THE EMERGENCE OF FIRST FINANCIAL CRISES IN EUROPE - A BRIEF HISTORICAL RETROSPECTIVE

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Abstract

Financial crises have become a frequent occurrence in recent decades, which makes us consider them as something new and modern. In fact, financial crises have a long history. In this article, we will look at some of the key crises for the American economy, which managed to cross its boundaries and have a negative impact on European economies as well.

Keywords: finance, banks, crises, USA

Unlike Europe, in the territories of the North American colonies, and subsequently the United States of America, the development of the financial sector followed the principle of "Laissez-faire" for minimal state regulation and intervention in business, and the lack of a central bank led to the emergence of the so-called "era of free banking", allowing each bank to issue its own banknotes, which freely compete with each other. It is these key prerequisites that lead to a number of financial crises in the newly created state, before the creation of the Federal Reserve. Among the more famous of them are the crises of 1819, 1832, 1857, 1893, and the Great Depression of 1929.

According to a number of researchers, the basis of the crisis of 1819 was the strong economic ties of the United States to Europe as a market for products and raw materials. The Napoleonic Wars raging on the old continent (1804-1815) contributed to the growth of the American economy and exports, especially in the field of agriculture (mainly wheat and cotton). This, in turn, caused a demand for land, the majority of which was purchased on credit by the federal authorities. (Megelsh, 2024).

The end of the wars in Europe led to the stabilization of local economies, which, with imports from new markets (e.g. cotton from India), led to a collapse in commodity prices of more than 70%. Against the background of this worsening economic situation, in 1818 the Second Bank of the United States had to make a payment in gold to foreign investors credited with the Louisiana Purchase from France in 1803, which forced the bank to demand its loans from the state banks it financed, which in turn demanded the loans from farmers and entrepreneurs. (Lumen Learning, n.a., Rothbard, 2007).

These factors, combined with the overproduction of agricultural products in the United States, led many farmers to be unable to service their loans, which in turn led to the confiscation of mortgaged property by banks. Mass bankruptcies, in turn, led to a collapse in property prices and the inability of banks to sell the collateral for loans. Reduced consumption of industrial goods also affected manufacturers, leading to mass layoffs and mass factory closures in Philadelphia, Pennsylvania, Ohio, and Kentucky.

The first serious financial crisis caused by this free monetary competition between banks, which subsequently led to a recession of the entire economy, was the Panic of 1837 (Gibson, n.a.). After the failure of attempts to restructure the Bank of the United States as a result of President Jackson's veto in 1832, each of the 850 national banks freely printed its own money, which in the overwhelming majority was partially covered with gold and silver. (Harvard Business School, n.a.) The increased money supply resulting from the lack of centralized banking regulation initially proved to be stimulating for the economy.

In 1836, a trend began to be observed towards a reduction in the external financing of American banks and the withdrawal of English capital, which led to the decapitalization of some banks, respectively to the devaluation of the money issued by them. The real start of the Panic of 1837 was marked by the Specie Circular issued by President Jackson – an executive order requiring federal land to be purchased with precious metal coins, rather than paper currency. This act put pressure on the banks, as a significant part of their depositors tried to convert their paper money into gold or silver coins. In the following months, 343 out of 850 banks went bankrupt, 62 experienced liquidity problems, and the American economy fell into a 6-year depression. (Gibson, n.a.)

And if the crises of 1819 and 1836 were entirely national crises, although significantly influenced by international factors, the crisis of 1857 is considered the first international financial crisis to leave the confines of the American economy and affect the financial markets in Europe. What is unique about it is the speed of its spread compared to the previous ones, mainly due to the mass penetration of the telegraph as a means of communication.

In the years before the crisis, there was a serious boom in the American economy, both as a result of the new territories acquired after the Mexican War (1846-1848) and the associated increased development of railway transport and the purchase of agricultural land by new settlers, respectively, and to the strengthening of industry. The discovery of gold deposits in California awakened dreams of quick wealth and directed new flows of people to western America. The increased demand for American grain crops from European countries during the Crimean War (1854-1856) further strengthened the desire for the expansion of the American economy, which was mainly financed through bank lending, including from European (mainly English and French) banks. (Grant, n.a., Kennedy, n.a.).

Although the Panic of 1857 is generally considered to have begun with the unexpected collapse of Ohio's largest bank, the Ohio Life Insurance and Trust Company (Rockoff 2000, 667), on August 24, 1857, when it unexpectedly stopped converting its notes into gold and silver, some authors attribute the bank's failure to both the excessive risk-taking by the bank's New York branch and the alleged abuses and embezzlement by its manager (Rapp, 2023).

The closure of Ohio Life caused a crash in the New York stock market, where the bank's shares, from $101 on August 27, 1857, lost 95 percent of their value, falling to $5 on September 2. The resulting banking panic caused New York banks to temporarily stop converting their notes into gold until October 13. The panic reached its peak in October 1857, when 1,415 banks failed and interest rates reached 60–100 percent per annum. (Kindleberger 1996, 128–129). Although the London-based Reynolds' Newspaper reported on November 15, 1857, that the panic had "spread to France," the main victim of the American crisis was the English economy, which financed numerous banking and railroad projects in the United States. (Rapp, 2023)

One of the most significant financial crises in human history was the Great Depression of 1929 in the United States, which lasted almost a decade, with industrial production falling by 47 percent in the first 4 years alone, gross domestic product by 30 percent, and unemployment exceeding 20 percent (for comparison, the Great Recession of 2007 led to a decline in GDP by 4.3 percent and an increase in unemployment to 10 percent). (History.com, 2023, Duignan, n.a.).

