The Financial Stability Watershed of the 1970s

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No banking crises 1935-1973; Many after 1973.

Why?

The early 1970s formed a watershed between financial systems which were beforehand:-

a) Subject to direct quantitative controls.
b) Nationally fragmented.
c) Oligopolistic, not competitive, (intentionally so).
d) Had liquidity (not capital) ratios.

And subsequent systems which were:-

a) Controlled by (policy) rate variation.
b) International/global.
c) Much more competitive.
d) Based on capital (not liquidity) ratios.

Key driving force was international (wholesale) market, plus better communications (IT).

In the earlier period there were fewer financial strains, because:-

i. Credit expansion (leverage) was (mostly) directly controlled (except for fringe).
ii. Adequate profitability was assured, (so forbearance would normally work).
iii. Accounting was opaque (hidden reserves) (n.b. could go either way, but made CB in a strong position to communicate).
iv. Culture (3/6/3. Capt Mainwaring).

and

Central Bank was supported by:-

i. Other banks (Lifeboat).
ii. More visibility (early intervention).
iii. Interest rate controls meant rises in policy rate led to mortgage rationing, so housing bubbles less prominent.

Life became more difficult afterwards, because:-

i. Credit expansion became more procyclical, (animal spirits varied more than policy rates; ‘This time it’s different’).
ii. Profitability constrained by competition.
iii. Fair value (i.e. procyclical) accounting.
iv. Culture (short-term profit maximisation).

and

Central Banks troubled by:-

i. Demise of life-boat (JMB).
ii. Silent runs and shortening maturities (Northern Rock).
iii. Housing bubbles (UK 1973/75, 1990/91, 2007/8, 2024/25).

Attempt to handle via:-

i. More asset liquidity (LCR/NSFR).
ii. More loss-absorbing capital.
iii. Bail-in.
iv. Culture(?)

Will it work?   Watch this space.