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)

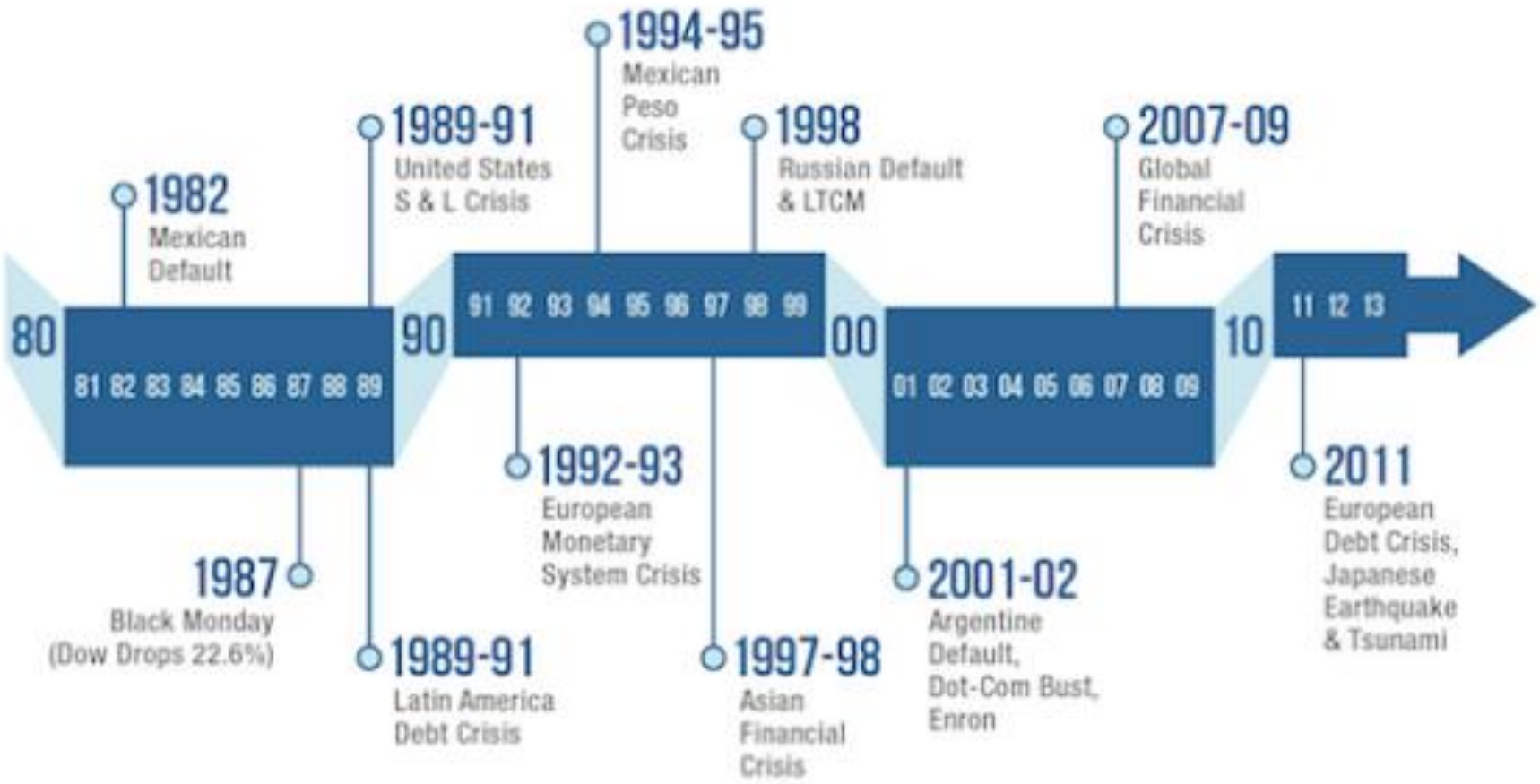
•1982 Latin American debt crisis: high US interest rates and high dollar, as well as falling commodity prices made debt servicing

•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”



