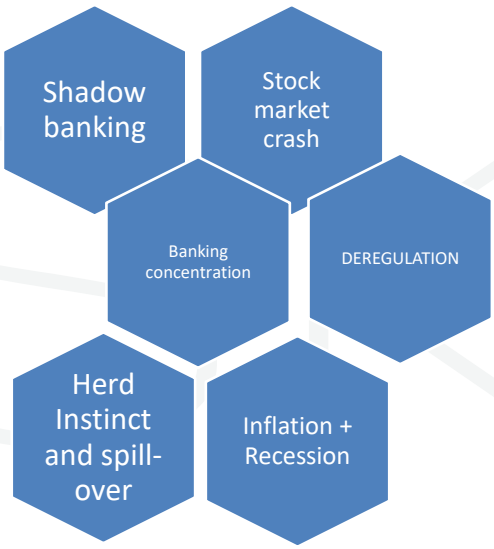


FINANCIAL CRISES:
WHAT, WHEN, HOW, AND WHY

DEFI-SKEMA-CIFE 2026-27
MICHEL-HENRY BOUCHET

1

FINANCIAL CRISES: THE ORIGINS



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Origins of Financial Crises (1)

FINANCIAL CRISES TYPICALLY RESULT FROM DOMESTIC VULNERABILITIES AMPLIFIED BY EXTERNAL SHOCKS, LEADING TO SEVERE AND LONG-LASTING ECONOMIC AND SOCIAL COSTS.

INTERNAL (DOMESTIC/ENDOGENOUS) CAUSES

1. EXCESSIVE CREDIT GROWTH AND HIGH LEVERAGE
2. WEAK FINANCIAL REGULATION AND SUPERVISION
3. ASSET PRICE BUBBLES (HOUSING, EQUITIES)
4. FISCAL IMBALANCES AND RISING PUBLIC DEBT
5. FRAGILE BANKING SYSTEMS (LIQUIDITY AND MATURITY MISMATCHES)
6. BAD GOVERNANCE (ASIA 1998)

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3

Origins of Financial Crises (2)

EXTERNAL (GLOBAL) CAUSES

1. GLOBAL FINANCIAL SHOCKS (INTEREST RATES, RISK APPETITE)
2. VOLATILE CAPITAL FLOWS AND SUDDEN STOPS
3. EXCHANGE RATE PRESSURES
4. CURRENCY MISMATCHES
5. INTERNATIONAL CONTAGION THROUGH TRADE AND FINANCE (SPILL-OVER EFFECT)
6. COMMODITY PRICE SHOCKS
7. EXCESSIVE LEVERAGE AND UNDER-CAPITALIZATION (EMCS CRISIS 1985)
8. SHARP RATING DOWNGRADING

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HISTORY OF FINANCIAL CRISES

- Overview of major financial crises, causes, patterns, and lessons

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5 MAIN TAKEAWAYS (1) :

1 **Financial crises are recurrent and systemic**: Crises are not rare accidents — they are recurring features of financial systems. From Tulip Mania (1637) to the 2008 Global Financial Crisis and COVID-19, history shows repeated cycles of boom, excess, panic, and collapse. Each time, actors believe "this time is different" — and each time, it isn't.

2 **Excessive leverage and asset bubbles are core triggers**: Most crises are fueled by: Rapid credit expansion + High leverage. Asset price bubbles (housing, equities, commodities)Overconfidence and herd behavior. When confidence breaks, highly leveraged systems unravel quickly.

3 **Domestic vulnerabilities + external shocks = crisis**: Crises typically emerge when internal weaknesses (weak regulation, fragile banks, fiscal imbalances, currency mismatches) are amplified by external shocks (interest rate hikes, capital flow reversals, commodity shocks, contagion).The interaction between domestic fragility and global spillovers is key.

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5 MAIN TAKEAWAYS (2):

4 **Crises have severe and long-lasting economic & social costs**: Consequences include: Deep recessions and prolonged slow growth + Banking failures and credit crunches. Capital flight + Rising unemployment and inequality. Increased public debt due to bailouts and stimulus. Example: Latin America's "Lost Decade" in the 1980s.

