The 2008 Crisis Wasn't Unique – But Will We Ever Learn?

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Contrary to what many people seem to believe, financial crises like the one that began five years ago are neither rare nor inexplicable. They have been occurring for centuries, and while each one has its own fascinating details, they also have much in common.

In Amsterdam in the 1630s, many people invested in tulip bulbs in the hopes of cashing out at higher prices; when prices eventually collapsed, so did the financial system. The South Sea and Mississippi Companies were founded in the early 1700s and thousands of English and French investors expected share prices to keep on rising; when prices eventually plummeted, the financial system was rocked and recessions followed.

The widespread building of canals and railways in the United States in the mid-1800s led to booms, collapses, financial crises and recessions. The 1929 stock market crash precipitated an enormous financial crisis that ushered in the Great Depression. Over the next 70 years, financial crises occurred in Spain, Norway, Sweden, Finland, Japan, Southeast Asia and many other countries – all before the global one that started in 2008.

The late Canadian-born John Kenneth Galbraith had a long career as a Harvard economics professor, public servant, U.S. presidential adviser, ambassador and public intellectual. He wrote dozens of popular books about economics, and he was famous for avoiding the dry, technical writing style practised by almost all of his colleagues. One of my favourites, which I assign every year to my students, is *A Short History of Financial Euphoria*, in which Mr. Galbraith argues that all financial crises share five common elements.

First, there always appears to be some new kind of investment or financial instrument to get investors excited. In Amsterdam in the 1630s, it was the arrival of tulip bulbs from foreign lands. A century later, publicly traded "joint stock" companies were the new thing, and the promise of far-away profits added an exotic twist. In the 2000s, the process of "securitization" and the creation of mortgage-backed securities seemed to offer both high returns and the safety of diversification.

The complexity of many financial instruments gets us to the second common element: The belief that money and intelligence travel together. It is probably natural to think that only really smart people can make it in the complex world of financial markets. When we see these people doing so well, we naturally conclude that they know a lot more than we do and, since they're so smart, maybe we should do whatever they're doing. And so the bandwagon starts rolling.

The third element is something very old: By borrowing a lot to purchase investments, investors become highly "leveraged." The wonderful thing about leverage is that for good investments, the return on equity gets highly magnified because the investor starts with so little equity in the first place. The terrible thing is that for bad investments, the same magnification happens in reverse – and many investors then find themselves with few assets but mountains of debt. In 1630s Amsterdam, individuals borrowed massively to finance their tulip investments. A century later, investors did the same to purchase shares in the Mississippi and South Sea Companies. In the 2000s, individuals purchased houses with enormous mortgages and investors then borrowed money to purchase the associated mortgage-backed securities. The tulips and company shares and houses were all purchased with the expectation of ever-rising prices. But prices didn't keep rising – they never do.

The fourth element is the assignment of blame after the fact. Maybe it falls on the founder of the company whose share prices collapsed, or the land developer whose real estate values evaporated, or the "predatory" mortgage lenders or the agencies that rated the riskiness of the mortgage-backed securities. There's rarely a shortage of people to blame. But Mr. Galbraith noted that we never blame "the system," because to do so would be to question the basis of a market economy – and who wants to do that?

Yet market systems have been prone to financial crises for hundreds of years. We can regulate the extent of leverage, the nature of bank lending, mortgage conditions, corporate governance, and much else. And we are right to do so, because financial markets do not work efficiently in the absence of such regulations. But let's not delude ourselves into thinking that we can prevent the intrinsic behaviour that fuels financial euphoria and leads to financial booms, collapses and occasional crises. These are an unfortunate but unavoidable part of a market economy.

Mr. Galbraith's final common element is our painfully short memory preventing us from learning from previous errors. So, maybe the most important lesson to be drawn from the past five years is that we should be less ignorant of our history. Our tendency to neglect the past, and to repeat crucial mistakes, will hasten the arrival of the next financial crisis.

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