

Course 3:A Brief History of Financial Crises

Course Outline

- 1/ A Brief Overview of financial crises and some macroeconomic explanations
- 2/ The Global Financial Crisis: events and causes
- 3/ Some overall lessons

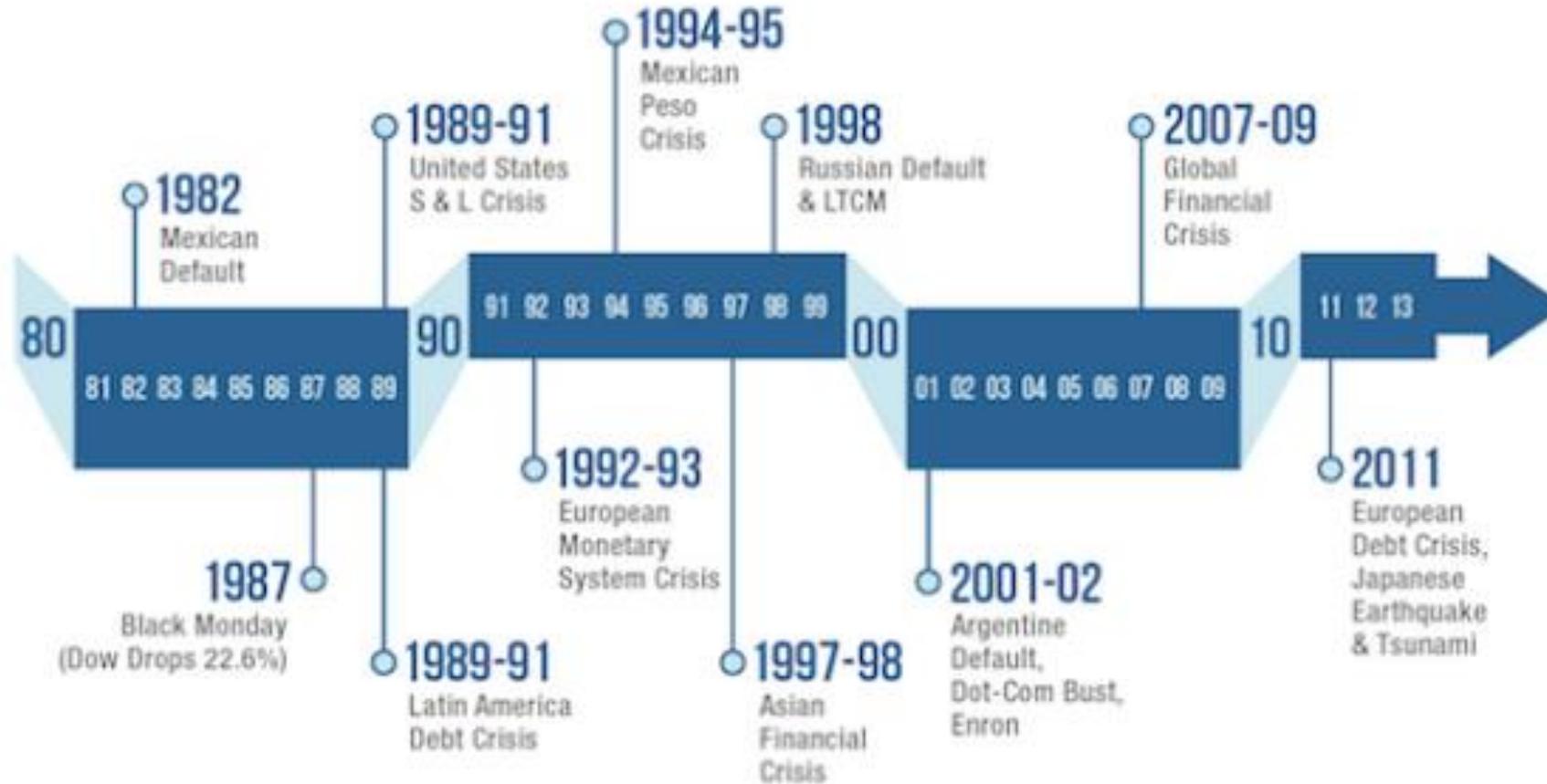
The Major Crises of the 20th Century (source: [ChatGPT timeline](#))

