to which Catherine referred.

Then, number 6, the international debt crisis of 1982. Number 7, the Japanese bank crisis of 1997–98, so this could be contentious, should you put the Asian crisis or just the Japanese one? They come very near to one another. As I wanted to limit myself to advanced economies I took the Japanese because it was quite serious actually. And surprisingly even so Japan was at the time the second largest economy in the world,

the Asia banking crisis in Japan did not have that much more effect on the world economy and the world financial system than the banking crisis in the Nordic countries a few years earlier. And finally, the most severe of all, the financial debacle of 2007–2008.

So, my idea was to put my list of financial, of leading financial centres, London, Paris, Berlin, then Frankfurt after the second world war, New York, Amsterdam, Brussels, Zurich, Hong Kong, Singapore, Shanghai coming now, and the financial crisis and to ask three questions. First, what has been the responsibility of financial centres in the outbreak of financial crises? Second, what has been the responsibility of financial centres in the transmission of financial crises from one place to another? And third, what has been the responsibility of financial centres this time, on the rise and fall — to use this expression also popular — of financial centres? First question Well it is quite simple. Major crises, to the extent that I've really broken this down to eight and they are all very big, very major crises, they take place inevitably in major financial centres because 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, usually more than one, SIFI.

So it is obviously a reason. So in that case the cause, the ultimate cause of the crisis might lie elsewhere say in Argentina or in Mexico. But in the end if there is no link between Argentina and London or New York then there won't be a crisis and the crisis will be confined to Argentina or to Mexico. 1982 is because all the world's largest banks were up to their neck with loans to countries, which couldn't repay. So the link, the cause might be, an emerging economy, but there have to be a close link. Now, the responsibility of financial centres in the translation of financial crises, while you would expect there is a heavy responsibility and then

really moves from one big centre to the other because of the integration of the world economy especially, the globalization. But, it is not — I don't think we did find much evidence of so much transmission.

First, as we've just seen, in my analysis at any rate, global crises have not been that many of them, and secondly, global crises are often less global as it is assumed. If I take my list of eight, six of the selected financial crises remained confined to a single centre, including the banking crisis of the Great Depression — of the global crisis. But in the end, the banking crisis of the Great Depression and each banking crisis broke out separately within a few certain months, or even year of the event. It did, however, move from Vienna to Berlin with the failure of the Creditanstalt, being followed by the German banking crisis. But if you take the American banking crisis they had little link in the end, direct link with — of course the devaluation of sterling and Britain leaving, the worst ended, had an effect on America and on the fragility of the finance system because of doubt of 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 too there are doubts about that — the effects of Creditanstalt. So, there are not that many global crises. The only two which really come to mind as transmission, global transmission between one centre to another and it is interesting, it is really because when we started work on financial crises that people realise that one of the strongest parallel 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. One of the reasons for this absence of transmission through financial centres is that some of these crises were contained and a solution was found before the crisis actually broke out.

That happened for example 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 created an assumed huge mayhem across all financial centres. But it was avoided. It was avoided because of the Bank of England organising the bank consortium to rescue Baring Banks. In the same way, 1982 there wasn't actually a crisis. There was a risk of a crisis, but with the IMF organising all the leading bankers discussed with the IMF plus the American Federal Reserve, and they established a scheme by which to prevent default by lending again 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 in 1982 you had the possibility to organise the banking financial actors, protagonists, and find a solution. This worked again for example in the American Panic of 1907 when there was a run on those trust companies which were actually solvent just had a liquidity problem, and Pierpont Morgan himself took all these bankers in the room and did they know that what we have to do. So, no, this did not happen in New York, which was not yet the leading financial centre but 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 affect and prevented major crises to break out. This failed in September 2008 when finally no solution was found for Lehman Brothers. Barclays couldn't buy it, and they wouldn't buy it and then they thought they could let it fail, and then will the younger member here remember what it was; what happened after that.

To my third point, what has been the responsibility of financial crises in 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 anyway, and well it reinforced a little bit its advantage but in the 30s anyway it did not matter so much because there was a big decline in international capital flows. Paris looked strong in the early 30s when Britain left gold but it was not enough to enable Paris to regain the position it had before 1914. So little change, and anyway what changed really was the big decline of international financial transaction.

And if you look after 2007–08 London and New York remained the two leading centres according to all sorts of criteria. I will say that the rise and decline of financial centres have been the result of two main factors, one is the change, 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 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; it took another between 50 and 70 years for New York to completely establish itself as the financial capital of the world. So you can discuss about the way there were talks in the late 1980s that Tokyo was going to overcome New York; it never happened. We will see what will happen with Shanghai.

