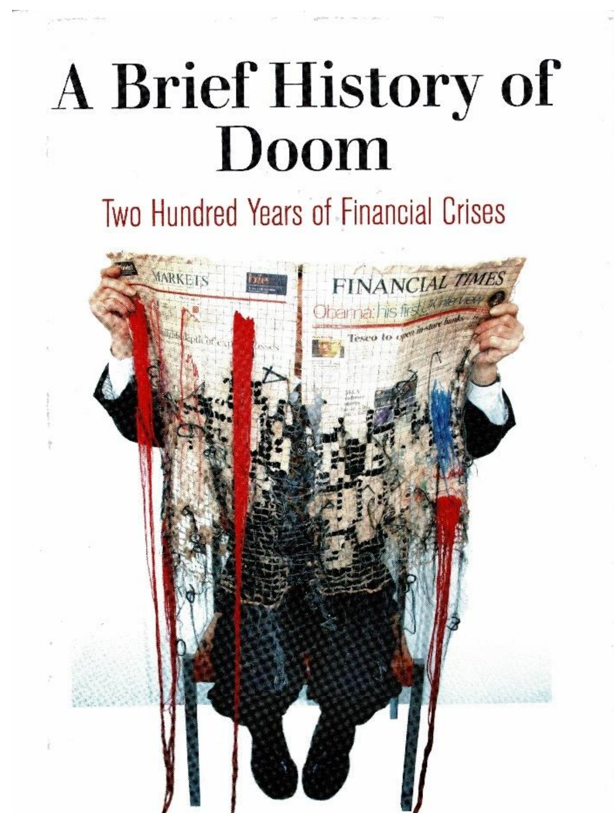
A Brief History of Doom: The New Kindleberger and Mackay

> "If readers take one lesson from this book, I hope it is this: when it comes to financial crises, we're not in the grip of unseen and hopelessly complex forces. Such crises are neither inevitable nor unpredictable. Runaway private debt and the resulting overcapacity does a better job than any other variable in explaining and predicting financial crises. It is our job to heed those danger signs." (Vague 2019, p. ix)



This brief book (196 pages, excluding endnotes) on the history and causes of financial crises usurps Kindleberger's *Manias, Panics, and Crashes* (Kindleberger 1978) and Mackay's *Memoirs of Extraordinary Popular Delusions and the Madness of Crowds* (Mackay 1852) as the definitive work on this vital topic. It surpasses both these works for several reasons, not the least of which is the career and experience of the author.

Mackay was a journalist and gifted writer; Kindleberger, an economist with an impressive record in both public service and academia. Both of them observed financial manias and crashes from their respective professional perches, outside the financial system itself.

Vague is an ex-banker, whose fortune was carved in the financial crisis emanating from the bursting of the 1979 oil shock bubble, whose hands-on management established two of America's biggest consumer credit card companies (First USA, which he sold Bank One in 1997, and Juniper Financial, which he sold to Barclays PLC in 2004), and whose professional access to the voluminous data he saw on the explosion in mortgage debt—from $6 trillion in 2002 to $9 trillion in 2005—led him to