- 1907 Panic (US): run on banks after failed attempt to corner the copper market
- 1929–33 Great Depression (global): stock market crash led to bank failures (the “Great Contraction” of money, lack of demand)
- 1931 European banking collapse: domino effect of Austrian bank failure

(Bretton Woods era of financial stability: 1945 until the 1970s)

- 1982 Latin American debt crisis: high US interest rates and high dollar, as well as falling commodity prices made debt servicing
- 1997 Asian crisis: crony capitalism, poor over-investment, “hot money” flight
- 2007–09 Global financial crisis
- 2010–14 Eurozone debt crisis: banking systems in “peripheral” states were severely stressed – “doom loop” with national debts

A more detailed list of crises since the beginning of “neoliberalism”



More recent – lesser crises

- **2013: Cyprus Banking Crisis**
Triggered by exposure to Greek debt. Depositors faced bail-ins (haircuts on bank deposits).
- **2015–2016: Chinese Stock Market Crash**
Not primarily a banking collapse, but banks were pressured due to high leverage in shadow finance.
- **2018–2020: Turkish Currency and Banking Crisis**
Lira collapse led to high inflation and strains on banks heavily reliant on foreign borrowing.
- **2022–present: Ukraine War & Inflationary Shock**
Energy and commodity prices surged, stressing global debt markets. Not a banking collapse but a systemic strain.
- **2023: US Regional Bank Failures**
Silicon Valley Bank, Signature Bank, and First Republic failed due to interest-rate risk and depositor runs, raising fears of contagion.

Global Financial Crisis 2007-2008

- What happened?
- Early 2000s, very low interest rates by Fed (1% June 2003 to June 2004) – to fight deflation after Internet stock crash in 2000 and broader crash in 2001, following 9/11
- Global savings glut
- Housing market boom
- Followed by a collapse
- Beginning with the sub-prime sector

Lehman Brothers: September 2008

- August 2007: BNP Paribas freezes funds
- September 2007: Northern Rock bank run
- March 2008: Bear Stearns bailout (absorbed by JP Morgan, already chaired Jamie Dimon)
- September 7, 2008 Fannie Mae and Freddie Mac placed in conservatorship (they were essential nationalised, as the government guaranteed \$5 trillion in mortgage loans)
- September 15, 2008: Lehman Brothers file for bankruptcy
 - A conspiracy (unlikely) – moral hazard argument (markets have to work)
- September 16, 2008: AIG bailout up to \$85 bn

“Why had no-one predicted the crisis?”

The Queen opening a building at the LSE, November 2008

British Academy replied in a letter on 17 June 2009,
reasons:

- 1/ many did foresee the crisis: problems of timing, and willingness to act – how?
- 2/ many warnings about global imbalances, global savings glut, equity withdrawal etc.

The Global “Savings Glut” (Bernanke) and The “Minotaur Economy” (Varoufakis)