A taxonomy of financial crises

Type	Typical mechanism	Example
Banking crisis	Bank runs / insolvency	1931, 2008, SVB
Currency crisis	Capital flight / exchange-rate collapse	Mexico 1994, Asia 1997
Sovereign crisis	Loss of confidence in government debt	Greece 2010–12
Asset-price crash	Bubble / repricing	1987, dot-com
Balance-of-payments crisis	External financing suddenly stops	Latin America 1980s
Systemic crisis	Several mechanisms interact	2008

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.
- **2022 UK pension crisis (September)**
  A poorly thought-out "mini-budget" let to strong falls of the pound and gilts and a sell-loop as pension funds needed had to meet margin calls
- **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.
- **2023: Collapse of Crédit Suisse (taken over by UBS):** *Financial Times* film 14 July 2022

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): Watch the scene in the "Big Short".
- 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

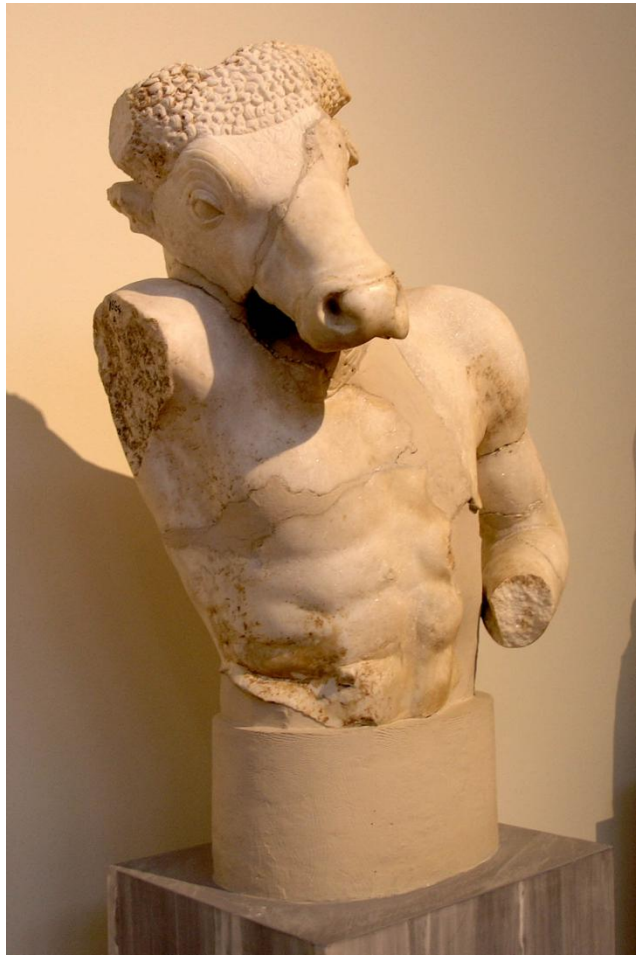
“Why had no-one predicted the crisis?”

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)