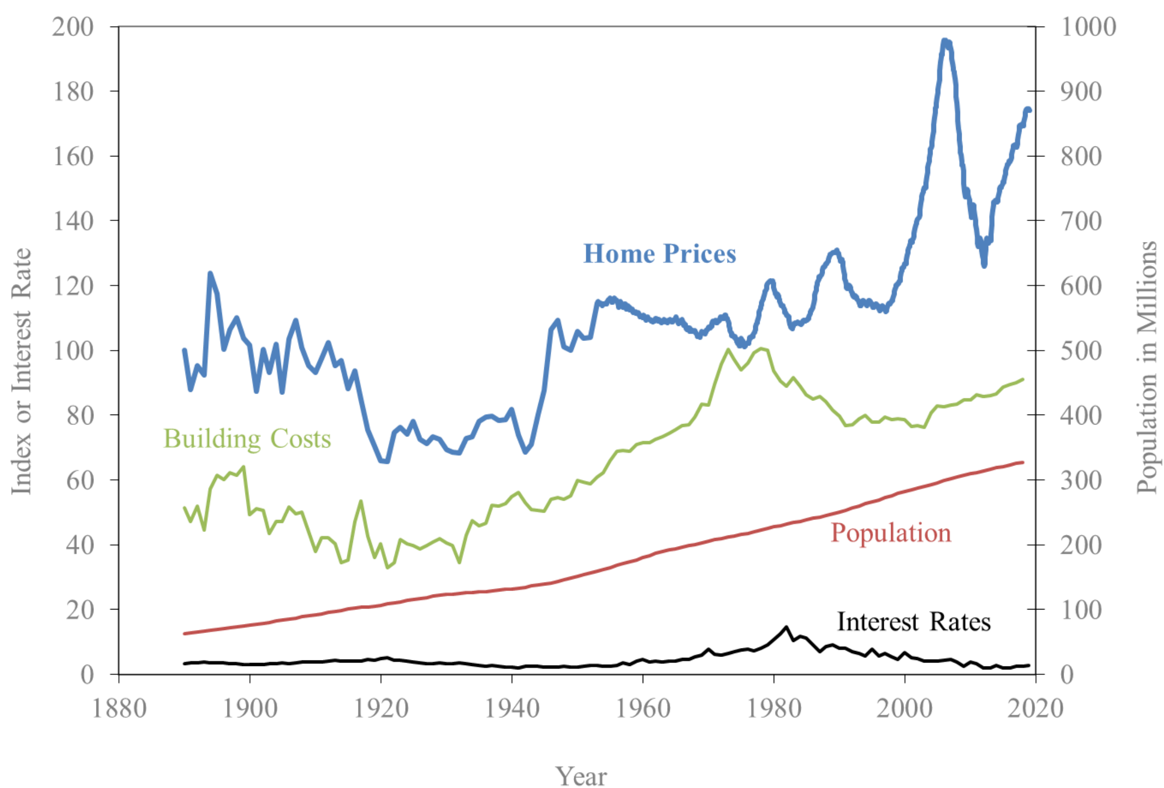
anticipate the Subprime Crisis and exit banking altogether. Vague has seen financial crises from the inside—and not merely survived but prospered.

In the hands of most Americans, this experience would lead to a "How to Get Rich" book. Vague's ambition with this book is very different: to make society richer by understanding what causes financial crises, and thereby preventing them in the first place.

Vague's banker's perspective gives him an incomparable advantage over not only MacKay and Kindleberger, but over me as well: having seen the booms and busts of banking from the inside, he knew where to look, and what to look for.

For example, I dismissed the possibility of a real-estate bubble as a catalyst to the Great Depression, because Robert Shiller's data (Figure 1) seemed to show that house prices were flat during the 1920s, and if anything, declining. That was as far as my investigations went.

Figure 1: Robert Shiller's Real House Price Data: www.econ.yale.edu/~shiller/data/Fig3-1.xls



Vague knew better, and he knew where to look. I got my history of the Great Depression primarily from J.K. Galbraith's *The Great Crash* (Galbraith 1955). Vague asserts that Galbraith "glossed over the national real estate boom beyond Florida… Florida had a famous and fraud-riddled real estate surge that came to an ugly end in the hurricane of 1926, but its equivalent played out in any number of major U.S. cities, especially New York and Chicago" (Vague 2019, pp. 18, 22-23). Vague found evidence in history books, that I have never consulted, of a 1920s real estate boom with elements strikingly similar to the Subprime Bubble:

