Introduction

The Financial Debacle of 2007–8 has raised many questions, at economic, political, social, and international levels, revolving around its causes and its consequences. How did we get there? Where do we go from here? For years to come, economists, historians, and other social scientists will attempt to answer these questions. While the first one will remain the same, the second will gradually become: where *did* we go from there, and how? It is with this second question that this book is primarily concerned, even though the present tense is still being used. It could be argued that dealing with this issue is rather premature. The answer is: yes and no. Yes, because nobody, least of all historians, can predict the future, so the exercise might be judged futile. No, because history can inform discussions regarding the future: an enquiry into the effects of past financial collapses could be illuminating in the current turmoil, and historians have a unique role to play.

There remains much uncertainty about the outcome of the crisis. Some questions are of a general, others of a more specific order; some are still topical, others already, or in the process of being, outdated. In the early days of the crisis, for example, there was some concern about the future of capitalism.[1] Not so much its survival as a mode of production—as a matter of fact, capitalism has never *really* been under threat during an economic crisis in the last 200 years—as the type, or types, of capitalism most likely to prevail after the downturn. Has the 'Anglo-Saxon' model of market-dominated capitalism had its day? Has the European model of a more regulated and socially conscious capitalism still something to offer? Is there room for the emergence of a new model, possibly influenced by Asian practices? The debate, however, has moved on. In early 2009, the main area of anxiety was about the effects of the financial crisis on the 'real economy' and the risks of what has been labelled the 'Great Recession' turning into a 'Great Depression'.[2] Attention was focused on the discretionary fiscal measures taken by governments in order to prevent such an outcome. As they appeared to have worked, questions were raised about the right exit strategies and the long-term consequences of the deterioration of fiscal balances. By the time this book has been published, new questions will no doubt have arisen.

However, given the violence of the shock and the direct responsibility of financial institutions for the outbreak of the crisis, many questions have unabatedly revolved around the financial sector itself. Have banks become 'too big to fail'? Should commercial banking be separated from investment banking? Have bonuses been responsible for the excesses leading to the crash? Should financial institutions be more tightly regulated? Will the financial sector shrink significantly in the foreseeable future? Will Wall Street and the City of London retain their world leadership or will they be upstaged by financial centres in Asia or the Middle East? Finance services play a central role in post-industrial societies and their future shape is of prime importance to all other questions, not least the exit from the current recession and the rebuilding of a more sustainable model of economic growth. It has repeatedly been said that this crisis offers a unique opportunity to reshape the financial system. Will the opportunity be seized, should it be seized, can it be seized? Is there much scope for reform in the face of the developments of financial activities since the 1980s? Is the current economic, political, social, and international context conducive to radical reform?

This book is an attempt to revisit the history of financial crises in the light of these very contemporary questions. In no way should this be seen as an instrumentalist approach to history. Historical research does not take place in a vacuum; its agenda has always been dictated, more or less directly, by the challenges faced by a changing world. Financial crises have periodically wrecked the financial system. To what extent have they also contributed to its shaping? Surprisingly no historical work has seriously attempted to deal with this question. The history of financial crises is in itself hardly a new topic. Innumerable accounts of individual crises are available—the most famous undoubtedly being John Kenneth Galbraith's *The Great Crash 1929*, published in 1954 and never out of print since then. Broader comparative analyses are of necessity less common. The classic work remains Charles Kindleberger's *Manias, Panics, and Crashes*, originally published in 1978 and also constantly re-edited—a masterful essay combining a long-term (1720–1975) historical perspective with a (non-mathematical) economic model. Kindleberger was interested mainly in speculative booms and the financial crises they provoked, the panics that followed, and the role of the lender of last resort.[3] Moreover, the crises of the late twentieth century have generated a new literature, of a more quantitative nature, based on comparisons over time and across countries, and mainly concerned with the macroeconomic aspects of financial crises.[4] Carmen Reinhart and Kenneth Rogoff's book published in 2009, *This Time is Different*, a quantitative analysis spanning eight centuries, belongs to this genre and is primarily concerned with showing that, however different financial crises appear to be, they display remarkable similarities, in both time and space.[5]

Less attention has been paid to another side of the history of financial crises: their effects on the financial architecture. We know, of course, about banks' bailouts, banking concentration, the lender of last resort, financial regulation. But our knowledge remains patchy, limited to a single country, the aftermath of a single crisis, or a single aspect of the financial system. Few historical studies have analysed, in a long-term historical and comparative perspective, the extent to which major crises have redesigned banking firms, increased or decreased the level of state intervention, reformed corporate governance, encouraged international cooperation, or provoked fundamental shifts in global financial and geo-political power—in other words how financial crises have not only undermined, but also reshaped the financial world. These are the main issues that this book intends to address.