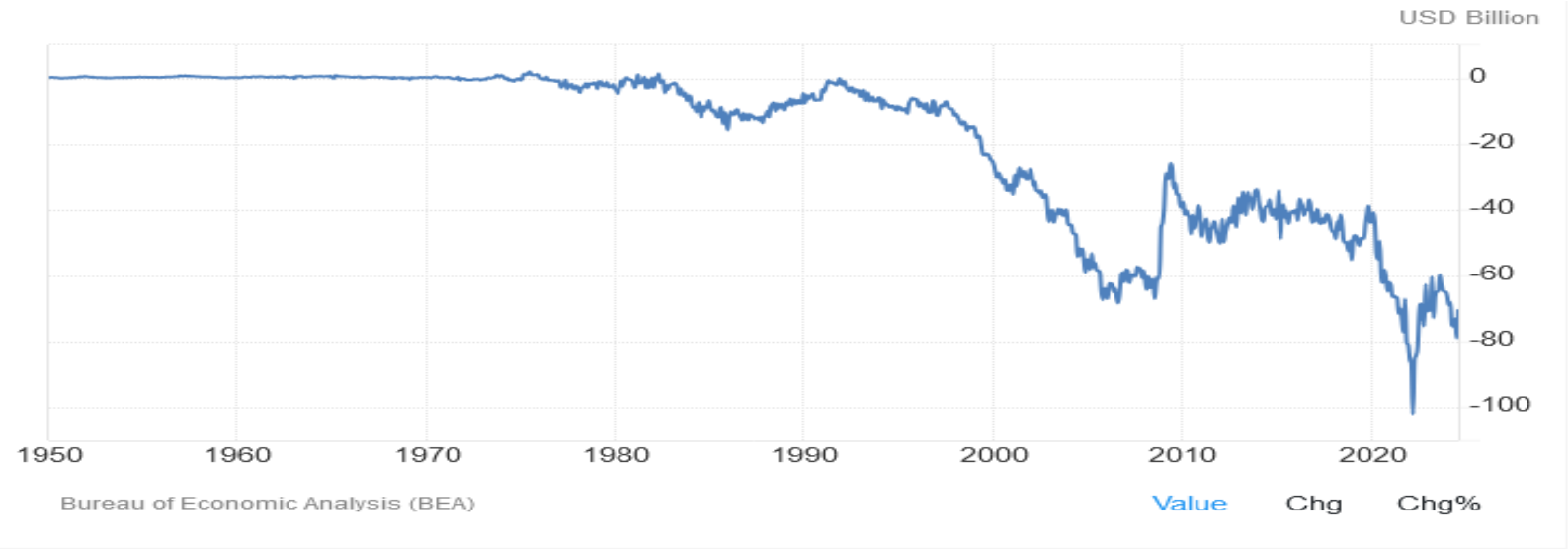


“global surplus recycling mechanism” (GSRM)

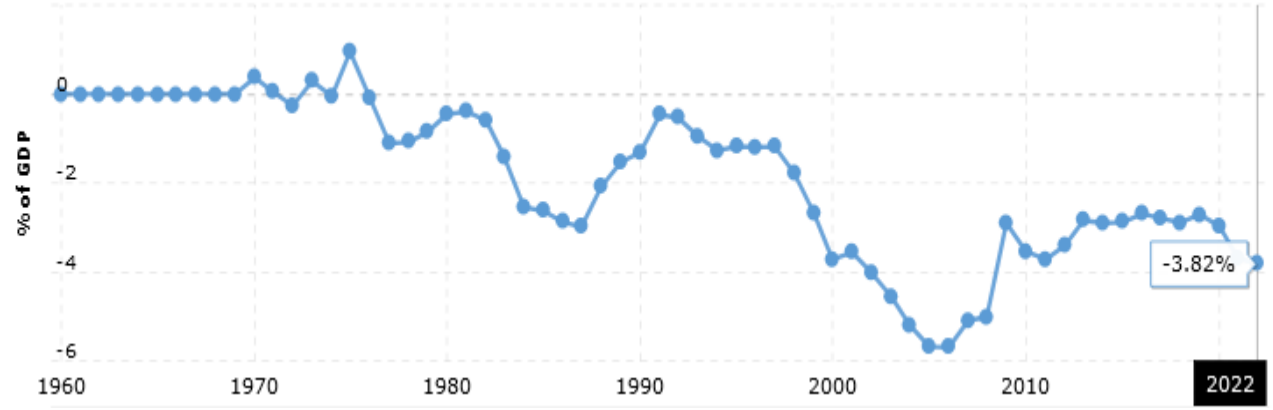
US: consumer of last resort after post 9/11 global slowdown, US was holding up world demand

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?

