

The financial crisis of 2008: a historical perspective

Momigliano Lecture 2009

Youssef Cassis

I am extremely honoured to have been invited to give the 2009 Momigliano lecture. I should like to thank ICSIM, and in particular my old friend Franco Amatori, for this invitation. This is a very prestigious lecture, which has previously been given by far more prestigious scholars than myself. I hope to do justice to this tradition.

The topic of my lecture is: “The financial crisis of 2008: a historical perspective”. As a financial historian, I felt that, in the present circumstances, this was the obvious choice.

There has been an increased demand for history since the beginning of the crisis nearly a year ago –more than at any time in my career. How does the current crisis compare with previous ones, especially 1929? And how can we expect things to develop in the light of past experiences? Historians can answer these questions and reflect upon the present by combining the explanations offered in the heat of the moment with the caution dictated by their knowledge of comparable past events.

Nevertheless, historians need hindsight, as well as sources, in order to make a judgment and draw some kind of balance sheet. Put another way, the event on which they are reflecting must have come to an end. Has the financial crisis of 2008 come to an end? Apparently yes, though nothing can be taken for granted. Moreover, the *financial* crisis must be distinguished from the *economic* crisis which is far from having run its course. And should the recession turn into a deep depression, banks would be exposed to possibly serious problems.

The financial crisis of 2007-2008

The distinction between economic crisis and financial crisis is important and enables me to clearly define the scope of my lecture. I will be dealing with the acute crisis –one could even talk of panic– which followed the fall of Lehman Brothers on 15 September 2008. Of course, the financial crisis started earlier, in the summer of 2007. On 9 August, the French bank BNP Paribas suspended three of its investment funds, giving as a reason the impossibility to properly value their assets. BNP

Paribas announcement signalled the beginning of the credit crunch: banks became increasingly reluctant, if at all prepared, to lend to each other.

As we all know, this freezing of the interbank lending market was caused by the crisis of the US subprime mortgage market. The housing market had boomed in the United States since the mid 1990s, fuelled by low interest rates. House prices more than doubled between 1995 and 2006 when, following two years of rising interest rates, the bubble eventually burst, with ensuing mortgage defaults. The collapse of the housing market was aggravated by two interrelated factors: on one hand the very low credit and high level of indebtedness of the recipients of these mortgages; and on the other hand the securitization of this debt, in the form of mortgage-backed securities (MBS), whose value soared during the first years of the 21st century.

We also know what happened next. Bank losses mounted alarmingly: in May 2008, asset writedowns and credit losses, including reserves set aside for bad loans, were estimated to have reached 380 billion dollars since January 2007 at the world's 100 biggest banks and securities firms. The leading banks withstood the heaviest losses: Citigroup headed the list with 43 billion dollars, followed by UBS (\$39 billions) and Merrill Lynch (\$37 billion); their CEOs –Chuck Prince, Stan O'Neal and Marcel Ospel–had all been replaced by spring 2008. There was a run on a British bank, Northern Rock, a mortgage lender, in September 2007, the first on a British bank for more than a century –it was nationalized a few months later. The difficulties of another bank sent more alarming messages to the market: Bear Stearns, Wall Street's fifth largest investment bank, was taken over by JP Morgan Chase on 17 March 2008, with the backing of the Federal Reserve –its market value had fallen from 18 billion dollars in April 2007 to \$3.5 billion on 14 March 2008 and a mere \$240 million three days later!

Warnings about the risks of a serious recession became increasingly louder and central banks continued to pump liquidity into the system. Faced with mounting writedowns, banks attempted to strengthen their position by raising capital, mainly tapping sovereign wealth funds in Asia and the Middle East.

By August 2008, Citigroup has raised nearly 50 billion dollars, Merrill Lynch and UBS nearly \$30 billion, Royal Bank of Scotland and Bank of America more than \$20 billion.