5 **Regulation and crisis management matter more than prevention**: Crises cannot be fully prevented, but they can be mitigated.

Key lessons: Strong financial regulation and supervision are crucial: Central banks must act as lenders of last resort (Bagehot)Governance and risk assessment are central. Debt restructuring mechanisms (e.g., Brady Plan) can restore market access.

In short: prevention is limited — mitigation and institutional design are essential. Good governance, prudent risk management, and centralized regulation are crucial to anticipate and mitigate financial crises

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WHAT IS A FINANCIAL CRISIS?

- Private or public debt default
- Severe disruption in financial markets
- Bank failures
- Sharp asset price declines

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EARLY FINANCIAL CRISES: SPECULATION AND WEAK REGULATION

- Tulip Mania (1637)
- South Sea Bubble (1720)

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1. EARLY FINANCIAL CRISES (17TH–18TH CENTURIES)



Tulip Mania (1637, Netherlands): Often cited as the "first recorded asset bubble"

What happened: Contract prices for some bulbs of recently introduced and fashionable tulips reached extraordinarily high levels. The major acceleration started in 1634 and then dramatically collapsed in February 1637. Prices of tulip bulbs soared and then collapsed.

Key cause: Speculative bubble driven by herd behavior.

Impact: No critical influence on the prosperity of the Dutch Republic, which was one of the world's leading economic and financial powers in the 17th century, with the highest per capita income in the world from about 1600 to about 1720.

South Sea Bubble (1720, Britain) & Mississippi Bubble (France)

What happened: Shares of monopoly trading companies collapsed.

Key causes: Excessive speculation, weak regulation, misleading information.

Lesson: Financial innovation without oversight can destabilize economies.

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2. EARLY FINANCIAL CRISES (18TH CENTURY)

Main Features of the Law Financial System (1716–1720)

1. Massive public debt problem in FranceAfter Louis XIV's wars, France was basically drowning in debt.The monarchy needed a radical solution.Enter John Law, a Scottish financier with big ideas about money and credit.2. Creation of a private bank issuing paper money
2. In 1716, Law created the Banque Générale, which issued paper money backed partly by government debt. Key innovation: Expansion of money supply through banknotes Move away from metallic currency (gold/silver)This was revolutionary for the time.
3. The Mississippi Company scheme: Law merged trading companies into the Compagnie des Indes (Mississippi Company), which: Controlled French trade and colonial ventures; Took over large portions of French public debt; Debt holders could swap government bonds for company shares. So public debt was converted into equity speculation.
4. Massive speculative bubble Shares of the Mississippi Company soared: Easy credit; Expanding money supply; Government backing; Wild expectations about colonial wealth; Paris went full speculative mania. Fortunes were made overnight.
5. Monetary expansion without sufficient backing. The system relied heavily on: Continuous issuance of paper money ;Confidence in future profits; But the real economy couldn't support the scale of financial expansion.
6. When confidence cracked, everything unraveled.

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3. EARLY FINANCIAL CRISES (18TH CENTURY)

Consequences of the 1720 Collapse

1. Stock market crash :The Mississippi bubble burst: Share prices collapsed dramatically.
2. Banking crisis: People rushed to convert paper money into gold/silver. The bank couldn't meet demand. Confidence evaporated.
3. Inflation and currency collapse: Over-issuance of paper money led to:

- Severe inflation
- Devaluation of currency
- France experienced one of the first large-scale monetary collapses.

4. Loss of trust in paper money: The crisis deeply traumatized French financial culture.

For decades: Strong distrust of banks + Suspicion toward paper currency + Slower financial development compared to Britain. This arguably affected France's long-term economic trajectory.