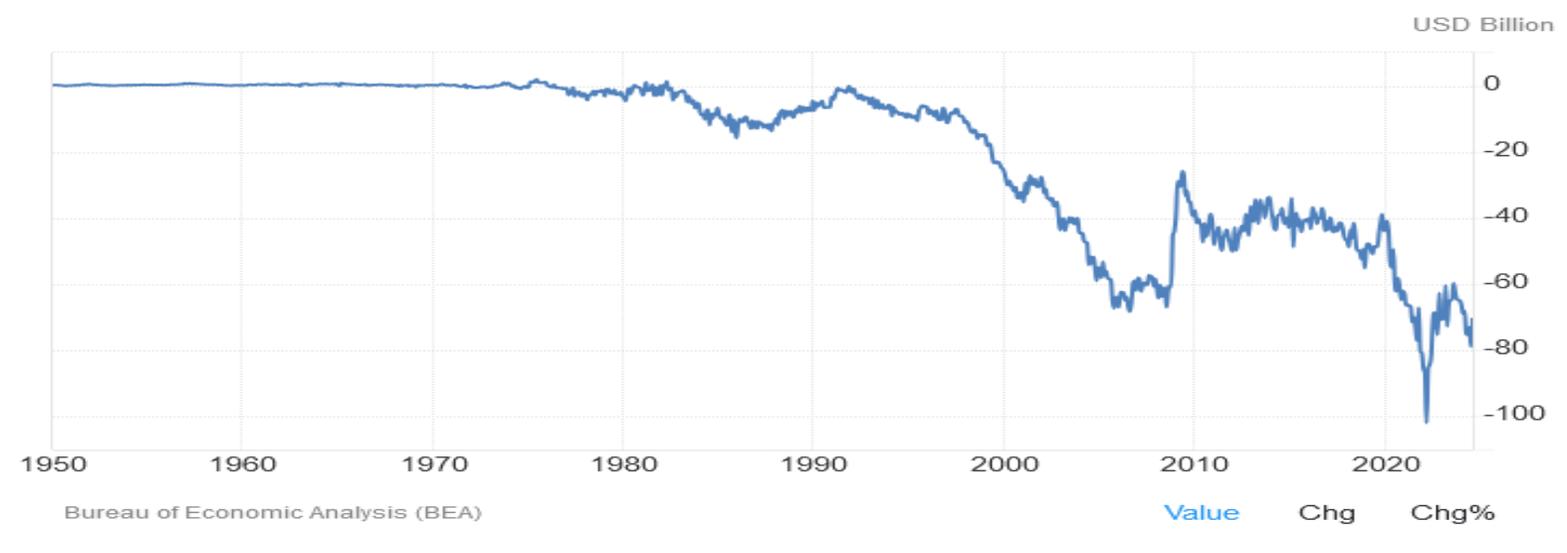


*“global surplus recycling
mechanism” (GSRM)*

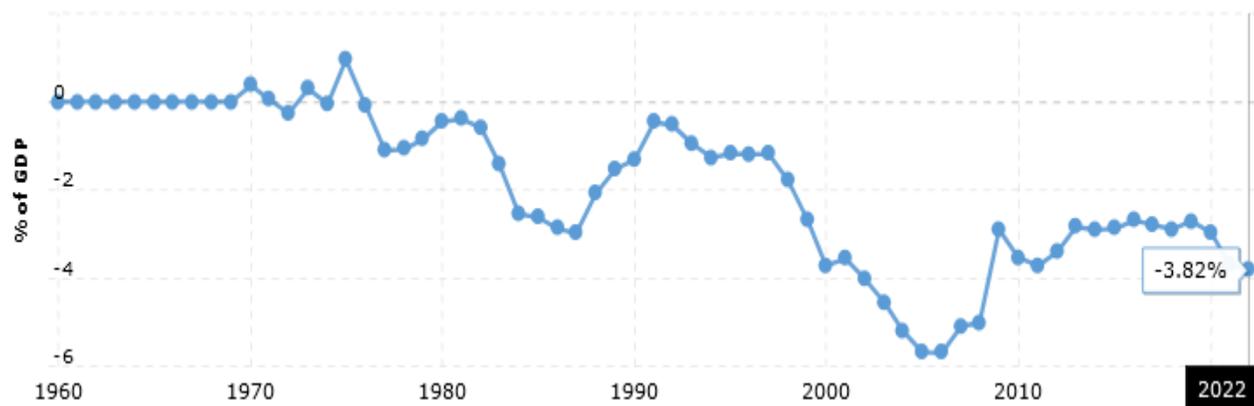
US: consumer of last resort
after post 9/11 global
slowdown, US was
holding up world demand

China (especially) and
other Asian countries
were lending to the US
and exporting to the US

US trade balance: the “consumer of last resort” - (2003: Kenneth Rogoff “the best recovery money can buy”). Is the deficit as sustainable for ever?



