The History of Financial Crises

By Dr. Monia Mazigh, 2019©
Summary of Financial Crisis 1792

♦ Speculators: Duer and his friends. They “cornered” the market for the U.S 6% bonds

♦ You buy the share of BUS at $300 as down payment and you borrow the rest from banks

♦ Duer and his friends borrowed money to buy many US 6% bonds. The price of bonds went up. From $110 in Dec. to $126.5 in March

♦ On March 9, Duer defaulted on his debts

♦ Chain of default, collapse
Summary of Financial Crisis of 1792

- Easy credit: by January 1792 the BUS issued 2.2 million of notes and deposits

- Some of these loans found their way to Duer and his friends.

- Drain of bank reserves

- When the policies of credit were tightened too much: it was too late: the whole system collapsed.
Hamilton’s Plan

- Asked all banks to lend merchants (gave them 3 months grace period)
- BUS short term debt were accepted by all government agencies
- The government bought back the debts to inject liquidity in the market
- Dutch bankers gave a loan of 1.2 million to the US treasury
- The BUS lend money at 7% instead of 6%: incentive for borrowers to lend money
Jefferson and Madison opposed the views of Hamilton.

Jefferson and Madison dreamed of a nation of republican farmers.

Hamilton was accused by his political opponents in turning the United States into a nation of paper speculators!
The First Emerging Market Crisis 1825
Historical Context

- The historical context: the Latin American countries broke free from Spanish colonialism
- The Industrial Revolution was at its height: strong exports of British goods and commodities
The Wealthy Economy

- Wales became a raw materials Centre: it was producing 3 million tones of coal a year.
- Manchester was the first industrial city in the world: turning raw materials to chemical and machinery.
The Britain of Charles Dickens

♦ Children work in factories

♦ Railway expansion

♦ Industrial production grew by 34% between 1820 to 1825

♦ Wealthy British wanted somewhere else to invest their newly acquired cash
The Financial Prospects in Britain

- Government were in good supply but with the Napoleonic wars over, the risk went down and the return fell from 5% in 1822 to 3.3% in 1824

- The inflation was around 1%

- The real return was about 2%: safe but boring!

- London became the European financial hub. Foreign investors went to London to seek new funds

- New global bond market emerged: debt issues by Russian, Prussia and Denmark became in demand
The Latin Emerging Market

- Between 1822 and 1825, Columbia, Peru, Chile, Mexico and Guatemala successfully sold in London bonds worth of £21 million ($2.8 billion in today’s prices)

- The British mining companies operating in South America became popular: the share of Anglo Mexican increased in one month from £33 to £158
What Went Wrong

♦ South America was six month away from London by ship

♦ The financial information received by investors was not reliable. Many lies and false information misled the investors. Many journalists were paid by companies to promote their shares

♦ Investors didn’t do their due diligence. They didn’t conduct proper checks about their investment

♦ Examples: Poyais bonds sold by Gregor MacGregor on behalf of an imaginary country
Financial Information or Misinformation?
Gregor MacGregor: the “Leader” of Poyais
The crisis

♦ Historical rivalry between Spain and Britain

♦ The British government supported the Latin countries in their independence wars

♦ The British investors assumed that the British government will give their financial backing to Latin countries.

♦ Mexican and Columbian bonds were risky but paying 6% compared to the British 3%
The Panic

♦ In 1823, Spain was on the verge to default
♦ The British government didn’t come to the rescue of the Latin countries
♦ Peru’s bond in 1825 fell by 40% of their face values
Panic and Collapse

- British banks were taken by investors who asked for cash: bank runs.
- In December 1825, the Bank of England tried to respond to the accrued demand.
- First, the Bank of England increased the supply of money, then it made it too tight and finally it refused to act as Lender of Last Resort.
- An infusion of gold reserves from Banque of France saved the Bank of England from total collapse.
The Fall-out of the Crisis

In 1826, more than 10% of the banks of England and Wales failed.

The banking system will change forever after this crisis.

Investors were blamed for their foolishness.

Britain financial chiefs, including the Bank of England blamed the banks instead.

The bank laws allowed a maximum of six partners to supply the equity: many small banks.
What really happened

- This was the first **modern economic crisis** most likely caused by economical cycle

- The Napoleonic Wars had been exceptionally profitable for all sectors of the British financial system

- There was an **expansionary** monetary actions taken during transition from wartime to peacetime economy initiated a surge of prosperity and speculative ventures.

- The stock market boom became a bubble and banks caught up in the euphoria made risky loans that led to a stock market crush
The Consequences

Needed bigger banks that can stand increased demands in times of crisis

The committees of Westminster copied what was being done in Scotland
More Consequences

The Scottish banks resisted better to the crisis

The Scottish banks are “joint stock” lenders who partners together and issues equity to whoever wants to buy it

The English copied this new banking system: the megabank system was born
Today’s Consequences

♦ Britain became a world leader in banks and bonds

♦ Many small banks started to merge to form huge, stronger banks: banks started gobbling up rivals
Merging of Banks

- The merging process never stopped until today
- In Britain, the 4 largest banks hold 75% of the country’s deposits.
- The failure of one of them poses a systemic risk to the whole economy
“Too Big to Fail”

- Banks became so big that any failure will have disastrous consequences on the economy.
- Importance of the state intervention in any crisis to bail them out.
- Paul Krugman agrees with this “theory”.
- Opponents to this concept, claim that there is a moral hazard when the big banks can take advantage of their sizes to make profit on the back of the rest of the economy.
Downsize?

- Alan Greenspan, ex chairman of the US Federal Reserve said

“ If they are too big to fail, they are too big”
# The “Canadian” Big Five

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<th>Market Capitalization (Billion CAD)</th>
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Too Big to Fail, Again...

- During the 2008 financial crisis, the Bank of Canada, along with the Canada Mortgage and Housing Corporation and the US Federal Reserve provided up to $114 billion of liquidity support to Canadian banks.

- Of this amount, $69 billion was part of the CMHC mortgage insurance program, a facility set up in 1954 to handle such situations.

- The bank regulator is the Office of the Superintendent of Financial Institutions (best known as OSFI), whose authority stems from the Bank Act. The financial groups are also governed by regulatory bodies (bank regulators, securities regulators, insurance regulators, etc.) in each country in which they operate.
Your thoughts...