Charles Kindleberger has described financial crises as being 'like pretty women: hard to define but recognizable when encountered'. Economists distinguish between currency crises, banking crises, and twin crises, combining banking and balance-of-payment problems. Hundreds of financial crises have broken out across the world since the mid-nineteenth century.[6] Their depth and, especially, their international character have varied considerably. The Financial Debacle of 2007–8 was a global crisis that started in advanced economies, in the first place the United States, and historical comparisons are most effective when involving countries presenting a relative homogeneity—in economic but also social and political development. Consequently, this study will concentrate on major financial crises—those whose reach can be considered to have been global or to have involved one, or several, of the main financial powers. Particular attention will be paid to banking crises, which are particularly relevant from our perspective; and the notion of 'crisis' will be understood in the broad sense of the word, including both short and acute shocks and longer periods of deep instability. Crises erupting in emerging economies have not been included in the analysis, because they present a different reality—at economic, social, and political levels. Financial crises have been far more disruptive in emerging economies, not only because of their lesser degree of economic and financial development, but also because of the balance of power between the core and the periphery. Some financial panics in advanced economies have been caused by financial crises in emerging ones—the Baring Crisis of 1890 and the International Debt Crisis of 1982—and in those cases due attention will be paid to both sides of the problem, and to the way the core industrial countries have been able to absorb the shock and transfer it to the periphery.

Eight financial crises will be taken into consideration for our analysis: the Baring Crisis of 1890; the American Panic of 1907; the Financial Crisis of July–August 1914; the banking crises of the Great Depression of the 1930s; the Financial Instability of the early 1970s and the ensuing bank failures; the International Debt Crisis of 1982; the Japanese Banking Crisis of 1997–8; and the Financial Debacle of 2007–8.

The number of cases might appear limited, given the hundreds of financial crises recorded in recent quantitative analyses. However, it should be remembered that, apart from the Great Depression, the vast majority of financial crises have taken place in emerging economies, and most were currency crises.[7] Other financial crises have broken out in advanced economies since 1890, but they have been confined, either to small or peripheral European countries (Italy, Spain, Portugal, and, especially, Norway in the early 1920s; Spain, Norway, Finland, and Sweden from the late 1970s to the early 1990s) with little spillover on, and limited interest aroused in, other countries; or to circumscribed episodes in a major economy (Continental Illinois in 1984 and the savings and loans crises in the 1980s in the United States, the Bank of Credit and Commerce International in Britain in 1991, the Crédit Lyonnais in France in 1993, and Long-Term Capital Management in the United States in 1998).

The eight selected crises have been the most serious, not necessarily in terms of loss of output, but in terms of systemic risk. Apart from the American Panic of 1907 and the Japanese Banking Crisis of 1997–8, it was during these crises that a real risk of collapse of the international financial system presented itself—even if the panic was not caused by financial recklessness, as in 1914, or the danger was not absolutely imminent, as in 1982. As far as the Financial Debacle of 2007–8 is concerned, it is with these crises that the most significant parallels can be established, especially, in connection with the main theme of this book, the opportunity to reform the banking system that they might have offered. The American and Japanese crises have, nevertheless, been included, because they affected respectively the world's largest (already by a significant margin in 1907) and second largest (and still the most dynamic in the 1980s) economies; and, especially for the American Panic of 1907, because their international impact was far from negligible.