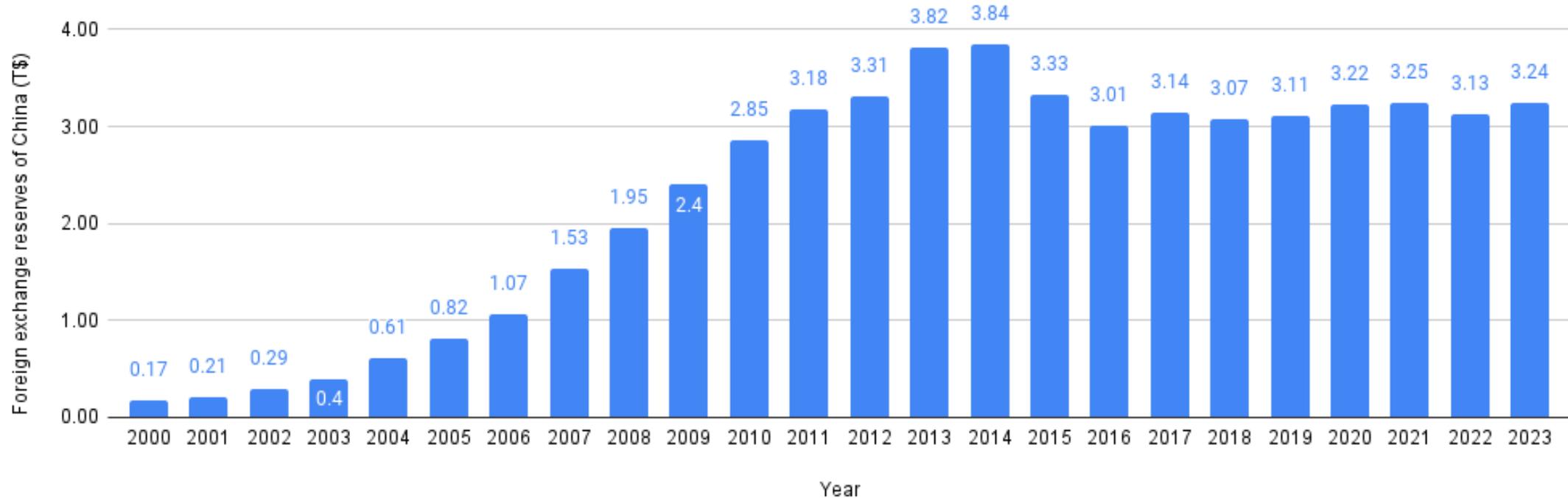
Source: <https://tradingeconomics.com/united-states/balance-of-trade>



Source: <https://www.macrotrends.net/global-metrics/countries/USA/united-states/trade-balance-deficit>

China Foreign Exchange Reserves

Foreign exchange reserves of China (T\$) Year-end



As of 2014, China had been the largest foreign holder of [U.S. Treasury securities](#) since 2008, when it overtook [Japan](#) in this respect,^[8] accounting for about 22% of all U.S. Treasuries held by non-Americans.^[9] However, as of 2024, China reduced its holdings of U.S. Treasury securities to \$782 billion which made it the second largest foreign U.S. Treasury holder behind Japan.^[10]

Source: https://en.wikipedia.org/wiki/Foreign-exchange_reserves_of_China, retrieved 9 October 2024.

Letter to the Queen continued 2

- 3/ wishful thinking combined by all - politicians charmed by the market - models good at predicting short-term, small risks.
- 4/ people trusted the skills of bank management;
- 5/ a general “feel good” factor: households cheap goods and credit; bankers making money; governments receiving taxes > a psychology of denial;
- 6/ the authorities lacked instruments to “take away the punch bowl” – “light-touch” regulation;
- 7/ inflation low > no sign of overheating;
- 8/ everyone seemed to be doing their job; failure to see series of interconnections.
- 9/ psychology of herding.

Other factors:

- Chuck Prince, CEO Citigroup: **“When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing,”** 9 July 2007 to FT.
- Fraud, especially as boom intensifies (Martin Wolf)
- Raghuram Rajan: 2005 warning Jackson Hole
 - IT and financial interconnectedness
 - Excessive leveraging by banks
 - 2010 “Let them eat credit” > neoliberalism fueled by credit as household income stagnated.
- André Orléan: **when credit is cheap and asset prices are rising, rising prices lead to *higher* demand!**
- Hyman Minsky: **“stability breeds instability”**

Massive intervention

- Interest rates slashed
- Fed and other central banks lent massively to markets in the face of the credit crunch: Bagehot's principle
to lend "quickly, freely and readily", at a penalty rate of interest, to any bank that can offer "good securities" as collateral. (Lombard Street, 1873)
- Numerous short-term lending facilities established (Fed even substituted itself for the commercial paper market)
- The Fed also set up swap lines with other central banks
- Globally, public authorities mobilised \$14 trillion to provide direct capital to banks and guarantees.