5. Political and institutional fallout: John Law fled France. The monarchy's credibility suffered. Public debt problems persisted. The crisis showed the danger ofb lurring state finance and speculation + Monetizing public debt too aggressively + Financial innovation without regulation
6. In short: The Law crisis combined monetary expansion, debt restructuring, and speculative mania into one grand experiment. It temporarily solved France's debt problem — but at the cost of a massive bubble, financial collapse, inflation, and long-term distrust in banking.

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19TH CENTURY CRISES

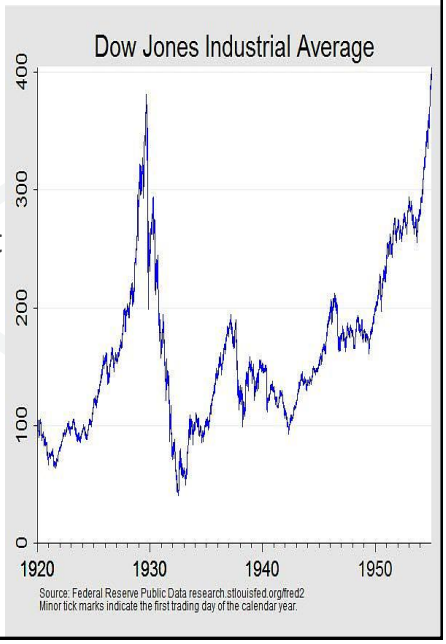
- Panic of 1873
- Railroad speculation
- Long Depression 1929-1934

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THE "GREAT DEPRESSION" (1929): THE *MOTHER OF ALL FINANCIAL CRISES*?

- Stock market crash: in 1928-29, prices doubled in the US stock market: Fed intervened with tighter monetary policy to raise interest rates
- October 24-28, 1929: 40% market value drop
- Severe droughts in the Midwest led to farmers' debt crises: waves of defaults on farm mortgages
- Bank panics and failures: march 1933, temporary closing of all US banks. Bank panic spread to the rest of the world
- Global economic collapse: continuing declines in stock prices until mid-1932



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POST-WAR CRISES

- Bretton Woods collapse (1971)
- Oil shocks (1973, 1979)
- Global Financial Crisis 2008

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LATE 20TH CENTURY CRISES

- Latin American Debt Crisis (1985-1990)
- Asian Financial Crisis (1997-98)
- Global capital flow volatility

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MAIN CAUSES OF THE MID-1980'S EMERGING COUNTRY DEBT CRISIS 1

1. **Excessive borrowing in the 1970s**

After the oil shocks (1973, 1979), oil-exporting countries deposited huge surpluses in Western banks. Those banks recycled the money as loans to developing countries.

Result: Cheap credit: Massive external borrowing. Mostly in US dollars. Often short-term and variable interest rates. Countries assumed growth would continue forever. It didn't.

2. **US interest rate shock** (Volcker shock, 1979–1981) The US sharply raised interest rates to fight inflation. That caused: Global interest rates to skyrocket. Debt servicing costs to explode. Dollar appreciation (which made dollar-denominated debt more expensive). Suddenly, countries couldn't pay.

3. **Collapse of commodity prices**. Many emerging countries depended on commodity exports. In the early 1980s:Commodity prices fell. Export revenues declined. Foreign exchange earnings dried up.

No dollars → no debt repayment.

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MAIN CAUSES OF THE MID-1980'S EMERGING COUNTRY DEBT CRISIS 2

4. **Weak domestic policies**. In many countries: Poor fiscal discipline. Overvalued exchange rates. Inefficient state-led development models. Corruption and political instability. Debt was often used for consumption or unproductive projects rather than export-generating investment.

5. **Banking system overexposure**. Western commercial banks: Lent aggressively. Underestimated sovereign risk. Concentrated exposure in Latin America. When Mexico declared in 1982 that it couldn't service its debt, panic spread.