These sums proved vastly insufficient as things took a turn for the worst in late summer 2008. On 7 September, the two mortgage companies Freddie Mac and Fannie Mae were taken over by the US Government. They owned or guaranteed 5 trillion dollars of debt, nearly half the home loan market, and the failure of either of them was judged to present too high a risk for the financial markets in the United States and worldwide. A different view was taken about Lehman Brothers, America's fourth largest investment bank, which filed for bankruptcy protection on 15 September. The same day Merrill Lynch, one of Wall Street's "big three" investment banks, announced that it had agreed to be taken over by Bank of America.

The fall of Lehman Brothers marked a turning point, the passage from a severe downturn to an acute crisis –or from crisis to panic. The entire banking system was contaminated by hundreds of billions of "toxic assets", not only mortgage backed securities, but all types of structured products –asset backed securities, collateralized debt obligations, credit default swaps– now possibly worthless. No bank, whatever its size and reputation, appeared to be sound or safe and other big banks might be allowed to fail. This was not to be the case and Lehman Brothers remained the sole major casualty. Governments stepped in to directly rescue banks and prevent the financial system from collapsing, with increasing talks of banks' "nationalizations". On 16 September, the Federal Reserve came to the rescue of AIG (American International Group), the world's largest insurance company, offering it an 85 billion dollars loan and taking an 80% stake in the company. During the following months, more than thirty banks in Europe and America, including HBOS and RBS in Britain, Goldman Sachs, Morgan Stanley and Citigroup in the US, Commerzbank in Germany, UBS in Switzerland, to quote but the most famous, were bailed out in various ways by their government, usually through direct loans or equity injection. State intervention proved quite efficient and by early 2009, the acute financial crisis appeared to have ended.

Historical parallels

Discussing the events of 2007-2008 in a historical perspective requires establishing meaningful comparisons in time and space –in order to compare like with like. The first thing to be said about the financial crisis of 2008 is that it was a *banking crisis* –as opposed to a stockmarket crisis or a monetary crisis. The second thing is that it was a *global crisis* –a global crisis that started in core countries, in the first place the United States, rather than at the periphery, as had been the case with the banking, monetary and “twin” crises that had mostly affected emerging markets in the last twenty years or so. And finally, needless to say, it was a *very serious crisis*, especially in terms of systemic risks.

I will take these three elements as the basis for historical comparisons: a banking crisis, the weight of the core countries, and systemic risks. From this perspective, three historical precedents can be identified: the financial panic of August 1914; the banking crises linked to the Great Depression of the 1930s; and the Debt Crisis of the early 1980s.

Let’s first consider the financial panic of August 1914, at the outbreak of the First World War. During the final days of July and the early days of August 1914, growing rumours of war and then the outbreak of hostilities plunged all the financial centres into a deep crisis. The collapse of stock exchanges, interest rate rises, the withdrawal of funds from banks and, its corollary, the banks’ demand that loans be repaid, on top of which came the risk of non-payment –all that cumulatively threatened to trigger off a series of bankruptcies and paralyse the entire credit mechanism. Only exceptional measures, calling for state intervention, enabled business to resume under conditions that few contemporaries imagined would persist longer than a couple of months.

The liquidity crisis that affected the City of London, then the world’s financial centre, is particularly interesting from our perspective. Bills amounting to 350 million pounds (more than 60 billion pounds at today’s purchasing parity) were in circulation on the London discount market and would have to be paid when they fell due; in other words, within a period of three

months. And yet, owing to the outbreak of war, a good third of these drafts (about £120 million), whose drawers were from then on in the enemy camp, were likely to remain unpaid, thus forcing the acceptors to honour the guarantee they had given to the holders of these bills. But these acceptors, the London merchant banks, were unable to do this, their own funds amounting to a mere 20 million pounds. The commercial banks' huge assets, upon which the entire edifice was built, were at risk of being frozen. Disaster was avoided thanks to the combined intervention of the Bank of England, the commercial banks and the government: among other things, a moratorium on debt repayment was announced on 2 August 1914, while the central bank procured the liquid assets needed to keep the system functioning.