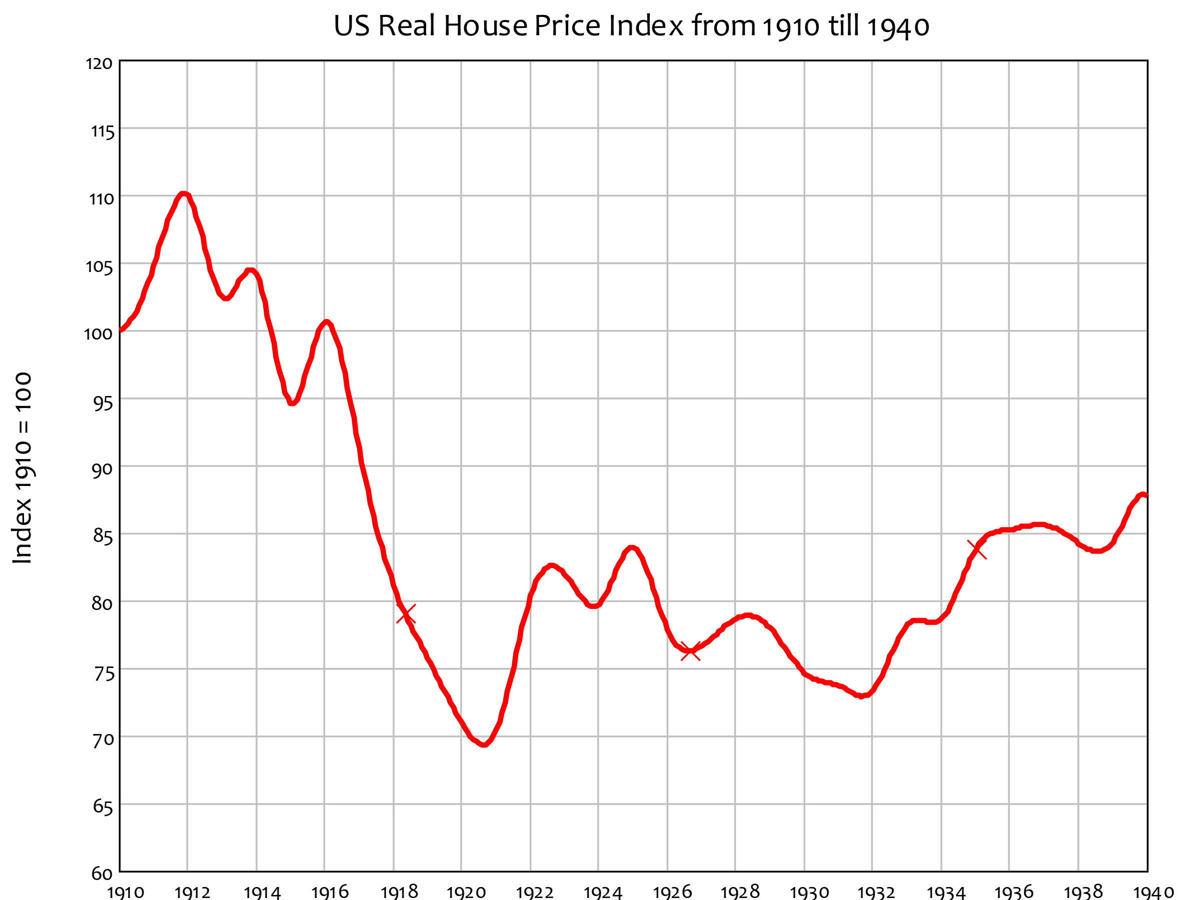
> The state of the nation's housing had become a national issue in 1921, when Secretary of Commerce Herbert Hoover began to advocate for increased home ownership as "the foundation of a sound economy and social system"… Hoover

> urged homebuilders to become more efficient and lenders to become more generous. New tax incentives supported home construction… Banks, building and loans, bond houses, and other lenders responded to Hoover's call. As Robert M. Fogelson reports, Albert E. Kleinert, Brooklyn's superintendent of buildings, reflected on the frenzied pace of the era when he said "They [the speculators] are now selling property between twelve and one o'clock and then at two o'clock they notify the tenants that the rent will be raised, and then when they show an income gain on paper, they sell again. More often than not, the new owners repeated the process." (Vague 2019, p. 20-21.)

That last story sounds like hyperbole to me (from Mr Kleinert), but it speaks of the same "house flipping" mentality we saw during the Subprime Bubble—and the story is about the town that gave us Donald Trump, after all.