So that was the main reason; it is a slow process and there is one factor which can hasten this process and this is another financial crisis; you need a big war. If you see the French war in the case of the change between Amsterdam and London, then the First and Second World War, for the passage between London and New York. It happened at a lower level as well, you know, Paris were competing strongly with London in the second empire between 1850 and 1870 but then after a defeat against Russia in 1871 it remained number two but it lost much of its capacity to compete. Berlin was completely eradicated after world war two. So this could be bad news if there were to be a big change in the hierarchy. But as I say, it was a very slow process, basically we will all be dead by then. Thank you very much.

ML: Thank you for this fascination journey and interesting ending of your speech. I just wanted 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 there would have to be some metric. Mostly 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 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 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 the ability of the tendency for forbearance in particular, so accepting lies on a balance sheet and just hoping for the best, or even more recently if thinking about China and other cases like that they averted crisis by setting up asset management companies; this is something that South Korea did as well, and just manipulating the bank's balance sheets in this sort of way to avoid

failure. But still that quite probably is 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 that with database with many crises and look more specifically at some of them. However, I looked carefully at the appendices of Reinhart and Rogoff and I am certain that they have put this crisis then you look in the book what they refer to.

RR: Those that are not on the database.

YC: And France 1994 might have been, so there has to be a level of weighting what is more important, you know, to have a kind of hierarchy. Also, as I call it 800 years I should have called it forty years because the database is basically starting 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 Baring crisis does not appear because it nearly failed, it appears because of the crisis in Argentina. This is why there is confusion, and there are two very different crises. Regarding the debt crisis the literature discuss 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 that, 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 when you Youssef, about the non-impact of the financial, global financial crisis on the behaviour of different financial global centres. But I was surprised when you say that, well how global should a financial crisis be to be called a global financial crisis? Your examples of Baring 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, and Germany. So, I mean how global should it be to be counted as a global financial crisis? That's my first question. The other question is about specific countries for Mexico for example in 1982 it was a crisis, it was a hard crisis. So I mean specific people, specific countries or regions as it were, there are a lot of them actual crises. Do you agree?

YC: Yes, I agree with you.

Q1: But, and you mean and 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 both of you agree with but there probably then there'll be no global crisis at all, completely global. I mean even the last one it is said you know China wasn't that affected by it after all and they helped relaunch in the world economy. So there'll be none. 1914 wasn't complete I mean so in that case I tend — well there is always a little bias and arbitrary choices made according to. One of the reasons I've made this choice is because I think what happens in advanced economies

when there is a crisis is different than one in an emerging one. And I think the database which we pulled together don't make sense, but it is a trend in the IMF; they are the ones who were heard 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 the smaller one. But they are never completely global it is true. So, but I fully accept your remark and doubts about my.

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 an outcome. It is not a simultaneous crisis that Canberra in Australia, for example, is then affected a bit further down the line; not because of their financial structures. I wonder if we could identify financial crises differently if we did not just look for bank failures and stuff but were looking for measures of liquidity in markets and that sort of thing. Because that's what affected the world from the global financial crisis that just left, is the sucking sound in international liquidity. And 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 maybe in the, you know, convergence in that sort of measure. Certainly, you would see that in the 1930s, as 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 to Catherine. What you suggest is: to take loan financial, a case of 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.

ML: Next question?

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

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, their efforts towards harmonisation and talk the banking union then, it sparks a lot of regulatory changes and the introduction of regulation in the 1970s and early 1980s in a range of European states. But they has

never the willingness, the political, or indeed the economic will, to be giving up sovereignty over the regulation of your 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 all this other sort of thing.

So, what you have with the single supervisory mechanism I think, in the European Central Bank, is they're capturing the SIFIs if you like, and sort of ignoring these other institutions. But the other institutions they're not even shadow banks they're savings banks and regional banks. There is a systemic fragility from ignoring them, and separating out the SIFI from others. 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 of on a global level? Because there are systemic fragilities that bleed from those institutions and we saw that in the 1970s we saw it in the 1980s that small institutions can generate liquidity crises that then prompt solvency crises further on. And we see this literature now with the FSB 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 would be the strongest and they've been talking about for decades, there's still this intransigence or path dependency or inertia that maybe there's another way that, Youssef was kind of talking about it, in the national structures the banking systems, and it is therefore their regulatory structures match the structure of the banking systems, and they are distinctive.

Q3: Thanks for very interesting comments and presentations. 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 why 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 pointed out as what they see is a risk to the function of market is the 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 back history, have we seen this before that this could be an early warning sign where the market participants even say that if this leads to less liquid markets then we have a problem.

CS: Yes. Definitely, and the death in liquidity in the markets it is, 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 and securities markets, hedge funds, until very recently there was a lot of reliance on self regulation in industry standards and some sort of non-state sort of collectives and other groups of industry led organisations to self regulate. This is because of the complexity and all the resources, 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 role, clear role in the monetary system and because of protection of 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 affects the liquidity of markets and stability.