A parallel with the Great Depression is a “must” when talking about the current crisis. Was 2008 a repeat of 1929? The answer is not straightforward. 1929 was made up of three inter-related shocks: the stockmarket crash of October 1929, a series of banking crises taking place, depending on the countries, between 1931 and 1934, and a depression which lasted, again depending on the countries, until the late 1930s. In 2008, the main shock was the global banking crisis of 2008 and there remains some uncertainty as to the depth and length of the economic crisis. Causation was also different: in 1929 the stock market crash was the signal that precipitated the crisis, in 2008 it was the banks' collapse or near collapse. In 1929, the bank crises were caused by the economic depression, in 2008, the bank crisis led to a deep recession. In 1929, restrictive monetary policies were the main cause of the depression, in 2008 discretionary fiscal policies might well have saved the world from depression.

The German banking crisis of 1931 displays, in its unfolding rather than its causes, most similarities with what happened in September 2008. On 13 July 1931 the Danat Bank, one of the country's big banks, weakened by the collapse of the large textile company Nordwolle, closed its doors. This provoked a run of depositors on the other banks, which decided to pay only 20% of the sums that their clients wanted to withdraw; in other words, to suspend their payments. What caused the crisis?

First, the German banks were penalised by the interruption of foreign capital inflows into Germany, following the 1929 Wall Street crash. Second, they had to contend with massive withdrawals of foreign funds due, on one hand of the persistence of the crisis, resulting in a large part from Chancellor Brüning's deflationary policy, and on the other hand to international tensions, especially surrounding the payment of reparations. And third, in July 1931 they were no longer able to obtain refinancing from the Reichsbank, whose gold and currency reserves had shrunk to the point where gold cover for banknotes had dropped below its statutory minimum.

The intervention of the German government put an end to the panic. It ordered the immediate closure of all banks for two days, during which the Dresdner Bank also declared itself bankrupt, and introduced exchange controls on 15 July. With state backing, the Reichsbank set up the Akzept-und Garantiebank to obtain credit for commercial banks and savings banks. Furthermore, the government undertook major restructuring, which boiled down to the near nationalisation of the big banks, forcing the Dresdner Bank and the Danat Bank to merge into a new institution, 91% held by the State and the Reichsbank. At the same time, the authorities ended up owning more than 50% of the Commerzbank's equity capital and approximately 35% of that of the Deutsche Bank. These mergers were followed by the reduction of equity capital, that of the Dresdner & Danat falling from 220 to 150 million Reichsmarks and that of the Deutsche from 285 to 144 million.

The third crisis we should consider is the Debt Crisis of 1982. From the mid 1970s to the early 1980s, international capital movements were dominated by commercial bank credit to third world countries. These were the largest international bank loans: their amount increased from about 40 billion dollars in 1975 to 160 billion in 1980. As for emerging countries' foreign debt, it went from 126 billion dollars in 1975 to 455 billion in 1982, with the share of private debt, mostly made up of bank loans, growing at the same time from 43% to 56% of the total. Resorting directly to the capital market thus temporarily became less important: bank loans, usually in the form of syndicated floating-rate Eurocredits, clearly had the edge over in-

ternational issues. This was a new way of transferring capital to sovereign states. Until then, and especially before 1914, banks had served as intermediaries between the borrowing state and the public, making the latter bear the risk of any possible default: Russian loans, considered safe investments, were a classic example. This time it was the banks that were on the front line. Their credits were fuelled by “petrodollars”, in other words the deposits of oil exporting countries, whose revenues more than quadrupled between 1974 and 1980 following the two “oil shocks” of 1973 and 1978. Between 1974 and 1980, they accumulated 383 billion dollars in liquid assets, half of which was invested as short-term bank deposits with the biggest American and European banks.

