The History of Financial Crises

By Dr. Monia Mazigh, 2019©
The first modern day Financial crisis 1792
Core Purposes of Finance

♦ Finance is like an economic time machine

♦ Allows today’s savers to transport their surplus money in the future

♦ Allows today’s borrowers to use the future earnings now.

♦ Also it can serve as a safety net: flooding, fire, illness
Bright side of Finance

- A well tuned financial system smoothes the sharp ups and downs of daily bumps
- It can be an engine of growth
Dark side of Finance

♦ When bubbles burst and markets crash, the savings can be wiped out

♦ How can we separate speculation from finance?

♦ Keep the good and remove the bad
Tulip Mania
First Economic Bubble
(1633-1637)

- Tulip mania is the first ever recorded economic bubble in the modern history

- Before the “burst” of the bubble in 1637, some single tulip bulbs sold for more than 10 times the annual income of a skilled craftsman

- February 1637, tulip bulb contract prices collapsed abruptly and the trade of tulips ground to a halt
Historical and Political Context

- Amsterdam merchants were at the centre of a lucrative East Indies trade

- Tulips were new to Europe, introduced by the Ottoman Empire (Turkey) and quickly became a luxury item

- Some kind of tulips became so rare. Thus highly expensive and in demand

- Even ordinary middle-class and poor families speculated on tulips.
The Scheme

♦ Dutch created a type of formal *Future Market* where contracts to buy bulbs at the end of the season were bought and sold

♦ The Dutch described tulip contract trading as *windhandel* (literally "wind trade"), because no bulbs were actually changing hands

♦ The entire business was accomplished on the margins of Dutch economic life, not in the “Stock Exchange” itself
Irrational prices?

- Speculators weren’t interested in Tulip bulbs themselves but instead in buying and selling quickly and making profits.
- The price a tulip bulb sold at 400 guilders and that was more than the yearly salary of an unskilled labourer
- Some bulbs went up to 5,000 guilders
The collapse

- Doubts arose as to whether prices would continue to increase
- Fears of oversupply and the unsustainability of the great price rise in the first five weeks of 1637
- Almost overnight the price structure for tulips collapsed, sweeping away fortunes and leaving behind financial ruin for many ordinary Dutch families
A Chronicle of a Crisis...
The Birth of the American Financial System

- Alexander Hamilton: First Treasury Secretary of the United States
- In 1790, 14 years after the declaration of the Independence, there were 5 banks and few insurers
- Hamilton wanted a state-of-the art financial system copied over England and Holland
- The first American central bank will open in December 1791 with a capital of $10 million dollars
- American new bonds will be traded publicly
Alexander Hamilton
Founding Father of the United States and
Father of the Bank of the United States
William Duer: The Speculator
William Duer

♦ William Duer was known as “The King of the Alley”

♦ William Duer was “Wall Street’s” very first insider trader, and the man behind the Financial Panic of 1792

♦ Before the panic of 1792, Duer was a name synonymous with integrity
William Duer

- Duer was a member of the Continental Congress. He was a New York judge and a good friend to Alexander Hamilton.
- His bride was chosen by Georges Washington.
How things went wrong?

- Duer knew that the investors wanted the federal bonds to pay for their Bank of the U.S (BUS) shares
- He borrowed from friends, people and companies
- Suspicious debt to finance the capital of the bank
The Story

✦ in 1791, Duer resigned his position at the Treasury and entered into a partnership with a man by the name of Alexander Macomb, one of New York’s wealthiest individuals

✦ Using Macomb’s money, and his own insider knowledge and connections, Duer, in March of 1792, began speculating on Bank of New York stock
When he ran out of Macomb’s money, he started borrowing. He borrowed from banks. He borrowed from brokers. He borrowed from shoe shiners, shopkeepers and street sweepers. He borrowed every last dollar he could get his hands on.
And More...

- He kept on borrowing more and more, his stocks were soaring higher and higher, and Duer and his newfound friends just couldn’t get enough of a good thing. Everybody was in on the fun, even the local undertaker
The Scheme

- William Duer and his colleagues attempted to drive up the price of US debt securities and bank shares. For a certain time, they succeeded.

- They were financing their buys with loans from the banks.

- When the loans became restricted.

- They defaulted on loans, prices fell, which caused bank runs.
Credit, Credit, Credit

- The Bank of the United States became overnight a giant financial debt
- For its first two months it made $2.7 million in loans
- What did people do with the loans? Speculation
- They borrow money to buy shares and then sell them to make profits
- The market became very risky and saturated. The profits quickly evaporated. But how to pay back the loans?
How All This Occurred?

♦ In March 1792, the BUS ran out of hard currency that backed its *paper notes*.

♦ The bank cut down its loan by 25%.

♦ The speculators couldn’t pay back the loans by taking new loans.

♦ In two weeks, the prices of government bonds, BUS shares and other companies shares went down by 25%.
The Crisis

- William Duer was arrested
- Companies collapsed
- Angry mobs took the streets
Duer was put behind bars, as was his friend Macomb. In fact, legend has it that Duer actually locked himself up. He had borrowed money from just about everybody in town: cobblers, tailors, blacksmiths and butchers—even widows—and now they were out for blood. His blood! The mob was angry, and it was gathering fast
Security prices before and after the 1st crisis

Federal frothiness

Security prices, 100=par value of US bond, $

Source: “America’s First Securities Markets, 1787-1836: Emergence, Development, Integration” by R.E. Sylla, J. Wilson, and R.E. Wright
Alexander Hamilton Bail-Out

- Use public money to buy federal bonds and restablish their prices
- Banks purchased nearly $250,000 worth of US debt to inject liquidity in the market
- Help protect the bank and investors who had bought at inflated prices
- Give cash to troubled lenders
- Ensure that banks with collateral could borrow as much as they wanted, at a penalty rate of 7% (then the usury ceiling).

His rules were that a central bank in a crisis should lend freely on good collateral, such as government securities, but at a high rate of interest so borrowers would have an incentive to repay the loans as soon as the crisis had passed.
The Buttonwood Agreement

♦ May 17, 1792, in Manhattan, a small group of men (24) in knickers and knee-highs formed a small club for doing business

♦ The signed an agreement beneath an ordinary buttonwood: the **Buttonwood agreement**

♦ That was the birth of **Wall Street**
Lender of Last Resort

- Over few weeks, Hamilton started a series of lender-of-last-resort operations

- The institution in a financial system that acts as the provider of liquidity to a financial institution which finds itself unable to obtain sufficient liquidity

- “Hamilton put”

- Effective management of a financial crisis may sow the seeds of another one

- “Greenspoon put”: similar actions in dealing with the Asian, Russian, and LTCM crises of the 1990s were assumed to have fueled the dot com bubble
Your thoughts...