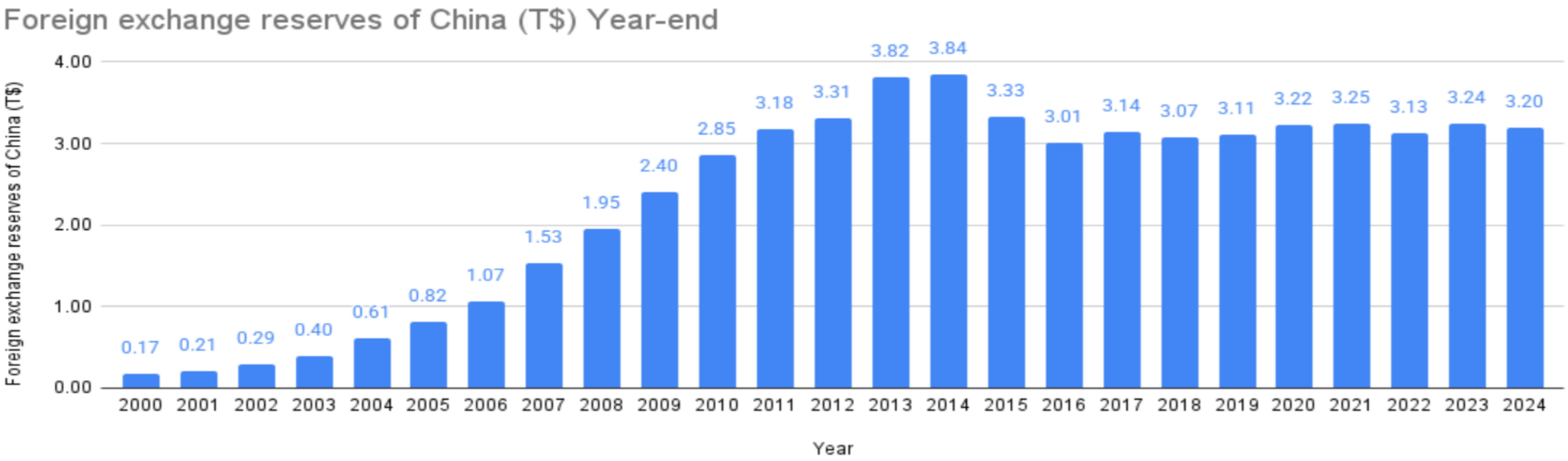


Source: https://tradingeconomics.com/united-states/balance-of-trade



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

China Foreign Exchange Reserves



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 being 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

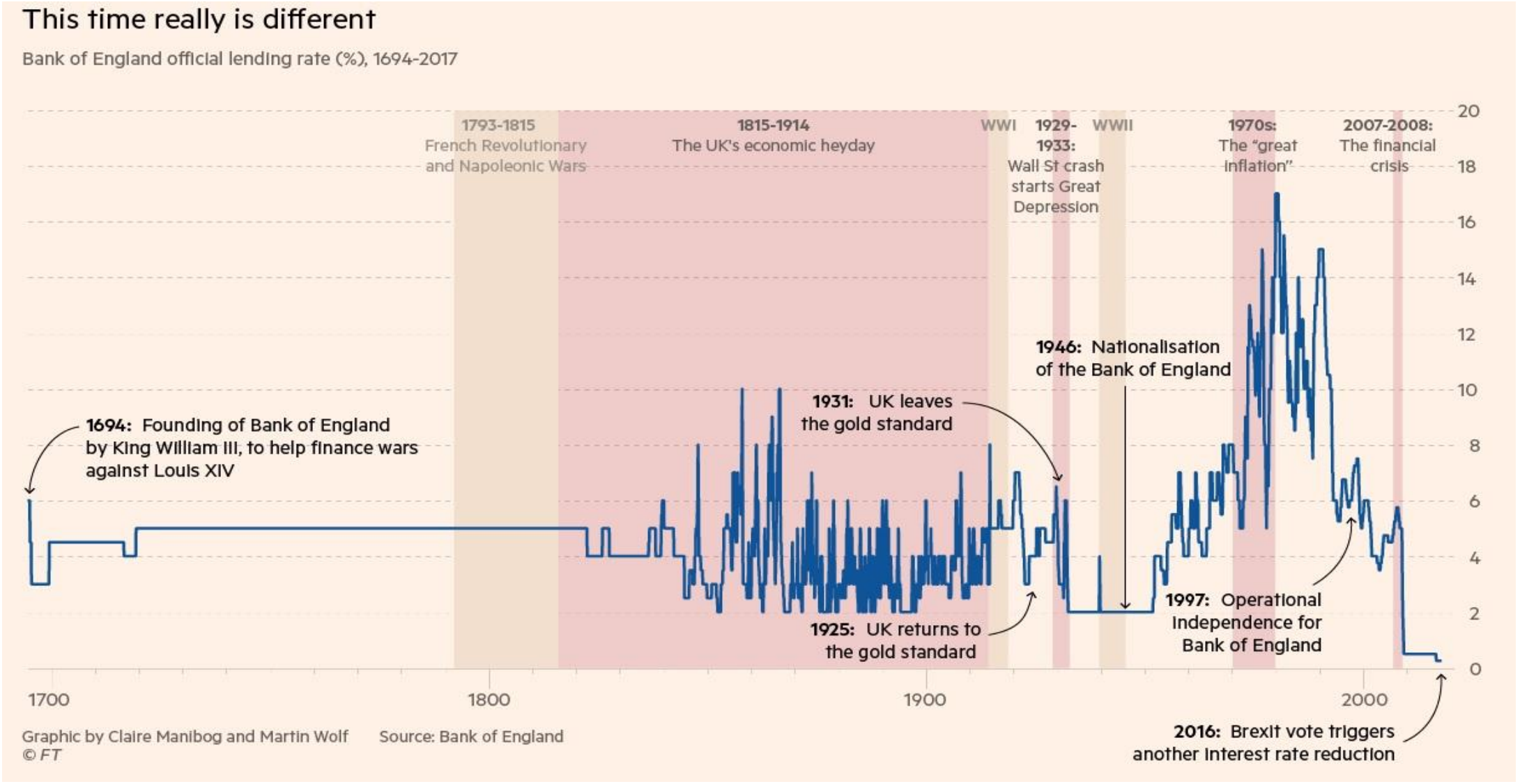
- Interest rates slashed
- Fed and other central banks lent massively to markets in the face of the credit crunch: Bagehot's principle