RR: There's a great 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 whack a 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 it is these rigid structures are going to solve it, or, we'll be able to regulate the whole market and it will all work, after that 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 the partnership. 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 absurd risk, but generally the partners would manage each other so that they would monitor each other so that you did not risk shift as they say in the jargon. That 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 one saw in 2007 or whatever 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 roman — I mean it is impossible the romantic situation, 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 was no failure, including during the Great Depression. It can work, and without any regulation because there was hardly any regulation. The fact 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 what 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 or something but.

YC: No, by the 1970s, So what makes it in other countries to and from, in Switzerland what happened in this country renowned for great stability they became so unstable in the last phase of the — I mean we can have lots of explanation but I'd like just to...

CS: Well in 1974 of course they bailed the banks in through the lifeboat so, and similarly in Germany 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 I referred to about crises in British banking or something, offers two explanations. One is that 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 with probably — with possibly the liquidities not sufficiently. The second one is the financial repression, that is not regulation that is 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 as well, is the potential for financial crises. You can get rid of financial crises where 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, generally, 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 like 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 problem I guess which the central bank had mentioned that by the Swedish Central Bank buying a lot of bonds at the moment they're actually contributing to the 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 at the end of it, or are those, which may take the form of inflation, although there's not much sign of it at the moment. But there certainly is inflation in asset prices. But so that's the latest caper and it is very hard to see that it ending without a whole load of unintended unravelling without a lot of unintended consequences. As programmes have been suspended now in the U.S. 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, somewhere between two per cent and four per cent interest rates is kind of what we would 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 you, all of you, could maybe give your thoughts about periods with no crises. Should we be surprised for these periods or what is the normal so to say? And should we see maybe as researchers lessons to learn from these periods more than fantasising you know, crisis periods? I mean we can point to forty explanations to the 2007–08 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 period 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. I like to say that because it is, in the end, okay there was 1973 but if you talk to people about 1973–75, I was just reaching twenty crises. People remember stagflation, the oil crisis the oil price, the Sunday without a car, and other things like that. But banking crisis 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. Nineteen-eighty two 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 as intermediary between the borrowers and the public. So if everybody loses money of course it is going to have an effect on demand and probably bring a recession but it is not the same as all the big banks collapsing. So that was a period that is very interesting, I think to understand why. There have been long periods in what — when I started, because all of us I think when, nobody had worked much on financial crises until 2007 and sort of suddenly you know as financial historian you've got to look at it because you know, there is demand. And I was more struck by the fact that there had been very few financial crises in industrialised countries over the 20th century, apart from the 30s, and even the 30s is quite you know, Germany. I want to start talking about the German banking crisis but it is very peculiar it is leading to hyper defeat in the war to hyperinflation, to the currency the Reichsmark, which are reparations. It is very political as much as economical. So, I think that you could look at it in a way that there has been quite a lot of stability in the financial system and then suddenly we had very, very severe financial crisis; I described it in all that I have

written as the most severe ever. Secondly, this 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 having the 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 of this period, this was the only period when it was stable because of financial repression I think it is a biased way of analysing reality. It is a very ideological and it is typically come from a certain view of the world. I just have a few thoughts on your question.

ML: Catherine first and then Richard to comment.

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 not 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 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 that kind of market activity.

RR: American economist Hyman Minsky proposed 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 fractional banking or whatever you soon as you start having time mismatches, currency mismatches, whatever, 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. So I would, and I rather tend to agree with that kind of proposition that finance is, inherently, is 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 which we're really calling, that goes wrong, that we're calling a crisis. There is another one of these IMF studies that looks at, that – compares financial crises in emerging markets with between countries which are prone to crisis, and particularly they looked at Thailand, and countries which have very few crisis if any, and they looked at India which I think since independence has had no financial crises. And then they looked at growth and development and Thailand despite having had half a dozen crises has a compound much — well this was until a few years, this is about 2012 I think — a much more impressive growth path despite all the crises than India before — this was before liberalisation. But the current

liberalisation in India will probably mean that they end up with some financial crises 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 absence of crisis. But I think we've become obsessed with, obviously because of 2008, with 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 but within, you know that have occurred across 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, but of course banks have been anyway...

ML: Perhaps the last question now.

Q5: In 1993–94, Sweden had a very critical situation, with the 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 predictors of the future I think, but what we do know a lot about is that institutions and the historical context matters. 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 is very difficult to predict. Greece's own sort of particular institutional context in Europe is in 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 in the sort of democratic politics in Germany as well which are overshadowing some of the position taking. So again, it is so highly contextualised that I am going to say that 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 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.

[APPLAUSE]

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