Learning from the **history of financial crises**

The last hundred years have been marked by a number of financial crises, from the Great Depression of the 1930s to the global financial crisis of 2008. Researchers in the Mercator project are looking at the way these events are remembered and how memories of them influence the bankers of today, as Professor Youssef Cassis explains.

The 2008 financial crisis had a dramatic impact, leading to a sustained recession across many of the world's most developed economies. The roots of the crisis lay, among other things, in excessive lending and reckless behaviour by some bankers at major financial institutions, a topic that Professor Youssef Cassis and his team are investigating in the ERC-backed Mercator project. "We are interested in what led up to the 2008 crisis," he outlines. The project's research centres around probing commercial and investment bankers' memories and knowledge of previous financial crises, to assess whether - and how - those recollections have influenced their approach to their work. "The project is about memory. We are interviewing people who were in senior executive positions at top American and European banks during the 2008 crisis (chairs, CEOs, CFOs, CROs), who had a global vision of what happened and made strategic decisions. What experience, memory, knowledge of financial crises did they have when the sub-prime crisis started? Had they themselves gone through previous crises?" explains Professor Cassis.

This research has uncovered an extremely diverse range of experiences. These include

Crowd gathering at the intersection of Wall Street and Broad Street after the 1929 crash.

the junk bond crisis of 1990, when the New York-based bank Drexel Burnham collapsed, and the European real estate crisis of the early '90s, while Professor Cassis says the events of 9/11 also influenced many bankers. "The 9/11 terrorist attacks led to a geopolitical crisis, with consequences across the Middle East, but they also caused severe financial issues," he says. "What also comes out is a difference between the macro level – relating to the financial system as a whole, or the national economy of a country – and the micro level, which is about what happens at the level of the company," he says. "Not surprisingly, however, bank executives' experiences of financial crises has been at micro-level." Financial crises differ in character, and the criteria by which their severity should be assessed is still the subject of debate; one important issue is the risk of contagion into other parts of the financial system. "The level of systemic risk is important, as the inter-links and relationships between institutions can lead to a domino effect," continues Professor Cassis. "Some banks are characterised as systemic banks, and they are subject to stress tests every so often by the monetary authorities, in order to see what will happen if they fail."

The project is also interested in the memory of the bankers in positions of responsibility at major financial institutions today, more than 15 years after the collapse of Lehmann brothers, which marked a key point in the development of the crisis. For this reason Professor Cassis is also conducting interviews with people from this group, looking at how their experience and recollections of the 2008 crisis affect the way they work. Many of those interviewed have clear memories of what happened in 2008, as they were already in fairly senior positions at the time, but their insights and experience may be lost when they retire. "What will happen in 15 years time, when many of these people will have retired? Will any memories remain?" asks Professor Cassis. "If the memory of the Great Depression is anything to go by, it is doubtful that the memory of the Global Financial Crisis of 2008 will survive until the late 2030s".

The cultural memory of financial crises

The events of 2008 will eventually become part of the cultural memory of financial crises, and will be subject to re-interpretation and analysis by subsequent generations, like the other major events Professor Cassis and his team are considering. Alongside the 2008 crisis, researchers are also looking at three other major financial events; the Great Depression of the '30s, the international debt crises of 1982 and the Asian financial crisis of 1997. "We're analysing the way that these four financial crises are remembered," explains Professor Cassis. While it's of course not possible to interview people directly involved in the Wall Street Crash, there is no shortage of material in films, books, newspapers and other forms of media. Every generation reinterprets the Great Depression in the light of the concerns of the time and wider trends in economic thought. "After the Great Depression we moved towards a more regulated economy, then from the 1970s onwards in a more liberal direction," continues Professor Cassis. "The narrative of events can change over time. We're looking at whether the answers individual bankers provide to our questions are compatible with the narrative of the day."

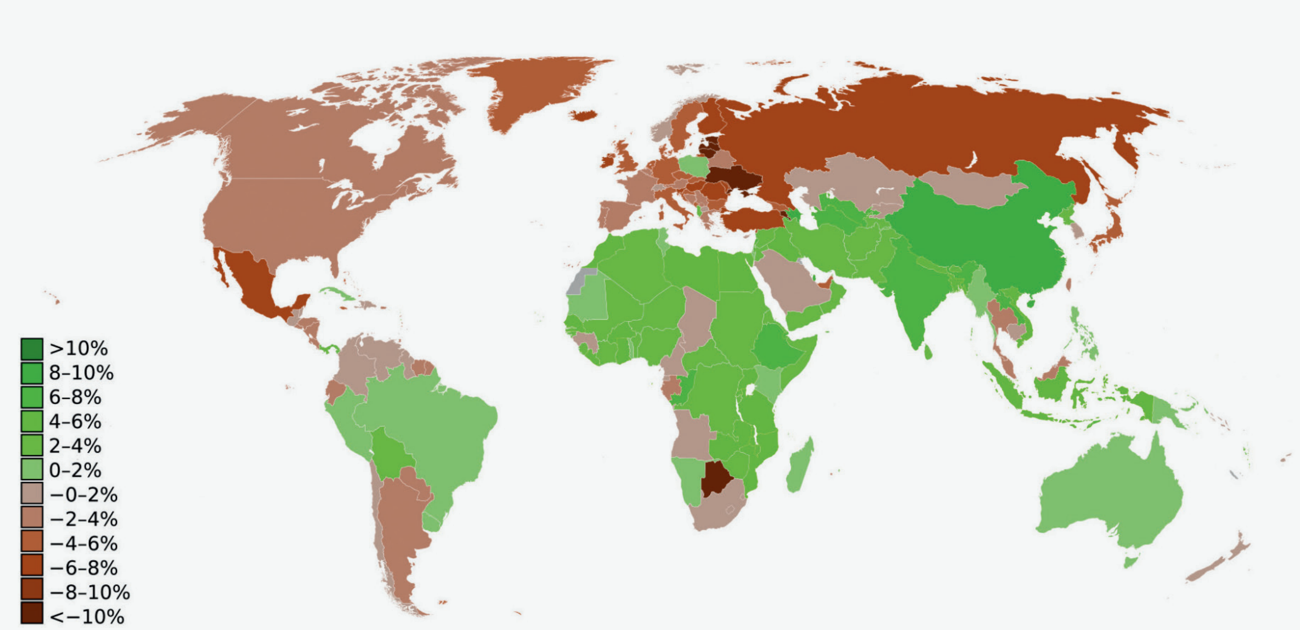
Researchers are also looking at how the changes of memory and narratives have influenced the process of regulation and - especially in the last forty years - deregulation. Two particularly interesting cases stand out here amongst the regulatory decisions that Professor Cassis and his team are examining. "The Glass-Steagall Act of 1933, which separated commercial banking and investment banking in the United States, was abrogated in 1999. This was probably the most potent symbol of the regulation that marked the post Second World War period," outlines Professor Cassis. "We're also looking at the decision not to regulate Over-the-Counter derivatives by the Commodity Futures Modernization Act (CFMA) in the United States in 2000."