Panic broke out in 1982, when Mexico unilaterally declared a three months’ moratorium on paying the principal on its debt, unleashing a debt crisis that lasted throughout the eighties. Several big banks, mostly American, were badly exposed and faced bankruptcy in case of default, with systemic risks of paralysis and even collapse of the financial system. Banks were accused of poorly assessing risk, lacking any historical knowledge, and ‘imposing’ loans on Third World countries irrespective of their capacity of servicing and repaying them. And yet the banks had been commended by national and international monetary authorities for skillfully solving the problem of international imbalances caused by the oil price hike! In any case, a major banking crisis was avoided, even though banks posted huge losses –in 1987, Citibank declared the biggest losses so far in banking history, setting aside \$3 billion as a reserve for losses on loans made to countries whose debts required refinancing. Third World countries, for their part, were far more heavily penalised, with austerity programmes imposed by the IMF and a drop in their living standards which took over a decade to recover.

Anatomy of financial crises

Every financial crisis displays at once unique and fairly standard characteristics. In this respect, the crisis of 2008 can be

considered as the most severe financial crisis in history. Never before did so many leading banks, in so many advanced countries find themselves, at about the same time, in a situation requiring state intervention in order to avoid collapse.

The financial crisis of 2008 can also be seen as the first truly global financial crisis in history. Admittedly, all leading financial centres were struck by panic in August 1914. However, this had more to do with the world dimension of the conflict than market integration –even though the latter should not be underestimated. The banking crises of the early 1930s did not affect simultaneously all countries and some, in the first place Great Britain, were not affected at all. The debt crisis of the early 1980s was in some respects comparable, not least because of the number of major banks under threat, but it never was as serious.

How can we account for the severity of the crisis of 2008? Some factors have to do with changes in the world economy, the passage to a post industrial society, starting in the 1980s and leading to a huge development of the service industries in general, and financial services in particular. Other factors have to do with unequalled levels of globalization, even by pre 1914 standards. While the ratio of foreign investment to world GDP was probably higher than 60 percent in 1900, it was well above 100 percent in 2000.

The financial crisis of 2008 did not only happen in a globalised economy, it also took place in a financial world where financial innovation had assumed a new dimension. The almost constant arrival of new financial products since the mid 1970s has been an unprecedented phenomenon in financial history. Monetary instability and the need to hedge against fluctuations in interest rates and in foreign exchange rates was a strong incentive. But the new financial products would never have reached such a degree of sophistication without, on one hand the incredible progress made in computing, and on the other hand the application to the markets of theoretical advances in the fields of economics and finance. One thinks in particular of the works by Markowitz and Sharpe on the efficient portfolio that links risks and return; by Modigliani and Miller on the conditions under which the value of a firm is independent of

its leverage ratio; by Fama on the efficient market where prices reflect perfectly the information available; and by Black, Scholes and Merton on calculating the value of derivatives. The financial innovations of the late twentieth century –indeed the transformation of banking and financial practices– are embodied in what has become known as securitisation –in other words the conversion of debt, especially loans, into marketable securities. What was new about this phenomenon was the type of assets converted into securities and the type of financial products emerging from this conversion, known as derivatives, in the sense that their value derived from that of an underlying asset.

Mortgages were the first debts to be securitised. Rather than keeping mortgages on their balance sheet, banks bundled them together, sliced them and issued bonds covered by these loans –the so called Mortgage-Backed Securities (MBS) –and then sold them to investors –banks, insurance companies, hedge funds and other financial institutions across the world. Other assets, in particular consumer debt –insurance policies, car loans, credit card loans, student loans and so on– were in turn securitized, bearing the generic name of Assets-Backed Securities (ABS). A third group of securitized assets were known as Collateralized Debt Obligations (CDO) and were mostly backed by loans and corporate bonds. Credit derivatives were also developed in these years, in the first place Credit Default Swaps (CDS), which offered protection against the risk of default on a debt through a contract between two parties, the seller as it were insuring the buyer in return of the payment of a regular fee.