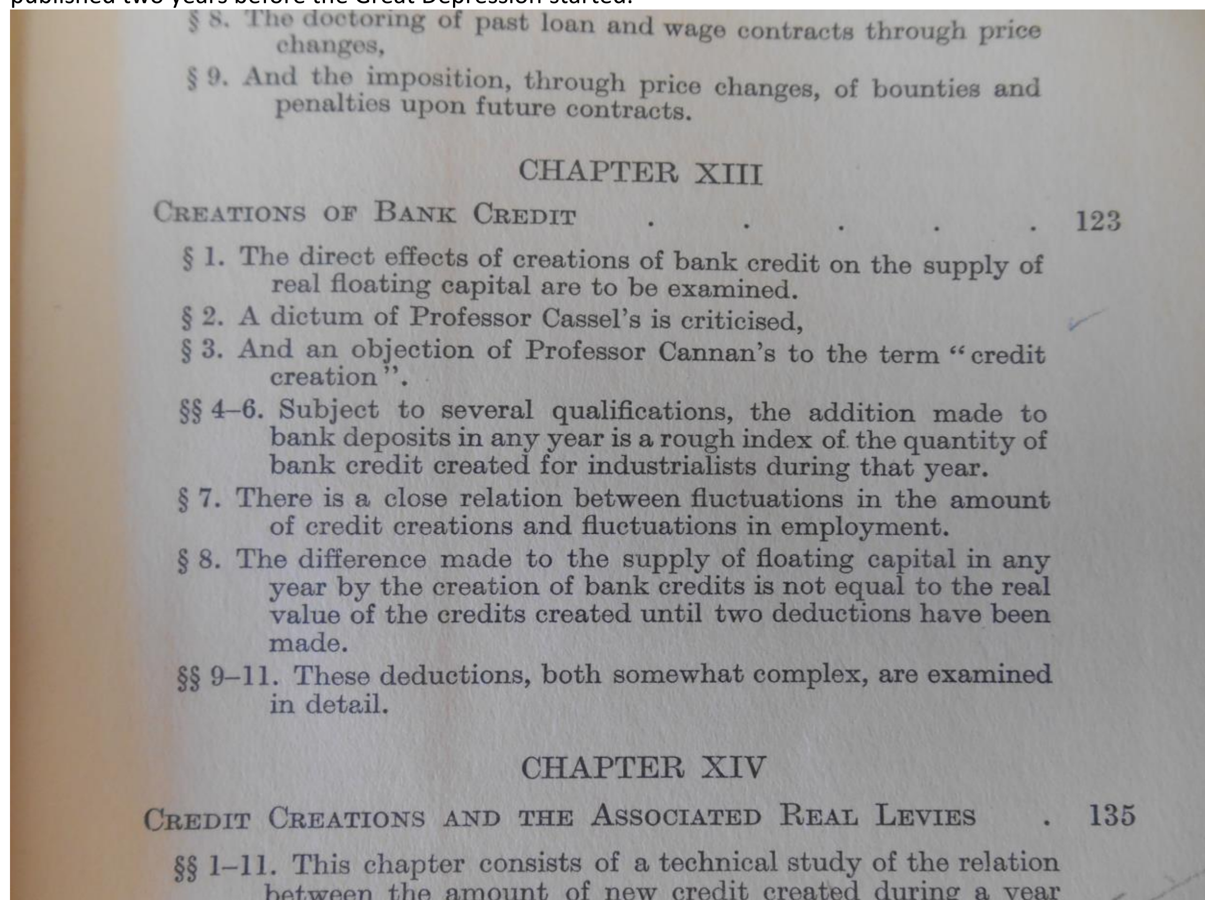
I took a second look at that Shiller chart. When you zoom in, there is a substantial rise in real home prices of 20 percent in the 2 years from 1921-23 (see Figure 2); at the larger time scale, that rise is masked by the substantial fall from 1912 till 1920. So it was there to see—I just didn't know to look.

Figure 2: Zooming in on Shiller, a 20% increase in real house prices in the 2 years 1921-23



One of Vague's points of which I was well aware was how everyone—except Irving Fisher (Fisher 1933) and, surprisingly, Keynes's nemesis Alfred Pigou (Pigou 1927)[1] downplayed the significance of private debt as a cause of the Great Depression—including Galbraith again.

[1] Nathan Tankus brought this to my attention: these are excerpts from Pigou's *Industrial Fluctuations*, published two years before the Great Depression started.



§ 8. The doctoring of past loan and wage contracts through price changes,

§ 9. And the imposition, through price changes, of bounties and penalties upon future contracts.

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§ 1. The direct effects of creations of bank credit on the supply of real floating capital are to be examined.

§ 2. A dictum of Professor Cassel's is criticised,

§ 3. And an objection of Professor Cannan's to the term "credit creation".

§§ 4–6. Subject to several qualifications, the addition made to bank deposits in any year is a rough index of the quantity of bank credit created for industrialists during that year.

§ 7. There is a close relation between fluctuations in the amount of credit creations and fluctuations in employment.

§ 8. The difference made to the supply of floating capital in any year by the creation of bank credits is not equal to the real value of the credits created until two deductions have been made.

§§ 9–11. These deductions, both somewhat complex, are examined in detail.

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CREDIT CREATIONS AND THE ASSOCIATED REAL LEVIES . 135

§§ 1–11. This chapter consists of a technical study of the relation between the amount of new credit created during a year

Vague observes that Galbraith thought that “money was tight” in the late 1920s, “even though loans were then growing at a robust 6 per cent per year.” (Vague 2019, p. 18) My figures differ somewhat from Vague’s (I use data from the US Census for the 1910s-40s, normalized to coincide with the post-WWII data from the Fed; Vague’s research team has assembled their own detailed data series by surveying and collating original data, all of which is available at https://bankingcrisis.org/), but I saw the same story: the Roaring Twenties boom was a credit-driven precursor to the debt-deflationary tragedy of the Great Depression. Though the private debt ratio rose dramatically from 1929 on, credit was actually negative—as low as minus 10 percent of GDP for three years—and this is what made the Great Depression truly great (see Figure 3).