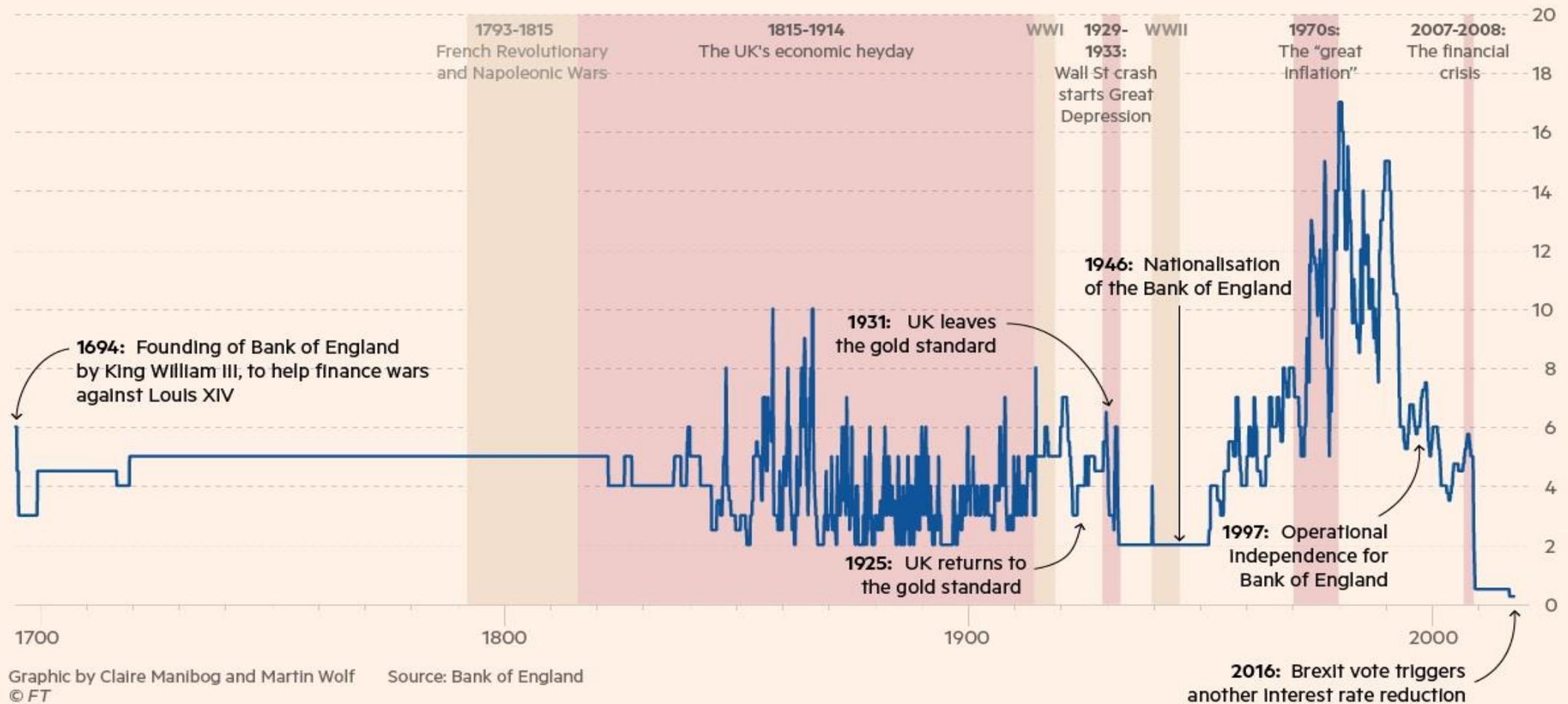
No return to normal

- There was re-regulation – next course
- But monetary policy remained abnormal until the end of 2021.
- Yes, some moderate increases in Fed funds rate, and some rundown of QE
- But the essential direction of policy remained “exceptional”

Martin Wolf: “Nothing like this has happened in 323 years”, *The Financial Times*, August 16, 2017

This time really is different

Bank of England official lending rate (%), 1694-2017



NEW YORK TIMES BESTSELLER

"The one economics book you must read now ... If you want to understand this bifurcated world and where it's headed, there is no better interpreter than Mohamed El-Erian." *TIME*

MOHAMED A. EL-ERIAN

With a new
Introduction
by the author



THE ONLY GAME IN TOWN

**CENTRAL BANKS,
INSTABILITY, AND AVOIDING
THE NEXT COLLAPSE**

Unconventional monetary policy

- Quantitative easing:
 - US (QE1, QE2 and QE3) November 2008 to October 2014: \$4.5 trillion
 - UK (March 2009 to end 2012: £375 billion); the policy was relaunched in August 2016 after Brexit referendum
 - ECB January 2015 - €60 billion per month
- Forward guidance – including unemployment targeting!
- What does this mean for banking?
 - Negative interest rates
 - “search for yield” speculative investments
- Traditional saving becomes impossible