In the 1920s, the United States experienced impressive economic growth (known as the "Roaring '20s"), combined with the massive introduction of innovations into everyday life - cars, telephones, cinema, radio, electrical appliances, which in turn increased consumer demand, respectively. production of these goods. This development did not pass by the financial sector, with the strongest growth being recorded in the investment sector. The tangible increase in household welfare generated security and optimism in society, combined with the policy pursued by brokerage houses and investment trusts for investing with borrowed funds through margin accounts (payment of 10% of the price of shares against collateral of the remaining amount with the share itself), generated broad investment interest among the population. (Richardson, Komai, Gou, Park, 2013).

Although the American stock market lost nearly 50% in the early 1920s during the so-called “Forgotten Depression,” the subsequent economic growth and high returns on stock market investments led to a kind of mania, in which people went to extremes in mortgaging homes to invest in corporate stocks. On the eve of the Great Depression, stock prices reached their highest values ever (over 19 times corporate after-tax profits), and the Dow Jones Industrial Index (DJIA) increased by 500% in just five years. (Segal, 2024, Duignan, n.a.)

The key event that triggered the Great Depression was the stock market crash on October 24, 1929 (Black Thursday), which saw the Dow Jones Industrial Index (DJIA) fall by over 20% in less than a week (Segal, 2024). Over the next three weeks, it lost almost half of its value, and the decline continued until the summer of 1932, when the DJIA closed at 41.22, its lowest level in the twentieth century (89% of its 1929 value). (Richardson, Komai, Gou, Park, 2013)

The stock market crash also had a negative impact on the banking sector through loans granted for the acquisition of shares and non-performing loans as a result of bankruptcies. In the period 1930-1932, four large-scale banking panics were registered in the United States, and by 1933, one fifth of the existing banks failed, and the government was forced to introduce the so-called "bank holiday" as a tool to control the panic. (Segal, 2024).

As part of its efforts to contain the economic crisis, the US government intensified its protectionist policies by imposing high tariffs on a wide range of agricultural and industrial products (the Smoot-Hawley Tariff Act of 1930). In turn, the US's leading trading partners took reciprocal measures, leading to a sharp decline in US exports, a decrease in industrial production, and a 66% decline in international trade. The resulting trade imbalances and the attempts of central banks to maintain a stable national exchange rate proved to be the main transmission channel through which the economic crisis spread throughout the world. (Segal, 2024).

With the end of World War II, the world economy began its recovery, and the new financial and economic agreements from Bretton Woods (1944) played a significant role in this, which laid the foundations of the new financial architecture (Marichal, 2009). Within the framework of the agreements established, the abandonment of the gold standard and the binding of exchange rates to the US dollar were adopted, although the latter retained its fixed price of $ 35 per troy ounce of gold (Ghizoni, 2013a, World Bank Group, n.a.). The conference laid the foundations of new international financial organizations: the International Monetary Fund and the International Bank for Reconstruction and Development (later transformed into the World Bank). The new international financial rules, including attempts to regulate national and international financial markets, significantly reduced the frequency and severity of financial crises in the economy. During this period, strong cooperation and coordination began between national central banks, as well as between creditor countries and banks such as the Bank for International Settlements (founded in 1930), the Paris Club (established in 1956), and the G-7 (1970) (Marichal, 2009).

Unfortunately, the stability achieved was relatively short-lived. The decision of US President Nixon in 1971 to end the dollar’s peg to gold due to financial deficits related to the Vietnam War put an end to the so-called Bretton Woods system (Ghizoni, 2013b). This in turn triggered new waves of financial instability around the world, and in particular the debt crisis in Latin

America in the 1980s, which led to the most serious decline in the world economy since the Great Depression of 1929 (Marichal, 2009). The measures adopted to contain the crisis included debt renegotiation and restructuring, combined with radical economic restructuring of the affected economies, including the privatization of many state-owned enterprises, trade liberalization and other neoliberal reforms, and became known as the Washington Consensus. (Hurt, n.a., Irwin, Ward, 2021).)

According to some authors, it is these measures that underlie modern financial globalization, associated with the rapid expansion of international capital flows and the emergence of new financial instruments. It is precisely the rapid movement of international capital flows to and from emerging markets that subsequently turned out to be the basis of a number of financial crises: Mexico (1995), East Asia (1997), Brazil (1998), Russia (1998) and Argentina (2001) (Marichal, 2009). The high degree of integration of global financial markets, the introduction of new and increasingly risky financial instruments, combined with the trend towards deregulation of the sector, also led to the Global Financial Crisis of 2007.

Summarizing the above, we can conclude that financial crises are an integral part of human history. Depending on the development of financial markets and instruments, crises have different origins, genesis and transmission in different historical periods, but they always cause problems in the real economy and a collapse in people's living standards. The high degree of integration of international financial markets, financial innovations and deregulation are prerequisites for the rapid transmission of problems arising in one economy to the world economy as a whole.

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