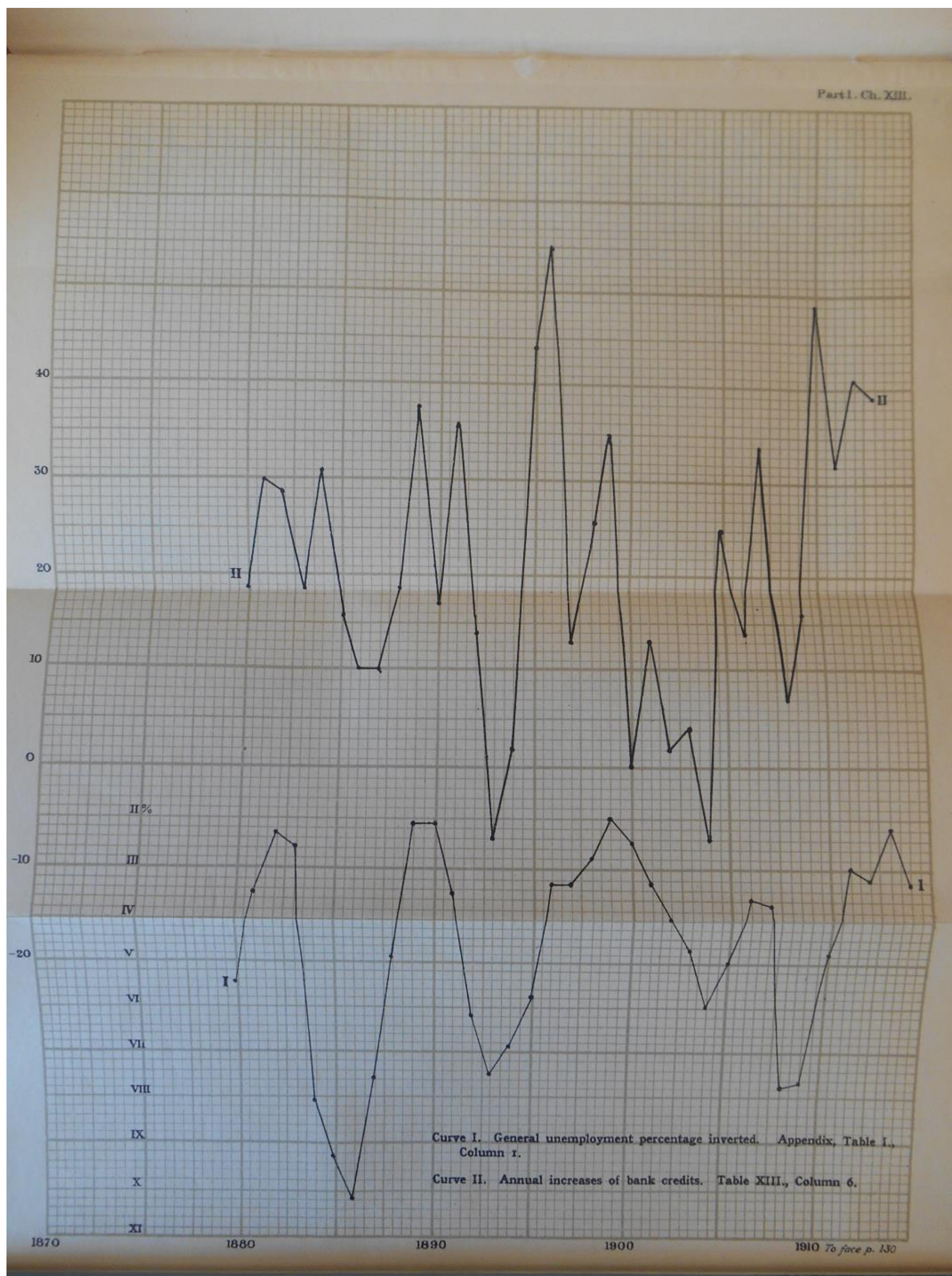