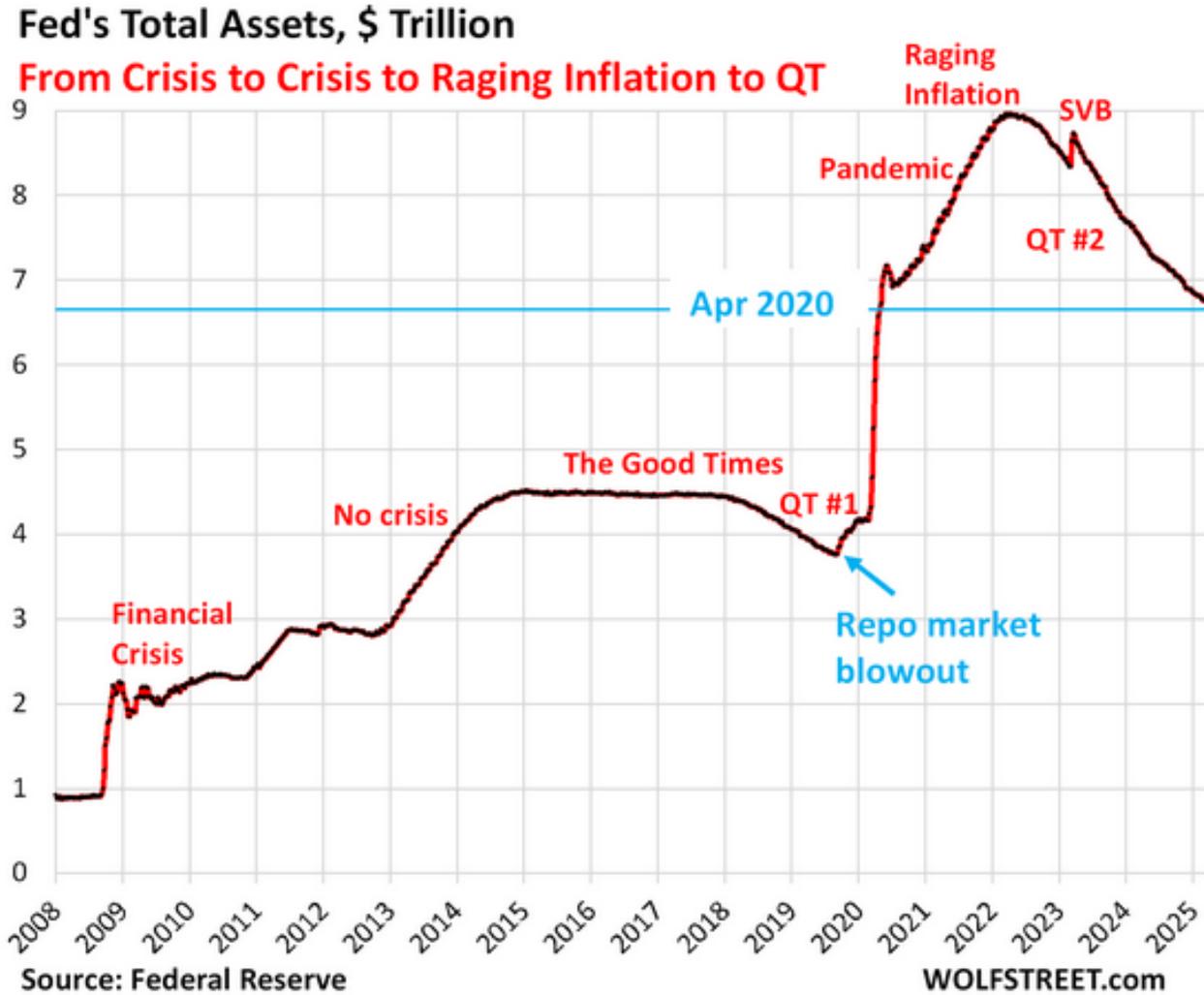
How successful?

- John Kay: QE a “leaky bucket” (2013) – House of Lords (2021): QE an “imperfect policy tool”
- Fiscal policy followed by “austerity” in Europe after 2010, because of traditional public spending worries, and Reinhart & Rogoff empirical study: when debt exceeds 90% of GDP it leads “on average” to a fall in growth rate of 1%.
- Eurozone experienced a significant public spending crisis: sovereign debt crisis.