  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



Unconventional monetary policy

- Quantitative easing

- 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%.

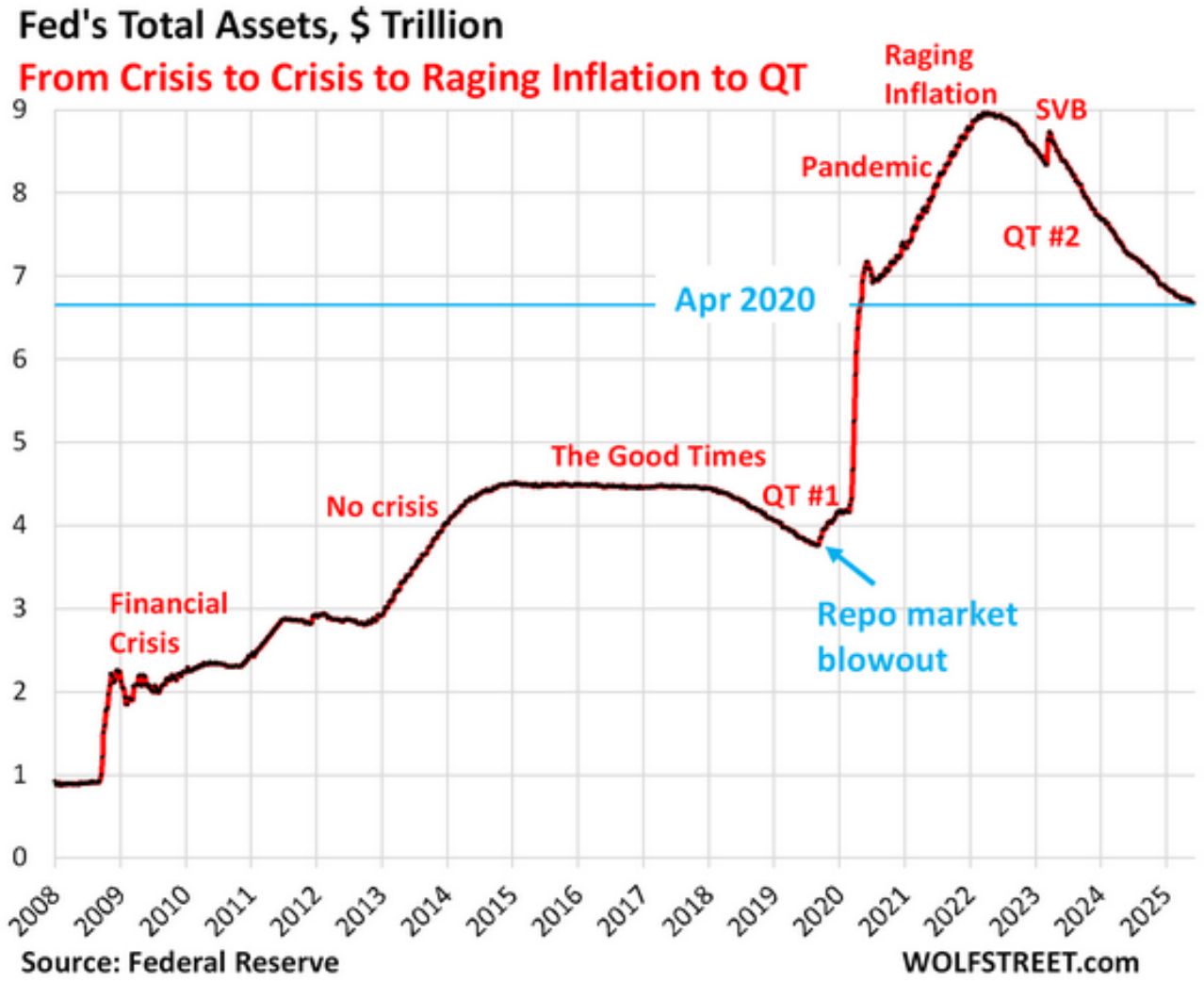
- Eurozone experienced a significant public spending crisis: sovereign debt crisis.