An individual's outlook is typically shaped by the economic circumstances in which they grow up and the prevailing narrative of the time, for example the general trend towards deregulation and market freedom in the US and the UK in the '80s under Ronald Reagan and Margaret Thatcher. Many of those in charge of financial institutions in 2008 entered the workforce during this period, often bringing with them a very different outlook from their predecessors, another topic Professor Cassis and his team are addressing. "An important question addressed by the project is whether a new financial elite emerged in the late twentieth and early twenty-first century. A prosopography (collective biography) of more than 500 leading bankers - looking in particular at their studies and careers - reveals some limits to the internationalisation of the financial elite, whether in terms of board composition or education and training," he says. "The growing number of MBAs and science degrees should not obscure the persistence of national traditions in higher education; and national peculiarities continued to permeate career patterns."

"What experience, memory, knowledge of financial crises did senior executives have when the sub-prime crisis started in 2008? Had they themselves gone through previous crises?"

Wider changes also took place in how economics was taught. "There was an increased 'mathematisation' of the discipline

World map showing GDP real growth rates for 2009. CIA world factbook estimates[1] as of April 2010. https://commons.wikimedia.org/w/index. By Gdp_real_growth_rate_2007_CIA_Factbook.PNG: Sbw01f, Kami888, Fleaman5000, Kami888derivative work: Mnmazur (talk) - Gdp_real_growth_rate_2007_CIA_Factbook. PNG, CC BY-SA 3.0, https://commons.wikimedia.org/w/index.php?curid=10058473



from the '70s and '80s onwards. Where previously there was a lot of space for the teaching of history and political economy, with essay-based exams, from the '70s onwards there was a general shift towards an increased emphasis on mathematics and economic modelling," says Professor Cassis. "This reflects the rise of neoclassical economics and the theory of rational expectation. The turning point is around the '70s/'80s – and this has important implications for the way in which we deal with financial crises."

Financial stability

Most of those who cut their professional teeth during this period weren't directly confronted with the instability of the financial system in the early stages of their careers, and began to take up positions of responsibility in the years leading up to 2008. This generation had not really experienced a major financial crisis before 2008, and to some extent had maybe forgotten that they could occur. "There was a belief that risk could be mastered, that technology enables better control of financial markets," outlines Professor Cassis. Some degree of instability is however inherent to the financial system, believes Professor Cassis. "Banks take short-term deposits and loans from the money market, and transform them into long-term loans or investments, and there is an inherent instability there," he continues. "It may not be possible to prevent all financial crises, but what should be avoided are the very serious financial events, like that of 2008, or the Great Depression. There may be more minor crises, which are localised or limited to a single institution."

The nature of a future financial crisis is very difficult to predict and prepare for, but there are some measures which banks can take, such as maintaining an adequate level of capital and liquidity. More broadly, remembering previous financial crises will remind bankers themselves that these types of events can happen, which may then influence their approach to their work. "Even when everything seems rosy, the market is booming and the economy is doing well, things can still go wrong," says Professor Cassis. The team is planning to publish a book bringing together the project's results, which Professor Cassis says will present a very detailed, nuanced picture of events. "The book will show the complexity of events. It will try to show that memory is important, but also quite an elusive concept," he outlines. "We hope to attract the attention not only of regulators, but also of commercial and investment bankers. We know very little about their views, unlike those of regulators, central bankers and policymakers, who have attracted far greater attention, as their role involves thinking about the economy as a whole, not only their own institution."

A financial crisis typically has many causes, but the behaviour of bankers can be a contributory factor. Some level of risk is inherent in the financial system, yet an awareness of history can also benefit bankers and help limit the possibility of a new financial crisis developing. "Memory is important, because it gives you landmarks, and it reminds you that there is an inherent instability in the system," says Professor Cassis. "Bankers who keep that in mind will tend to be more cautious."

MERCATOR

The Memory of Financial Crises: Financial Actors and Global Risk

Project Objectives

The MERCATOR project explores the extent to which the memory, or absence of memory, of previous financial crises can explain certain practices within the financial system. The project stems from two simple questions: do financial actors have any knowledge, memory and understanding of previous financial crises? And, more generally, how far are they aware of the inherent instability of the financial system?

Project Funding

The project leading to this application has received funding from the European Research Council (ERC) under the European Union's Horizon 2020 research and innovation programme (grant agreement No 884910).

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