



BANCO CENTRAL
DEL URUGUAY

Financial stability through the lens of historical economics

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Disclaimer:

The views expressed therein are those of the author and do not necessarily represent the opinion of the Banco Central del Uruguay

Can historical economics help
today's financial stability efforts?





STABLECOINS

A hand is shown holding a glowing, futuristic AI chip. The chip is a square with rounded corners, emitting a bright orange and yellow light. It is surrounded by a network of white lines and nodes, resembling a circuit or data flow. Various icons are scattered around the chip, including a globe, a bar chart, a document with a checklist, a location pin, a cloud with an upload arrow, a fingerprint, and a circular arrow. The background is dark with a bokeh effect of orange and yellow lights.







JOHN LAW. — Page 62.

Historical common sense

Google Books Ngram Viewer

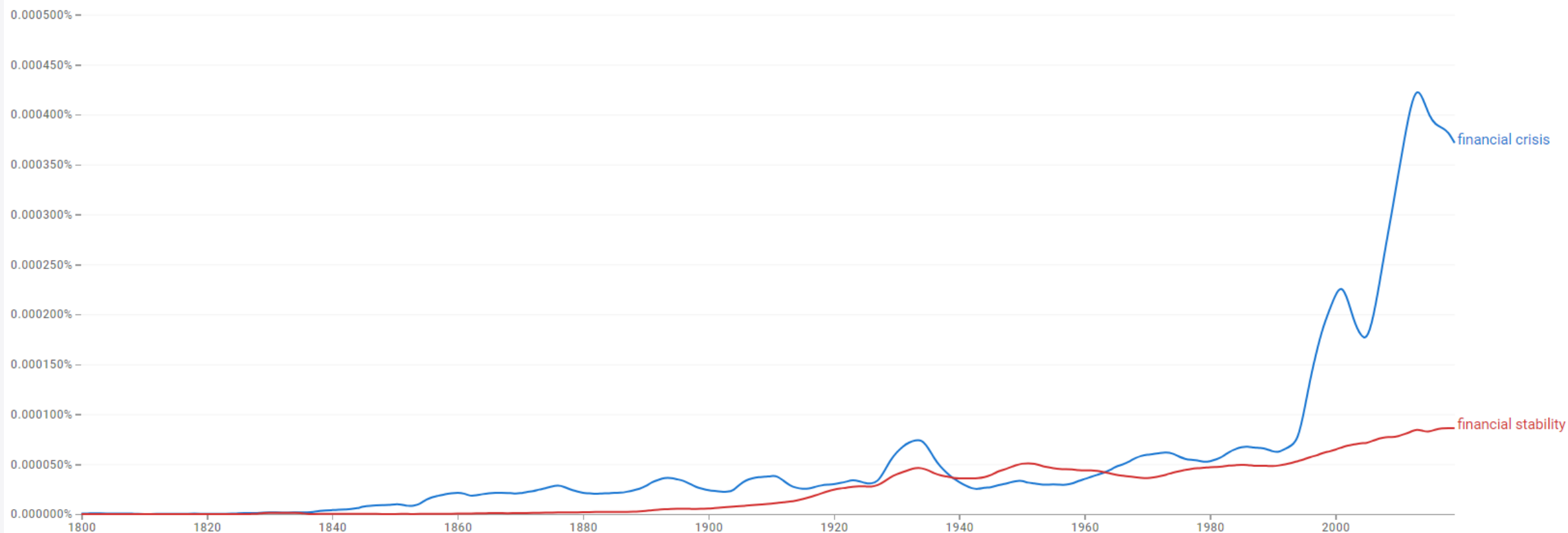
financial crisis,financial stability

1800 - 2019

English (2019)

Case-Insensitive

Smoothing



What does artificial intelligence answer?

 perplexity

New... Ctrl I

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I need to prepare a...

Financial stability...

Can historical economics help today's financial stability efforts?

Sources

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Answer

Yes, historical economics can help today's financial stability efforts by providing valuable insights into the evolution of financial systems, the drivers of financial crises, and the effectiveness of different policies and regulations. Understanding historical patterns allows policymakers and financial practitioners to identify trends, anticipate potential risks, and develop appropriate responses to maintain financial stability.