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MENU-BASED DEBT RESTRUCTURING: THE BRADY PLAN AND BEYOND





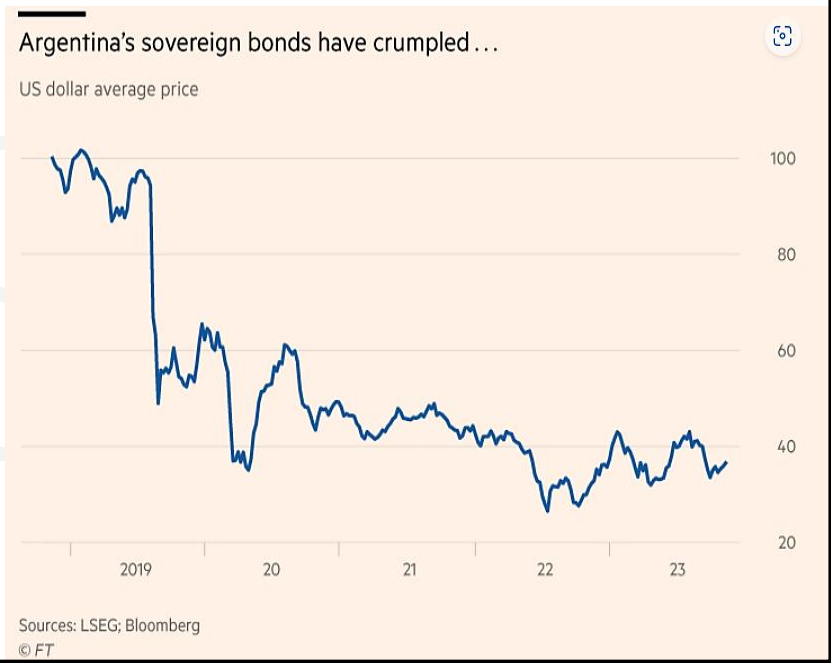
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THE SECONDARY MARKET OF LOANS AND BONDS PRICES

In the mid-1980s, when BOP tensions rise, with falling reserves, looming debt crisis and default, bondholders and creditor banks prefer selling their claims at a discount in the secondary market while buyers anticipate better future.

The market discount translates into accounting losses in balance sheets, though tax-incentives driven bank reserves offset the loss.

The price of the claim is the inverse of the discount and closley reflects « country risk »



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THE 1989-2026 PROCESS OF LONDON CLUB DEBT RESTRUCTURING

- **London Club banks** grant debt relief to debtor nations, in some proportion of secondary market discount through interest or debt stock reduction
- Accounting and regulatory incentives (loan-loss provisioning)
- Shift to specific purpose financing and voluntary lending

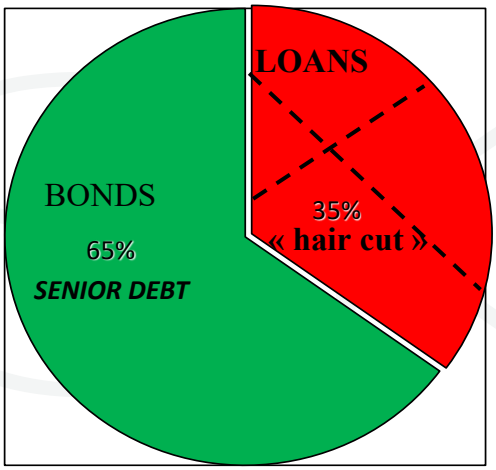
- **Debtor countries** adopt tough macroeconomic adjustment programs under the monitoring of the IMF/WB (SALs)
- Current account financing + Reserve build-up
- Objective: back to market-access for EMCs or to grants for low-income countries