And then came Covid-19

- US GDP collapsed at an annual rate of 30% in Q2 / 2020
- 22 million jobs lost in first two months:
 - Unemployment rose from 50-year low of 3.5% to 15% in April 2020
- Monetary and fiscal response unprecedented
 - From December 2019 to March 2021 nearly \$5.8 trillion was provided in fiscal support in the US (28% of GDP)
 - Similar measures in the UK – notably to support “furlough schemes”

US Federal Reserve: Recent balance sheet trends



Source: Wolf Richter, [“Fed Balance Sheet QT...”](#), Wolf Street, June 5, 2025

Fed used 5 types of actions

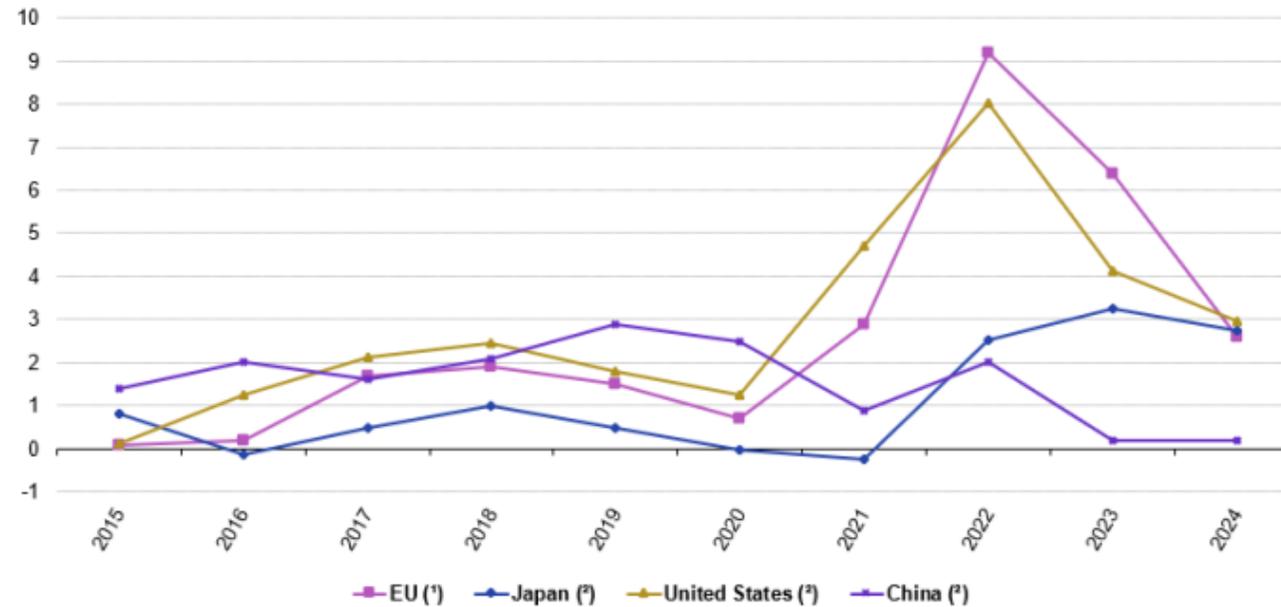
- 1/ conventional policy – cutting interest rates; forward guidance; restarting QE (of MBSs) and repo ops.
- 2/ liquidity to markets (commercial paper, mutual fund markets, dollar swap lines for foreign banks)
- 3/ facilities to support flow of credit to households, businesses, state and local governments
- 4/ temporary recalibrations to regulations and supervisory practices to encourage banks to provide credit to households and businesses.
- 5/ intervention in currency markets – “swap lines” – to stabilise currency movement.

Source: Richard H. Clarida, Burcu Duygan-Bump, and Chiara Scotti, "[The COVID-19 Crisis and the Federal Reserve's Policy Response](#)", Finance and Economics Discussion Series (FEDS), June 2021, retrieved 4 November 2021.

Since Covid – inflation and AI

EU HICP and Japan, USA and China CPI, all-items — annual average inflation rates, 2015-2024

(%)



(*) The data refer to the official EU aggregate. Its country coverage changes in line with the addition of new EU Member States and integrates them using a chain-linked index formula.