Main theses

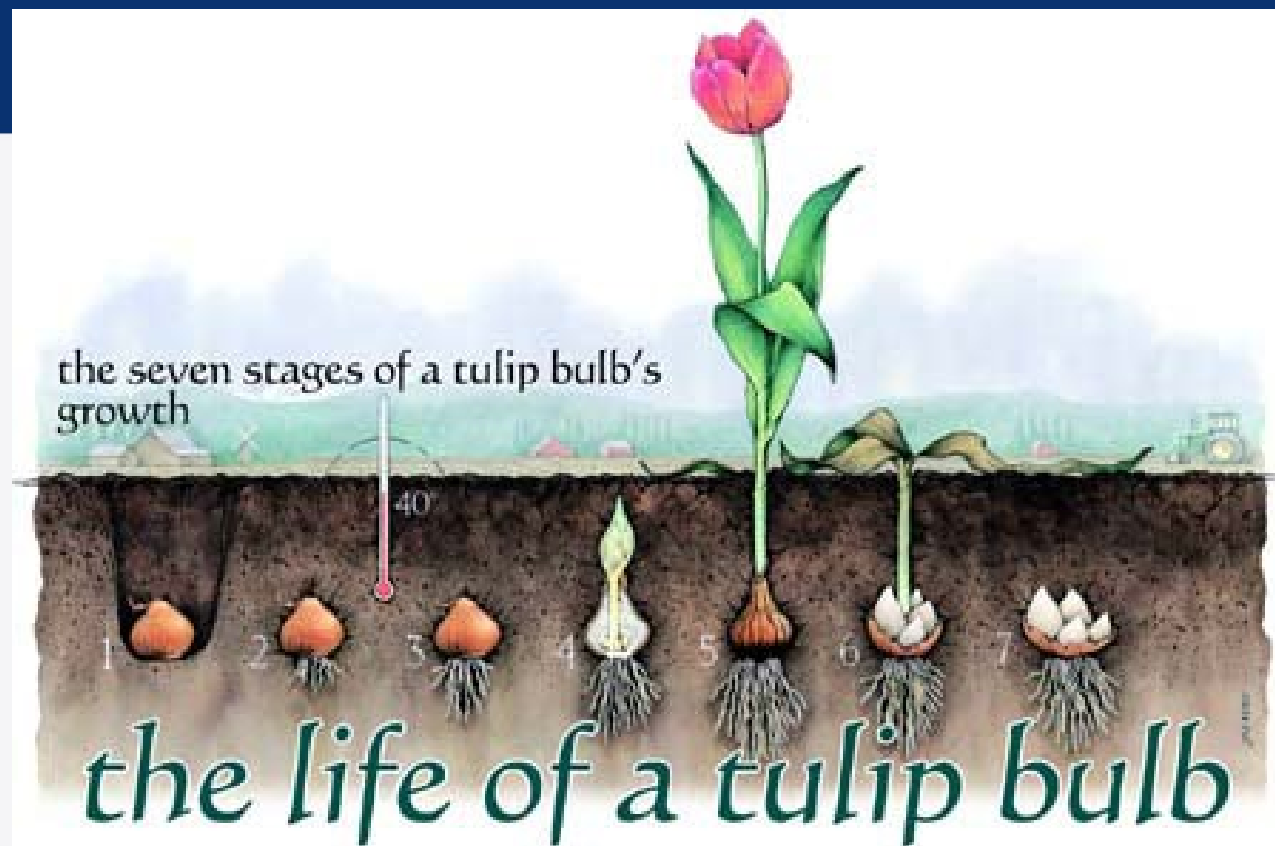
Flyby of a Black Swan is hard to predict but by studying the habits of the beast, it may be possible to catch a feather

“Happy families are all alike; every unhappy family is unhappy in its own way”
(Leo Tolstoy's novel Anna Karenina)

Tulip mania

1636 - 1637

Tulips



- Difficult to make lots of tulips out of one
- 7 -12 years before flower

Tulips



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Home // Fall Planted Bulbs // Tulips

100 Blooms of Purple and Pink Tulips Collection

★★★★★ 8 review(s)

#88313

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\$111.68 ~~\$159.55~~

You Save: \$47.87 (30.0%)

100 bulbs per package

Quantity:

Add to Cart

Write a review

Ships: Fall 2024 [?]