Means and Tools

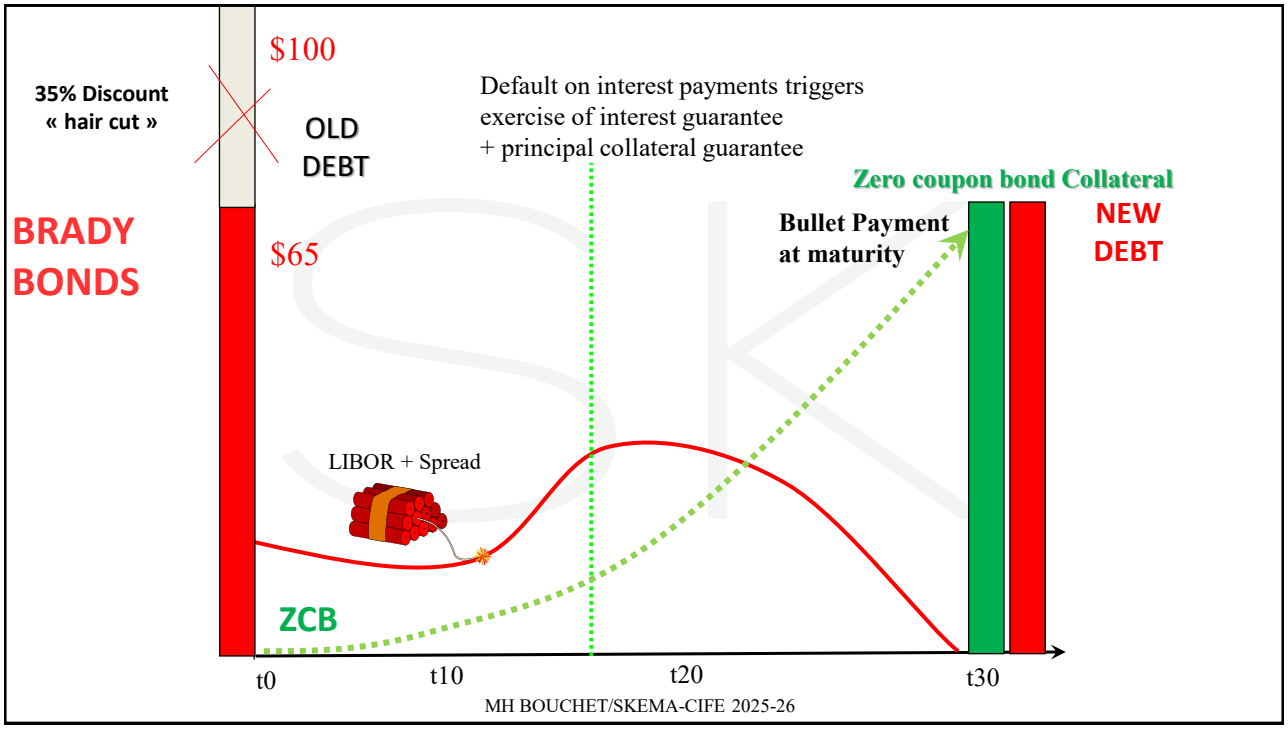
- Defaulted sovereign London Club debt to be exchanged for easily tradeable **Brady bonds** guaranteed by 30-year zero-coupon US Treasury bonds which the defaulting nation purchases with its reserves and official financing support (IFIs + Paris Club)
- Principal guarantee + x semi-annual interest payments, whose guarantee is rolled over
- **Bullet repayment** (e.g., 30 years)
- **Cross-default clause**
- **Debt conversion clauses**

THE BRADY PLAN IN ACTION: HAIR CUT!

New senior debt with long-term maturity, principal collateralization, rolling interest
Guarantee + cross-default clause



Debt cancellation backed up by commercial banks' reserves for loan-losses with regulatory incentives



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Brady bond deals of the 1980s & 1990s
(at the very least Brady-style with a menu of options)

- Baker plan launch 1985
- Brady Plan launch 1989

- Mexico: defaulted 1982, Brady deal 1989
- Costa Rica: defaulted 1981, Brady deal 1990
- Morocco: defaulted 1982, Brady deal 1990
- Venezuela: defaulted 1982, Brady deal 1990
- Philippines: defaulted 1983, Brady deal 1990
- Poland: defaulted 1981, Brady deal 1993
- Uruguay: defaulted 1983 (again in 2003), Brady deal 1991
- Nigeria: defaulted 1982, Brady deal 1992
- Jordan: defaulted 1988, Brady deal 1993
- Argentina: defaulted 1982 (again in 2001), Brady deal 1993