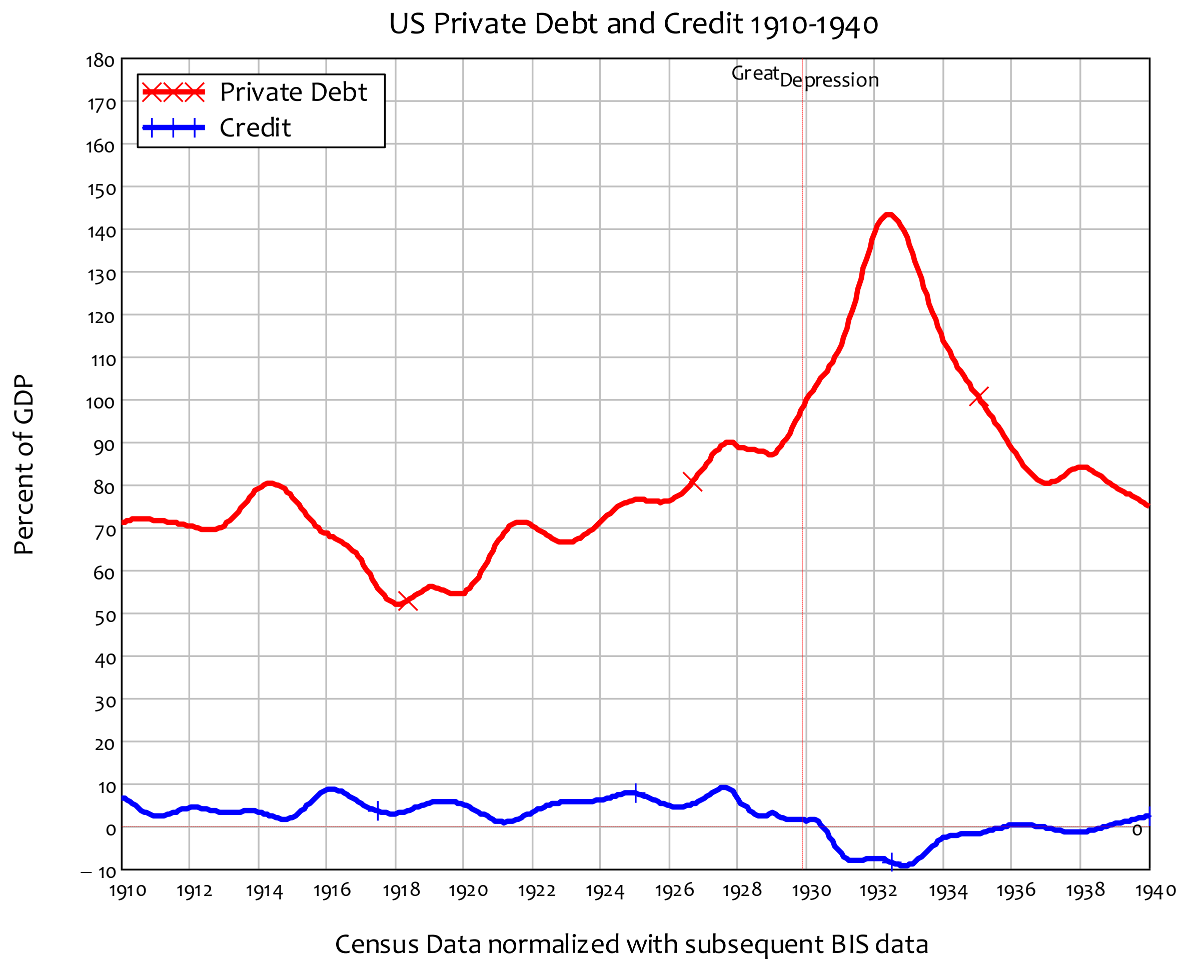