Earlier crises could have been taken into consideration. The 'Bagehot principle' of lender of last resort, which was to play a decisive role in the development of central banking worldwide, evolved from the banking crises of the mid-nineteenth century in England, especially the Overend Gurney crisis of 1866. Overend, Gurney & Co. was Britain's largest bank when it closed its doors on Thursday, 10 May 1866, provoking previously unseen panic.[8] At the height of the crisis, the Bank of England lent without restriction to banks, discount houses, and merchants in the City. The fact was clearly acknowledged by the Governor, Lancelot Holland, at the meeting of the bank's proprietors later that year. 'We would not flinch from the duty which we conceived was imposed upon us of supporting the banking community'—prompting Walter Bagehot to conclude in *The Economist* and then in his influential *Lombard Street* that the bank had accepted its role of lender of last resort.[9] In France, the 'doctrine Henri Germain', from the name of the founder of the Crédit Lyonnais and its chairman until 1905, was shaped by the severe crisis that followed the crash of the Union Générale in January 1882.[10] Germain laid down the unwritten rule for commercial banks of maintaining liquid assets, in particular by avoiding industrial financing, an activity to be left to another type of bank, the *banque d'affaires* (investment banks). Our story starts a little later, with financial crises taking place in a globalized world, with their effects being felt beyond the frontiers of the country where they originated. The crash of Overend Gurney and the Union Générale remained respectively a British and a French affair. Yet their significance in the shaping of modern finance should not be overlooked.

The way financial crises have contributed to the shaping of modern finance has depended to a large extent on the type of shock they have provoked: its intensity, its duration, its causes, its broader economic consequences. It has also depended on the socio-political context in which the crisis has taken place, and the analysis of the event made by contemporaries. From this perspective, each financial crisis has been different from the other. On the other hand, financial crises have displayed common characteristics—in terms of causes, patterns of development, or economic consequences. Historians have always been confronted with this dilemma, without necessarily finding the two approaches antagonistic. With the exception of the panic of July–August 1914, caused by the coming of the First World War, all the crises discussed in this study, including the most recent one, fit in neatly with the anatomy of a typical crisis identified by Charles Kindleberger. They started with a 'displacement', an exogenous shock creating new profit opportunities, which was itself followed by a 'bubble', fuelled by a credit expansion. A period of 'financial distress', when investors, aware of the imminent crisis, started to sell but were still tempted to buy, preceded the 'crisis' itself, which was precipitated by a specific signal, such as a stock-market crash or the collapse of a major bank. 'Revulsion' and 'discredit' then led to a panic, which was quashed by the intervention of the lender of last resort.[11] The selected crises also fit in with the more quantitative analysis of Reinhart and Rogoff, emphasizing the systemic risks posed by excessive debt accumulation and the illusion that 'this time is different' prevalent in each boom.[12]

Quantitative analyses have their merits, but they also have their limits. They do provide wide-ranging correlations and categorizations enabling a better understanding of the causes of financial crises, their depth and length, their interaction with recessions, and the effects of policy responses. But they inevitably lump rather than split, emphasize the commonalities rather than the specificities, and, for some of them, run the risk of being anachronistic by comparing disparate periods and contexts. This book concentrates on a limited number of major crises and follows a qualitative approach—not as an alternative to quantitative analyses, but because it is more adapted to the purpose of the book. In the case of major crises, whose occurrence is not very frequent, the differences, in other words the singularity of each event, are of paramount importance—the more so if one is to understand how the opportunities for change have been identified and why they have, or have not, been seized. Such an analysis requires adopting a multiple point of view, taking into account not only the economic and business dimensions of the phenomenon, but also its political (at both national and international levels) and socio-cultural ones.

The book is divided into seven chapters. The first two briefly present the eight major financial crises that have affected the advanced economies between 1890 and 2010. Readers will not all be familiar with these events, whose history, surprisingly, is not always readily available, so it is important to set the scene. The following five chapters each address one central question that has been on the agenda since the outbreak of the 2007–8 crisis. The first is concerned with the banks themselves, in particular whether and since when they have been 'too big to fail', the concentration movement, and the level of performance. The second discusses governance, with special attention to ownership and control and bankers' responsibility in connection with banking crises. The third question deals with regulation, especially the link between the depth of a crisis and the demand for regulation; the regulation, or absence of regulation, of financial innovations; and the extent to which financial institutions and markets have been regulated and deregulated. The fourth has to do with international cooperation, its successes and failures, including the global regulation of the financial system. And the fifth pertains to the changes in the balance of power in international finance. Each of these five issues is discussed within the context of the 8 major financial crises of the last 120 years, looking, in particular, at how they have affected, and been affected by, each crisis. As will be seen, many factors have contributed to the shaping of modern finance. Financial crises have been only one of them—and not necessarily the forces for change that we would like them to be in the wake of the Financial Debacle of 2007–8.