- Brazil: defaulted 1983, Brady deal 1994
- Bulgaria: defaulted 1990, Brady deal 1994
- Dominican Republic: defaulted 1982, Brady deal 1994
- Albania: defaulted 1990, Brady deal 1995
- Ecuador: defaulted 1982 (again in 1999), Brady deal 1995
- Panama: defaulted 1982, Brady deal 1996
- Peru: defaulted 1984, Brady deal 1997
- Ivory Coast: defaulted 1984 (again in 2001), Brady deal 1998
- Vietnam: defaulted 1982, Brady deal 1998
- Russia: defaulted 1998, Brady-like operation 1998

bondvigilantes.com

Bond Vigilantes

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MAIN CONSEQUENCES OF THE DEBT CRISIS (1)

1. "Lost Decade" in Latin Americo: a Growth collapsed in the 1980s.
2. GDP stagnated or declined : Real incomes fell: Poverty increased
3. IMF structural adjustment programs : Countries had to accept: Austerity measures Fiscal cuts Privatization Trade liberalization Currency devaluation These reforms reshaped many economies — often painfully (Mexico, Chine, Brazil, Argentina)
4. Banking crisis in the West: Major US and European banks were heavily exposed (Citibank, BNP) . There were real fears of systemic collapse. This led to: Coordinated debt restructuring :The "Brady Plan" (1989) converted loans into tradable bonds
5. Political and social instability The crisis triggered: Social unrest Rising inequality Democratic transitions in some countries Loss of legitimacy of state-led development models Neoliberal reforms gained ground partly because of this crisis.

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MAIN CONSEQUENCES OF THE EMCS DEBT CRISIS (2)

5. Long-term shift in global finance:

After the crisis: Sovereign risk assessment became more sophisticated Rating agencies gained importance. Capital markets replaced syndicated bank lending Emerging markets moved toward bond financing It permanently changed how emerging countries access international finance.

5. <u>In short</u>:

Cause: Too much dollar debt + rising US interest rates + falling export revenues + weak domestic policies.

Consequences: A decade of stagnation, painful reforms, financial restructuring, and a transformation of the global financial architecture: banks cut their exposure, swallow the "hair cuts", and countries shift to the global bond markets with crucial role of rating agencies

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GLOBAL FINANCIAL CRISIS (2007–09)

- Housing bubble
- Subprime lending
- Systemic banking collapse

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COVID-19 FINANCIAL SHOCK

- Pandemic-induced crash
- Unprecedented stimulus

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COMMON PATTERNS

- Excessive leverage
- Asset bubbles
- Loss of confidence

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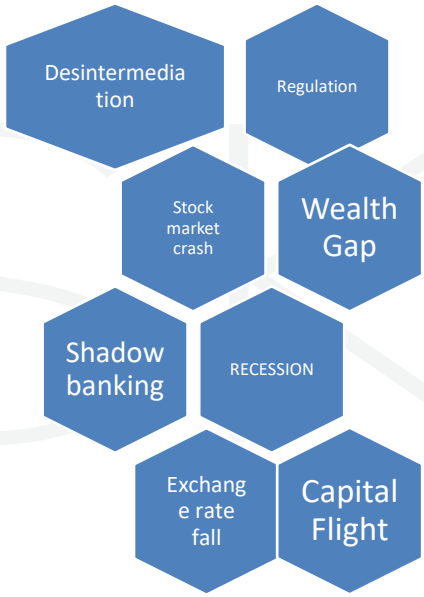
WHY DO FINANCIAL CRISES OCCUR AND POLICY LESSONS

- Regulation matters
- Central banks as lenders of last resort
- Crises recur

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SHORT-TERM IMPACT AND LONG-TERM CONSEQUENCES



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CONSEQUENCES OF FINANCIAL CRISES

Economic Effects

Recessions and prolonged slow growth

Sharp declines in investment and consumption

Financial Sector Effects

Bank failures and credit crunches

Loss of confidence in financial institutions

Capital flight (and brain drain)