Figure 3: The rising private debt and then negative credit that caused the Great Depression

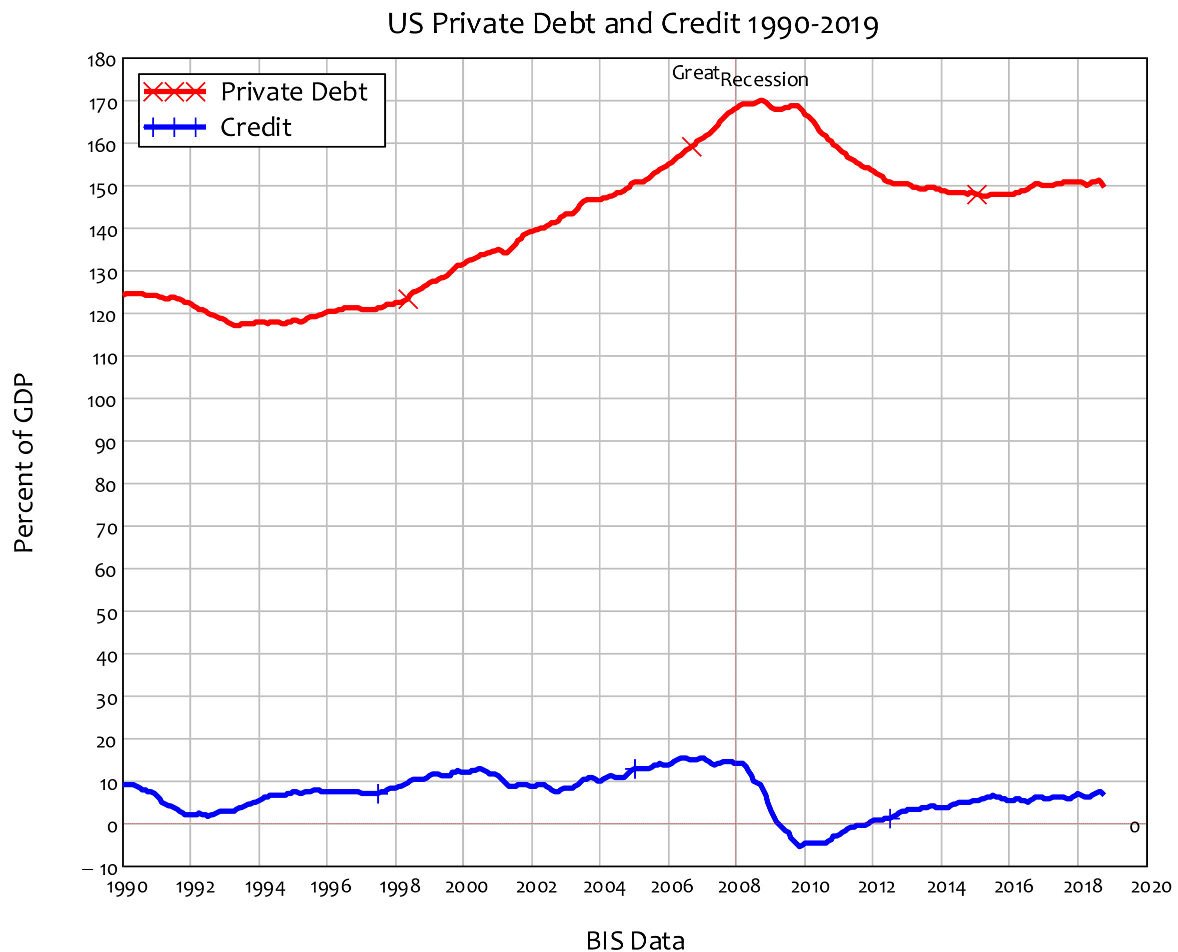


Neoclassical economists like Ben Bernanke rejected Irving Fisher's warning about how private debt and negative credit caused the Great Depression, without even looking at the data:

> Fisher's idea was less influential in academic circles, though, *because of the counterargument that debt-deflation represented no more than a redistribution from one group (debtors) to another (creditors)*. Absent implausibly large differences in marginal spending propensities among the groups, it was suggested, *pure redistributions should have no significant macroeconomic effects*. (Bernanke 2000, p. 24. Emphasis added.)

Consequently, the same warning signs of rising private debt in the 1990s and early 2000s were ignored by economists and policymakers, leading to the collapse of credit in 2008 that caused the Great Recession (see Figure 4).

Figure 4: The rising private debt and then negative credit that caused the Great Recession



Extensive and indeed intensive research by Vague's team at the Governor's Woods Foundation (a philanthropic institution Vague founded after leaving banking) shows that Bernanke's benign view of debt and credit has been wrong in every one of 20 major financial crises over the last 200 years, across the six major economies of the planet: the USA and UK of course, plus Germany, France, Japan and China. The book focuses upon the six biggest crises (the Great Depression, Japan's 1980-2000 Bubble Economy and Lost Decade, banking crises in the USA from 1819-1840, the railroad crises of 1847-1907, and the 2008 Great Recession), and shows via stunningly detailed archival and statistical research that "*Private debt is key,*

> *and the story of financial crisis is, at heart, a story of private debt and runaway lending. Time and time again it is a story of lending booms in which bankers and other lenders make far too many bad loans*. (pp. 6-7)

Speaking as a successful insider to the industry, Vague explains why crises occur so frequently, and why there are also periods without them:

> But financial crises recur so frequently … that we have to wonder why lending booms happen at all. The answer is this: growth in lending is what brings lenders

> higher compensation, advancement, and recognition. Until a crisis point is reached, rapid lending growth can bring euphoria and staggering wealth… Lending booms are driven by competition, inevitably accompanied by the fear of falling behind or missing out. (p. 7)
>
> Why do lending booms happen? Having spent a lifetime in the industry, I can report that there is almost always the desire to grow loans aggressively and increase wealth… So the better and more profound question is, why are there periods in which loan growth *isn't* booming? … when lenders are chastened—often in the years following a crisis. (p. 8)

There is much, much more of this in the book, as well as fascinating historical snippets from long forgotten, but at the time, highly significant, speculative booms and busts. To take one such snippet literally at random (I read the whole book in draft form, but for this exercise I simply flicked the book open at a random page):

> For example, in 1836 Bernard Marigny and his wife, Anne Mathilde Morales, mortgaged their sugar plantation in Plaquemines Parish—including the house, sugar mill, hospital, kitchens, slave cabins, warehouse, barn, stable, carts, plowing equipment, animals and seventy enslaved humans—in return for 490 shares of stock in the bank… American plantations were established and then expanded by owners who borrowed against their slaves, land, and future crops, all without a clear sense of how many other farmers were doing the same… "Buying a plantation," one grower later told Frederick Law Olmsted, "is essentially a gambling operation." (p. 103)

Each of the six chapters on a specific financial crisis is replete with details like this. This is a book of flesh and blood, as well as of economic history and statistics.

It is also not all gloom and doom, despite the catchy title. Though the focus of the book is on bankers behaving badly, Vague also emphasizes the positives of banking:

> Take away private debt, and commerce as we know it would slow to a crawl. The world suffered crisis after crisis in the 1800s, but per-capita-GDP increased thirtyfold in that century, and private debt was integral to that growth. Many of those nineteenth-century crises were rooted in the overexpansion of railroads, but they left behind an impressively extensive network of rails from which countries still benefit. (p. 16)

The book concludes with a short chapter on the prospects for crises in the immediate future—unlikely for the USA, ameliorated for China by its uniquely powerful government (but if there is no credit crisis, there is and will still be massive overcapacity)—and a brief discussion of remedies. Vague is (pardon the pun Richard!) a bit vague here. Like me, he recommends that the aggregate level of private debt and the rate of growth of that debt—otherwise known as credit—should be made a key economic indicator, every bit as important as the unemployment rate or the rate of inflation:

> The surest method to detect these dangers … is to measure aggregate lending totals in the whole and by sector. Where loan growth is extraordinary in relation

> to GDP, it is almost certain that lending standards have been relaxed. It should then be a straightforward matter for regulators to intervene as needed. (p. 194)

He also notes that, from the historical record, the recommendation that countries with high private debt to GDP levels should grow their way out of it appears impossible:

> Instead, private deleveraging in a given country has almost always occurred through one of three means: offsetting very high growth in public debt, which brings its own concerns; very high and sustained inflation, which is painful; or a very large net export position, which is hard to sustain without trade repercussions. Private debt deleveraging, absent any of these three things, reduces asset values and has a contracting impact on GDP, bringing duress. (p. 195)

He recommends instead "a broader strategy of debt restructuring or forgiveness" (p. 195), but without going into details of how this might be done. I have my own ideas—a "Modern Debt Jubilee" where the Central Bank's capacity to create money is used to offset private debt, rather than to fuel asset price inflation, as Quantitative Easing has done, plus limits on collateralized loans based on the income from the asset being purchased—and I know Richard has some ideas about modifying the time period over which banks are allowed to write off bad loans. Some more detail on those proposals would have been welcome, but is absent from the book.

However, that oversight is my only criticism. As it stands, *A Brief History of Doom* is *the* authoritative historical reference on why financial crises occur, with stunning detail on the six biggest crises in the history of capitalism. It is beautifully written, and manages to combine a strong unifying theme of the role of excessive private debt booms and credit busts (each chapter has a "Crisis Matrix" showing levels and rates of change of GDP, public and private debt at critical dates in the crisis) with engaging historical detail. If you have any interest in the financial system, you need this book.

Disclaimer

I was a consultant to Vague in 2013 when he began assembling the long-term debt series for the USA, and I also provided feedback on the book's penultimate draft. Richard is both a friend and a contributor to my Patreon crowdfunding campaign.

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