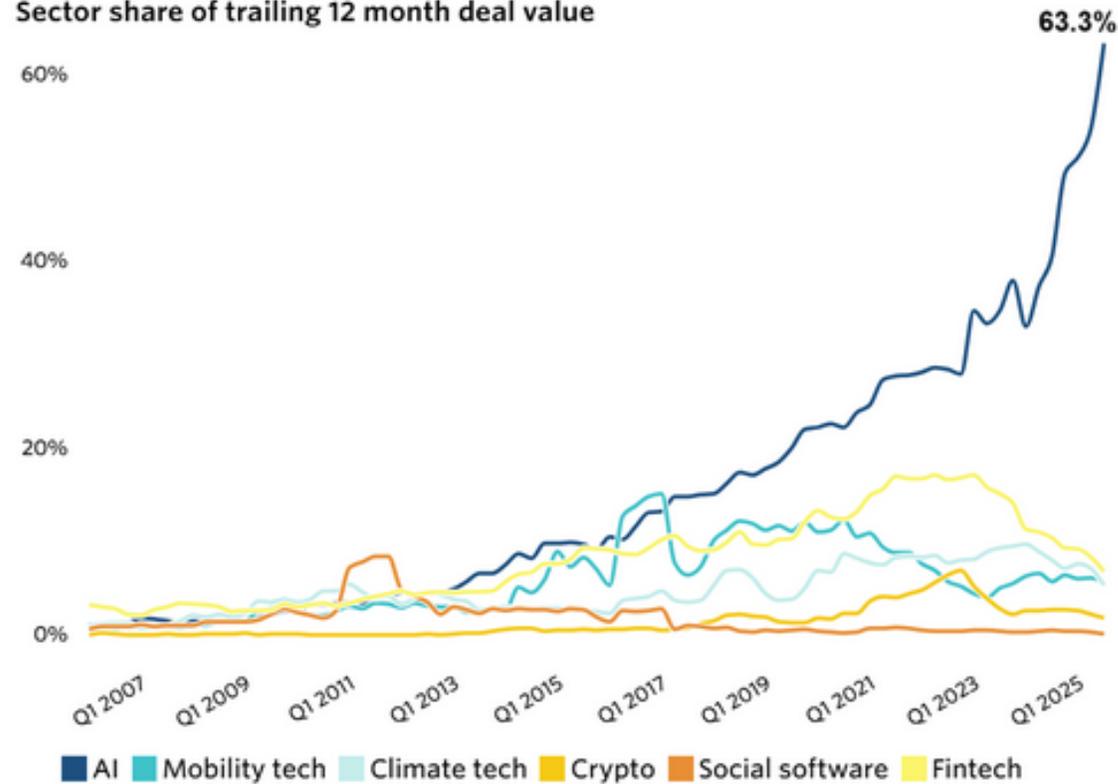
(*) National CPI: not strictly comparable with the HICP.

Source: Eurostat (online data codes: Eurostat (online data code: prc_hicp_aind) and OECD (G20-CPI All items))

2025 - US market is being driven by AI

AI deals are dominating the venture market

Sector share of trailing 12 month deal value



Source: Q3 2025 Quantitative Perspectives: A Fork in the Road • Geography: US • As of July 31, 2025

PitchBook

Source: Wolf Richter, [“AI Makes Past Hype Cycles Look Tame”](#), *Wolf Street*, September 30, 2025

Causes of financial crises ([ChatGPT summary](#), 2 October 2025)

- 1/ Excessive debt leverage
- 2/ Asset price bubbles
- 3/ Weak or risking banking system
- 4/ Currency and balance-of-payments crises
- 5/ External shocks
- 6/ Policy mistakes
- 7/ Loss of confidence & self-fulfilling runs

In short: crises usually involve **too much debt, too little trust, and a sudden stop in liquidity**

Takeouts

- Financial crises have different origins, but some similar characteristics
- Crises are endemic to modern finance, which has a long and complex history
- In the run-up to the GFC, macroeconomics was looking the other way
- There were many warnings of a crash, but regulators and operators could not and would not act
- Monetary policy and interest rates in the major economies were profoundly unusual between 2008 and 2022
- The authorities were careful and reactive to ensure market liquidity at the start of Covid
- But where do we go now? Risks of an AI crash, etc.