The History of Financial Crises — Lecture 1 Study Guide

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Lecture 1: The Anatomy of a Crisis

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1) What Is a Financial Crisis?

- **Working definition:** A **sudden decline** in the value of an economically important asset class (land, stocks, sovereign debt, currency, etc.).
- **Mechanics of a drop:**
- ↑ **Perceived risk** ⇒ ↑ required return (discount rate) ⇒ **lower price**
- and/or ↓ **expected future cash flows** ⇒ **lower price**
- In practice, crises usually involve **both**.

Why it matters: Asset price collapses are typically accompanied by **real-economy disruptions** (e.g., ~6% output losses in banking crises; median bank support ≈ **16% of GDP** in recent decades).

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2) The Learning Puzzle

- If crises are so costly, **why do they recur**?
- Competing explanations:
- **Minsky–Kindleberger:** recurring waves of **greed → fear** (behavioral cycles); crises are inherent, hard to prevent.
- **Historical particularism:** every crisis is **unique**; little to generalize.
- **Course position:** A **middle ground**—many crises share **discernible patterns**, but **not all are the same**. This opens the door to **prediction** and (in principle) prevention.

3) Core Thesis: Crises Can Be "Adaptive"

Crises aren't *desired* per se, but their risks are often **stapled to things societies choose**. Five adaptive linkages:

1. **Domestic politics & rent extraction**
2. Subsidizing risk (e.g., **deposit insurance**, subsidized mortgages) can reward the winning coalition—even if it **raises fragility**.
3. **Geopolitical competition**
4. Latecomer states **take bigger risks** (military + mercantilist) to catch up; crisis risk is a **byproduct of survival**.
5. **Innovation & learning**
6. New tech/markets (e.g., **Florida 1920s**, **1920s equities**) require risk-taking to **discover value**; some booms will bust.
7. **Fraud vs. privacy & entrepreneurship**
8. Tighter surveillance can deter fraud, but it also **destroys privacy**, **impedes discovery**, and **blunts incentives**.
9. **Fiat money & discretionary central banking**
10. Discretion can **mis-calibrate risk** (overly loose/tight episodes), yet fiat regimes persist because they're **flexible and useful** (even if imperfect).

Bottom line: *Crisis risk may be part of a* ***politically adaptive equilibrium****, not purely a mistake or mass irrationality.*

4) Two "Gorillas" of Subsidized Risk

- **Deposit Insurance**
- Empirical regularity: **more DI ⇒ riskier banks** (moral hazard via weaker depositor discipline).
- Global adoption **surges post-1980**, rarely reversed → strong hint of **political adaptiveness**.
- **Mortgage Risk Subsidies**

- Since mid-20th century, mortgage share of bank credit **more than doubled** in advanced economies.
- Subsidies often **inflate house prices** more than they increase homeownership—yet remain **politically popular**.

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5) Monetary Policy & Risk Perceptions

- **Loose policy** (e.g., 2002–2006) → **low measured risk** (VIX/spreads compress) across **stocks & bonds** → sets stage for a **sharp repricing** (2008).
- Discretionary fiat regimes **repeatedly** generate these cycles; reforms exist, but **political demand** favors discretion.

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6) A Taxonomy Approach (Not “all same” vs. “all different”)

Ask **common ex-ante questions** of each case:

- Was the collapse **predictable** (with information **available before** the bust)?
- Was there a **price boom**?
- Were there **political risk subsidies**?
- What was the role of **external balance**, **credit growth**, **FX regime**, **maturity structure**, etc.?

*Clustering crises by these dimensions yields **useful families** (e.g., subsidy-driven booms; FX/sovereign mismatches; innovation-learning bubbles), guiding **diagnosis & policy**.*

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7) Deep Dive Template: AD 33 Roman Banking Panic

Context

- Two lender types: **deposit banks** and **elite moneylenders**.
- Two key regulations: 1) **Usury ceiling** (caps on lending rates)
  2) **Italian land-holding requirement** for lenders (tie elite wealth to the imperial core)

Sequence

1. Under Emperor **Tiberius**, **rates rise**; senators press to **enforce usury ceiling**.
2. Ceiling **binds** → **credit supply contracts** → **land prices fall**.
3. To "support land," Senate **raises land-holding requirement** → lenders must hold **more land**, make **fewer loans** → **credit contracts further**, **land prices plunge**.
4. Crisis resolution: Tiberius acts as **lender of last resort** (3-year, **interest-free** loans from the treasury).

Lessons

- **Price ceilings** + **portfolio mandates** can **amplify shocks** via credit contraction.
- Regulations served **political cohesion** (anchoring elite wealth in Italy) more than **economic efficiency**.
- Politically useful tools (usury caps, capital/portfolio controls) **persist across eras** despite known inefficiencies.

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8) Enter the Modern Era (1600s →)

Technologies: Cannon, ships, navigation ⇒ **centralized states** + **global reach**.
Institutional innovations:

- **Sovereign monopolies** (trade routes, lotteries, banks)

- **Joint-stock corporations** (broad investor base)
- **Standardized sovereign debt** (e.g., British **consols**)
- **Privileged chartered banks** aligning finance with **state strategy**

Systemic risk lens: Early modern crises are primarily about **sovereign risk** and empire financing.

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9) Teaser: 1720 France & England

- **Mississippi Bubble (France): John Law** fused banknote issuance, monopoly ventures, and equity finance. Conceptually **innovative**, but **price-setting hubris** (propping share prices via money creation) doomed the scheme.
- **South Sea Bubble (England):** Parallel ambitions; different political-financial plumbing.

> *Both illustrate the **adaptive** (catch-up geopolitics) and **fragility** (policy overreach) sides of state–finance coalitions.*

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10) Methodology & Norms

- **Ex ante analysis only:** Judge risks **as they were knowable**, not with hindsight.
- Use **narrative + statistics** to identify **shared mechanisms** and **case-specific drivers**.

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11) Key Takeaways

- Crises = **sharp repricing of risk** (and/or cash flows) with **real output costs**.

- Many risks are **policy-made** and **politically durable** (deposit insurance, mortgage subsidies, discretionary fiat policy).
- Treat crises via **taxonomy**: patterns recur, but contexts differ.
- Political economy often **chooses fragility** as the **price of other goals** (coalitions, competition, innovation, privacy, policy flexibility).
- Early case (AD 33) already shows how **well-intended rules** can **mechanically worsen** a shock.

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12) Discussion Prompts

1. Which of the five “adaptive” channels do you think most explains **your country’s** crisis history? Why?
2. Can you design a **deposit insurance** regime that preserves **discipline** without courting runs?
3. What **ex ante indicators** would you monitor today to flag subsidy-driven booms?
4. How would **rule-based monetary policy** change the risk cycle? What are the political trade-offs?
