<u>Manias, Panics, and Crashes</u>
Charles Kindleberger

Financial Crisis: A Hardy Perennial

p.3 Financial Crises are associated with the business cycle, a period of expansion that leads to an eventual downturn

p.4 Great Depression was prolonged as there was no international lender of last resort
"Speculative excess, referred to concisely as mania, and revulsion from such excess in the form of a crisis, crash, or panic can be shown to be, if not inevitable, at least historically common."

p.6 Kindleberger's position is that markets work well most of the time, but occasionally can get a little heated and government intervention must step in

p.14 "History is particular; economics is general."

Anatomy of a Typical Crisis

p.15 Minsky Model
-External/exogenous event occurs (war, crop failure, adoption of an invention, etc.) that alters economic outlook and brings about opportunities for profit in new areas
-If/when new opportunities dominate the old a boom takes place
-Boom is fed by expansion of bank credit, which increases the total money supply
-Bank credit is extremely unstable
-If/when an urge to speculate is present, the increased demand drives prices higher, a positive feedback occurs fueling more demand, and euphoria ensues
-Market peaks when new speculators balance insiders that withdraw
-Crisis precipitates for multiple reasons (bank stretched too thin, fall in price of primary object of speculation, etc.)
-Panic takes over as realization spreads that there is only so much money, and not enough for everyone to get out at the top
-Three things that can quell a panic
1) prices fall so low that people are tempted to purchase less liquid assets
2) trade is limited or restricted (shutting exchanges, closing trading, etc.)
3) lender of last resort convinces market that money available to meet the demand for cash

p.17 "Pure speculation, of course, involves buying for resale rather than use in the case of commodities, or for resale rather than income in the case of financial assets."

p.18 "At a late stage, speculation tends to detach itself from really valuable objects and turn to delusive ones. A larger and larger group of people seek to become rich without a real understanding of the process involved."
Fraudulent schemes flourish when individuals don't perform due diligence

p.21 Basic pattern: displacement, overtrading, monetary expansion, revulsion and discredit

Speculative Manias

p.25 Mania implies losing touch with reality (hysteria or insanity), yet economic theory assumes that all economic participants are rational

p.27 Assumptions that markets are rational and destabilizing speculation is impossible have both been proven wrong over the course of history p.29 "irrationality may exist insofar as economic actors choose the wrong model, fail to take account of a particular and crucial bit of information, or go so far as to suppress information that does not conform to the model implicitly adopted."

p.30 Speculation develops in two stages
1) firms and investors respond to a displacement in a limited rational manner
2) capital gains dominate

p.32 Insiders and Outsiders
-insiders destabilize by driving up prices and selling at the top
-outsiders (stabilizers) buy at the top and sell at the bottom
-losses of outsiders equal gains of insiders--market is a zero sum

p.33 Bucket shops

p.41 Displacement: a large external event that changes horizons, expectations, profit opportunities and/or behavior

p.43 war, political revolution, restoration, change of regime and mutiny

p.49 The most significant crises feature at least two objects of speculation and two markets

p.55 Currency School: monetarists, seek to limit money supply
Banking School: Keynesians, wants or acts to expand money supply as the economy grows

p.57 Money as an elusive construct, cannot be pinned down or fixed eith in absolute volume or growing along some predetermined trend. New forms of money can always be created to help facilitate an economic boom
THOUGHT: claim that "money" is endogenous, but need a further understanding as to what these other forms of money are (or historically have been)
Problem with currency school is that limiting the money supply may not be practicable

p.64 Example of expanding credit fueling a boom: Margin used in French bank stocks (1880-1882), similar to the US during 1928-1929

p.74 "Moreover, economics cannot conduct carefully controlled experiments, nor can appeals to history settle the issue conclusively, since they are open to the objection that if the course of action had been somewhat altered, the outcome would have been different."

p.75 Does raising the discount rate slow, stop or prevent the expansion of credit that leads to a crisis? Examples

p.77 Good paragraph on the role of banks without a central bank
"Central banking arose to improve control on the instability of credit."
Conflict between what's best in the short-term and long-term

The Emergence of Swindles

p.78 Minsky's definition of "Ponzi finance": a financial activity engaged in when interest charges of a business unit exceed cash flows from operations

p.79 Swindles: illegal or immoral transactions that involve both misrepresentation and the violation of trust (either implicit or explicit)

p.81 Kindleberger takes the perspective that swindling is demand-determined (follows Keynes law that demand determines its own supply)--in other words swindlers exploit greed during booms

p.83 "Let us grant that swindling grows with prosperity. It increases further in financial distress from a taut credit system and prices that stop rising and begin to decline."