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

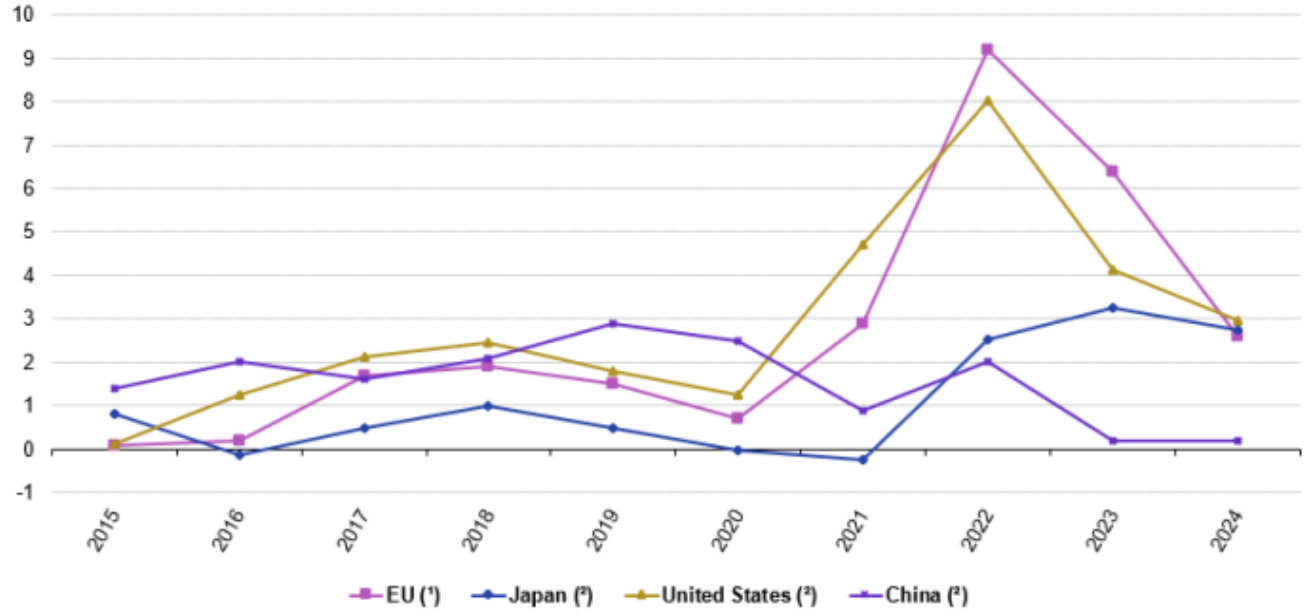
4/ temporary recalibrations to regulations and supervisory practices to encourage banks to provide credit to households and businesses.