Securitized debt grew spectacularly during these years. In the United States, ABS issuance quadrupled between 2000 and 2006, from 337 billion dollars to \$1,250 billion; while non-agency MBS issuance (those not guaranteed by a government agency such as Fannie May or Freddie Mac) rose from about 100 billion dollars to \$773 billion during the same period. The notional value of CDS rose from about 600 billion dollars in 2001 to more than \$60 trillion at the end of 2007.

Financial innovation has often been blamed for financial crises. In his famous book, *The Great Crash, 1929*, John Kenneth

Galbraith describes investment trusts as “the most notable piece of speculative architecture of the late twenties”. Investment trusts had been known since the 1870s in Great Britain when they began to flourish in the United States in the 1920s: from 40 before 1921, their number reached 770 by 1929, including 591 founded after 1927. Between 1926 and 1929, their assets went from one to seven billion dollars. Their sponsors were essentially finance or banking companies, going from the most respectable, like the main investment banks and commercial banks on Wall Street, to the most dubious. Powerful groups bringing together several investment funds were also set up. On the whole, investment trusts had a bad reputation, with incompetence, greed and dishonesty being the three main criticisms made of them. Their operating principle – in essence, collective investment and risk diversification – was fundamentally sound. But the practical application of these principles often left something to be desired, especially the structure of their capital, which enabled them to make highly leveraged investments.

Financial innovation is a means not an end. New financial products can amplify the effects of speculation, not cause it. Was the situation different in the early twenty-first century as a result of the high complexity and sheer opacity of the new derivative products? Probably not. Some senior bankers might have had little understanding of their working, but many did, not least the highly trained mathematicians and physicists who started joining the financial world in the 1980s. The same applies to the belief that the mathematical sophistication of the new financial instruments had made them less risky. In both cases, lack of control and pressure for ever higher returns led to increasingly high levels of risk taking, as witnessed by banks’ excessive leverage.

Admittedly, interest rates were historically low, there was a glut of liquidity in the markets, and the search for higher yields led to investment in risky assets. Two interrelated factors, in particular, contributed to the situation: one was the central banks’ accommodating monetary policy, above all on the part of the Federal Reserve. The other was the deepening global imbalances between surplus and deficit countries, with unduly high

savings ratios in the former and an alarming level of household indebtedness in the Anglo-Saxon economies; and the building of huge foreign exchange reserves in the emerging markets, mostly invested in US treasury bills. This macro-economic climate was no doubt conducive to a financial crisis, especially in conjunction with highly deregulated markets; inadequate supervision, as regulators placed excessive faith in markets' self adjusting capacity; and even greater failure of the rating agencies which proved incapable of properly assessing the risks attached to derivatives.

These factors suggest that, whatever its idiosyncrasy, the crisis of 2007-2008 displayed the typical pattern of a financial crisis identified by Charles Kindleberger in his classic book *Manias, Panics and Crashes*, on the basis of a model first developed by Hyman Minsky. There was a clear "displacement", caused by the wave of financial innovations, creating new profit opportunities. The bubble, starting in 2002 and ending in "euphoria" by 2007, was fuelled by low interest rates and excessive liquidity. It was followed by a period of "financial distress", between August 2007 and September 2008, when investors, aware of the imminent crisis, start to sell but are still tempted to buy; and then by the "crisis" itself, precipitated by a specific signal, in this case the collapse of Lehman Brothers. "Revulsion" and "discredit" led to a short panic, quashed by the intervention of the lender of the last resort.

The outcome of the crisis

Will the financial crisis of 2008 prove unique in the extent of its consequences? It is not for the historian to predict the future, but he is perhaps better placed than others to detect long-term trends.