When a bank buys its own stock it greatly weakens its ratios of cash and capital to deposits (deposits remain unchanged in the short run)

p.85 Mississippi Bubble was not a swindle, but based on two fallacies
1) that stocks and bonds are money
2) that issuing more money as demand increased was not inflationary (Banking School believes this?)

p.87 "Financial distress leads to fraud, so that the burden of losses can be dumped on others."

The Critical Stage

p.97 Bubble Act of June 1720

p.100 "Economic forecasters may know the direction of a move in business conditions, prices, and credit, but their capacity to foretell its precise timing is limited."

p.101 distress describes the period between euphoria and revulsion and discredit (or crash/panic)
Distress may be objectively defined for corporations, but not for an economy

p.102 Causes of distress and symptoms of distress can be difficult to distinguish

p.103 Distress occurs if
-investors and speculators become used to rising prices
-credit has been stretched thin in order to make capital gains and such gains are no longer available
-external drains (bad harvests, return of foreign capital to its home, etc.)

p.107 Speculation and extended credit are remote causes of a crisis while some unforseen event tends to be the instigator that snaps the confidence of the system
"Prices fall. Expectations are reversed. The movement picks up speed. To the extent that speculators are leveraged with borrowed money, the decline in prices leads to further calls on them for margin or cash, and to further liquidation. As prices fall further, bank loans turn sour, and one or more mercantile houses, or brokerages fail. The credit system itself appears shaky, and the race for liquidity is on."

p.113 Crash: collapse in asset price or failure of an important firm or bank
Panic: "a sudden fright without cause" may occur in asset markets or involve a rush from less liquid to more liquid assets

International Propagation

p.118 Ways that booms and panic are transmitted among various economies
1) psychological infection (ch. 3)
2) rising/falling commodity prices
3) short-term capital movements
4) interest rates
5) rise/fall of commodity inventories

p.120 South Sea and Mississippi Bubbles

p.133 International implications with Panic of 1907

Letting It Burn Out, and Other Devices

p.139 Idea that panic should be allowed to run its course is the product of two thoughts
1) one group taking a certain amount of pleasure from schadenfreude
2) the other sees panic as a purging of the system allowing for health and prosperity in the future

p.140 Latter view concedes that it may be difficult to obtain loans necessary for survival during crises (examples)

p.143 "The dominant argument against the a priori view that panics can be cured by being left alone is that they almost never are left alone. The authorities feel compelled to intervene."
p.145 Bank of England organized friends to survive the South Sea Bubble
p.146 Shutting down exchanges may stop panic, or it may actually worsen the situation
p.148 Use of clearinghouse certificates prior to creation of Federal Reserve

The Lender of Last Resort

p.161 concept of moral hazard
"All these issues derive from the basic dilemma that if the market knows it is to be supported by a lender of last resort, it will feel less (little? no?) responsibility for the effective functioning of money and capital markets during the next boom. The public good of the lender of last resort weakens the private responsibility of "sound" banking."
p.162 "The lender of last resort is a construct not of the mind of the economist but of the practice of the market."
p.163 Bank Act of 1844 was a victory for the Currency School (fixed supply of money) over the Banking School (money supply should grow as output and trade grow)
Paradox: 1) central banks should lend freely to quell a panic, or 2) leave the market alone to prevent future panics
p.167 First and Second Banks of United States as lender of last resort
p.168 Treasury's role as a lender of last resort--unable to "create money"
p.171 Some ambiguity as to who the lender of last resort is and their role may be good for avoiding moral hazard, and help make the market more self reliant
p.173 "A certain amount of uncertainty, but not too much, is useful in building self-reliance in the market."
p.174 Bagehot's rule of lending to all comers on the basis of sound collateral
p.180 Timing actual action requires a balance waiting for insolvent firms to fail, but not waiting so long that solvent firms need liquidity
Major problems facing lender of last resort are
1) timing (when to provide stimulus)
2) amount (how much stimulus)