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
(%)

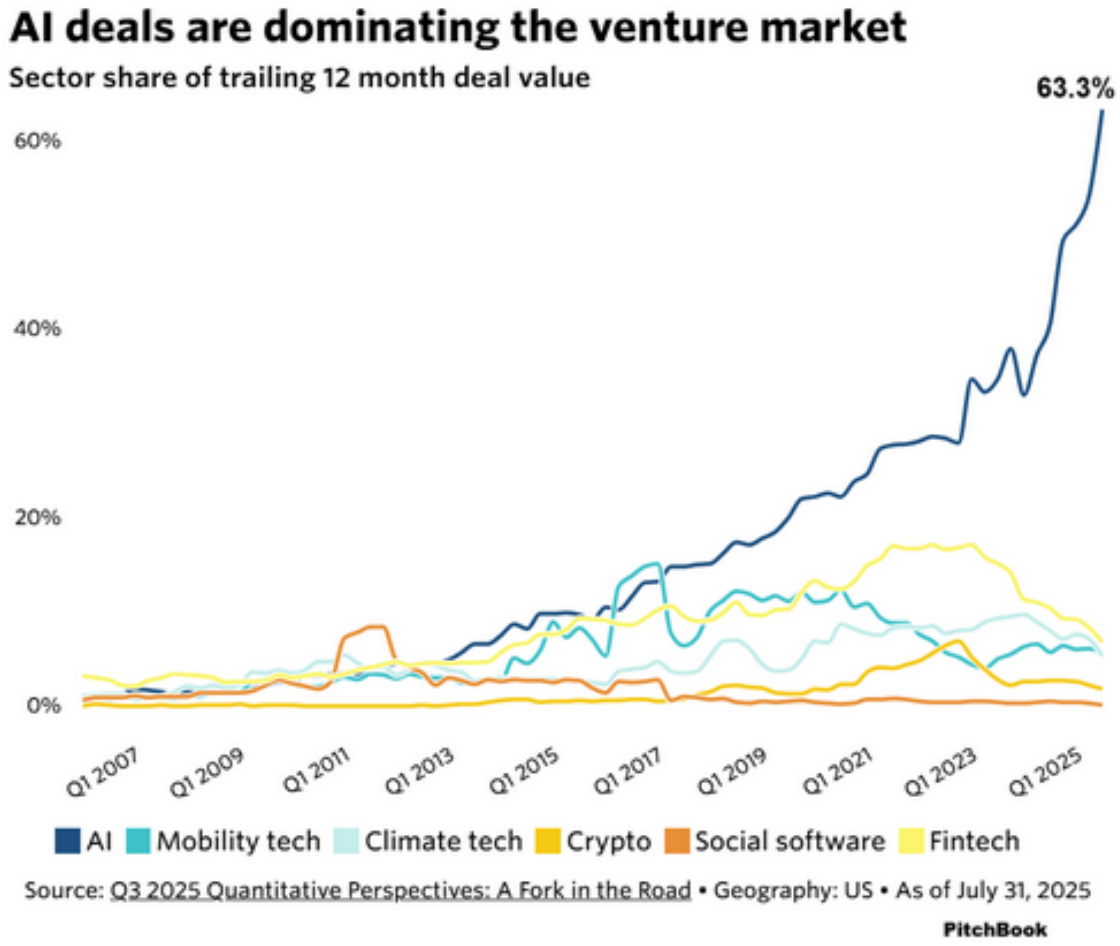


(¹) The data refer to the official EU aggregate. Its country coverage changes in line with the addition of new EU Member States and integrates them using a chain-linked index formula.
(²) National CPI: not strictly comparable with the HICP.

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

eurostat

2025 - US market is being driven by AI



Source: Wolf Richter, "AI Makes Past Hype Cycles Look Tame", *Wolf Street*, September 30, 2025

AI is no longer simply an analogy with the dot-com bubble (ChatGPT Go, 9 October 2026)

There are identifiable financial transmission mechanisms:

- very high valuations and concentration in US equities;
- enormous AI capital expenditure;
- increasing debt financing of AI infrastructure;
- private-credit exposure to software/AI companies;
- "circular financing" between chipmakers, hyperscalers and AI firms;
- dependence on continued expectations of future AI earnings;
- potential spillovers into bond and private-credit markets.
- The IMF estimates **$3.4 trillion of AI-related capital expenditure through 2029**, while hyperscalers have already raised more than $100bn in bond financing since January 2025 (IMF, Global Financial Stability Report, April, 2026)

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

1/ Excessive debt leverage
2/ Asset price bubbles
3/ Weak or risk-taking banking system
4/ Currency and balance-of-payments crises
5/ External shocks
6/ Policy mistakes
7/ Loss of confidence & self-fulling 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 – they usually have complex origins
- 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.