The effects of the financial crisis on the real economy have been rapidly felt. GDP shrank by 2.0 percent in the OECD area in the third quarter of 2008, and by 2.1 percent in the first quarter of 2009; and unemployment rose from 5.6 percent in April 2008 to 7.8 percent in April 2009. These are trends comparable to those observed in 1929-1930. In response, however, and in

sharp contrast to what happened in the early stages of the Great Depression, all governments introduced, in varying degrees, discretionary fiscal measures in order to boost demand, leading to a deterioration of their fiscal balances – a move widely acknowledged as being in the right direction and likely to prevent the recession turning into a depression. In this respect, the lessons of the thirties have definitely been learnt – Ben Bernanke is one of the best scholars of the Great Depression. Questions have also been raised about the future of banking, of international financial centres, even of capitalism! One of the main issues concerns the level of regulation. State intervention, supervision and regulation reached unprecedented levels during the Great Depression, in all countries. The United States was the first country to legislate; it was also the country that went the furthest in this field. Two laws were passed in 1933. The first, the Securities Act, contained various provisions aimed at improving the quality of information about the securities offered and traded on the stock exchange. The second, the Banking Act, better known as the Glass-Steagall Act, decreed the complete separation of commercial banking activities (taking deposits and making loans) from investment banking activities (issuing, distributing and trading securities), including if these activities were shared between parent companies and subsidiaries or through either the cross-holding of shares or overlapping directorships. These measures remained in place in the post-war years.

As is well known, financial markets were gradually deregulated from the 1980s onwards, in an economic climate increasingly dominated, especially within the financial sphere, by a market-oriented type of capitalism. The Glass-Steagall Act was finally abolished in 1999 with the Financial Modernisation Act. It had been de facto emptied of its substance the previous year, after the American cartel authorities had ratified the merger, under the name of Citigroup, of Citicorp, a commercial bank, and Travelers, an insurance company owning Salomon Smith Barney, an investment bank.

Will we return to a much tighter regulatory regime? It seems unlikely. The level of state intervention which followed the Great Depression and lasted until the 1970s was not only the result

of the financial crisis of the 1930s. It was a consequence of the “Thirty Years War” of the twentieth century, the years between 1914 and 1945, marked by two world wars and the most severe depression in history. Light-touch regulation will come to an end, excesses will hopefully be reined in, but this should not mean a return to the fifties and sixties. Regulation and supervision are more likely to be different, with more emphasis on systemic risks and international coordination, as witnessed by the proposals of the de Larosière report in February 2009, which include, among others, a gradual increase of capital requirements; a regulation of the “parallel banking system”, not least hedge funds; a better alignment of compensation incentives with shareholders’ interests and companies’ long-term profitability; the creation of a European Systemic Risk Council, chaired by the European Central Bank president; and a close cooperation between this European Systemic Risk Council and the IMF, central banks, and the BIS in order to develop and operate a financial stability and early warning system.

There remains the question of the balance of power in international financial. Will New York and London be toppled by Shanghai, Singapore or Dubai? This, again, seems unlikely. The financial crisis should not disrupt the hierarchical order, at least in the medium term. New York took thirty years to replace London as the world’s financial centre, at a time when the American economy was already far larger than the British one. The same applies to the change of leadership between Amsterdam and London at the turn of the nineteenth century. Emerging markets will have to meet several conditions, not least in terms of wealth and openness, before claiming the mantle. On the other hand, the growing weight of a number of emerging economies, above all the BRICs (Brazil, Russia, India and China) will enable them to host a financial centre of world significance, as did Germany and the United States in the nineteenth century, with Berlin and New York respectively; and Japan in the twentieth, with Tokyo. So Shanghai, Mumbai, Moscow and Sao Paulo should in due course, though not necessarily at the same time, rank alongside New York, London, Tokyo, Frankfurt and Paris in a multi-polar financial world.

History suggests that major upheavals in international finance are usually triggered off by a military cataclysm –irrespective of the outcome, whether victory or defeat. When comparing 2008 with 1929, it must be borne in mind that the Great Depression was intrinsically linked to two world wars –hence its unique character. The crisis of 2008 burst out in a different, much happier context. Its depth, length and impact should be far less dramatic.