Social and Fiscal Effects

Rising unemployment and inequality

Increased public debt due to bailouts and stimulus

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ACADEMIC APPROACHES AND KEY THEORIES

- Keynes
- Minsky: Financial Instability
- Fisher: Debt-Deflation
- Kindleberger cycle
- Rogoff and Reinhart
- Eichengreen

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A SUCCINCT ACADEMIC LITERATURE REVIEW ON FINANCIAL CRISES (1)

Classical & Early Views

- Walter Bagehot (1873) – Lombard Street
  - o Central banks should act as lenders of last resort during panics.
- Irving Fisher (1933) – Debt-Deflation Theory: Over-indebtedness → deflation → real debt burden rises → crisis deepens.

Keynesian Perspective

- John Maynard Keynes (1936) Financial crises driven by animal spirits, uncertainty, and investment collapse. He justifies countercyclical fiscal policy.

Financial Instability Hypothesis

- **Hyman Minsky** (1977, 1986) « Financial Markets and Institutions » (Pearson)

Stability breeds instability (widely applied to the 2008 GFC)

Three financing stages:

1. Hedge finance
2. Speculative finance
3. Ponzi finance

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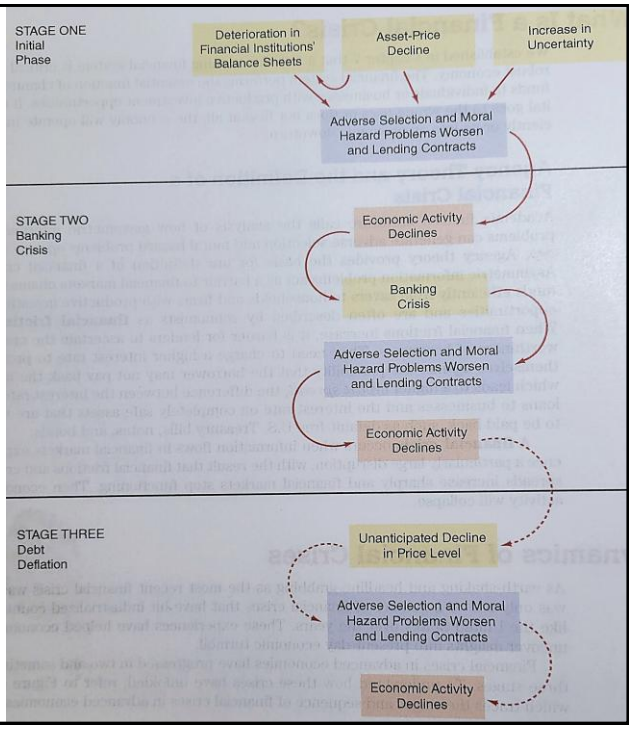
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HYMAN MINSKY

« FINANCIAL MARKETS AND INSTITUTIONS »

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1. Role of financial innovation and financial liberalization
2. Stability breeds instability
3. The role of herd instinct
4. Euphoria and panics: asset-piece boom and bust
5. bank panic and debt deflation
6. Behavioral finance matters!
7. When the bubble bursts, asset prices realign with fundamental economic values



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A SUCCINCT ACADEMIC LITERATURE REVIEW ON FINANCIAL CRISES (2)

Information & Banking Models

- **Diamond & Dybvig** (1983) Bank runs arise from self-fulfilling expectations. Justifies deposit insurance.

Modern & Global Perspectives

- **Kindleberger & Aliber** (2011) – Manias, Panics, and Crashes: Crisis cycle: displacement → boom → euphoria → panic → crash. Spill-over effect and herd instinct as driving forces!
- **Reinhart & Rogoff** (2009) – This Time Is Different: Financial crises are recurrent; debt thresholds are central (90% D/GDP ratios)
- **Eichengreen, Barry**

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CONCLUSION

- Crises are systemic (capitalist market economy)
- Spill-over effect is key driving force
- Regulation is crucial
- Prevention is limited, mitigation is key
- Key role of governance and prudent risk management
- Globalization as « echo chamber » since 1980s

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