+ Add to Wishlist

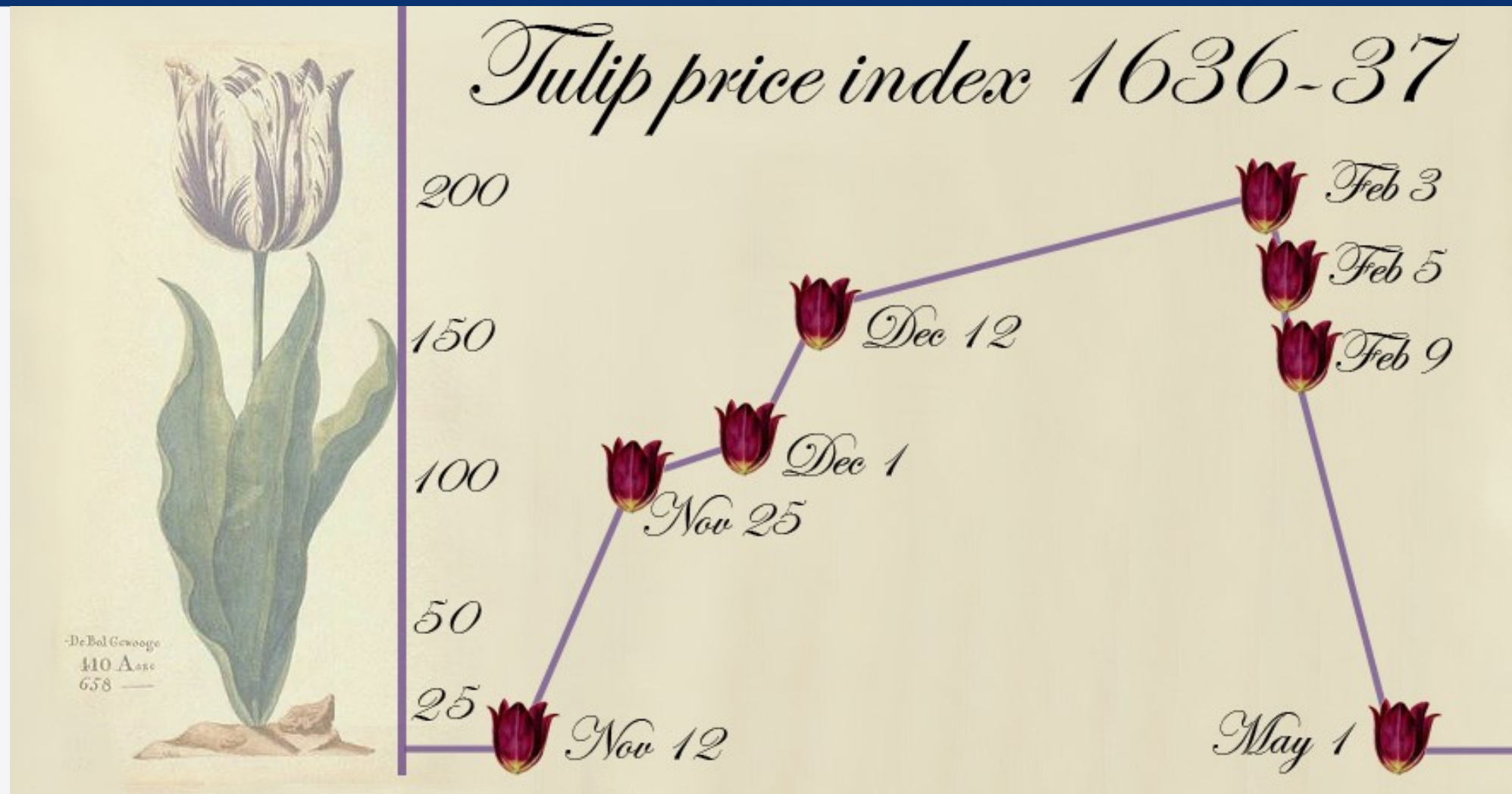


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Tulip mania

- In 1636 Amsterdam the price of bulbs skyrocketed
 - Five acres of prime land or a house in Amsterdam
 - Bulbs did not exist in real life
 - Procurement contracts and futures
 - Contracts changed hand up to 10 times per day
-
- Amsterdam had wealthy merchants
 - Bulbs saw as an unparalleled status symbol
 - When the market became popular, speculators entered

Tulip mania



What about Bitcoin?

72.884,20 USD

+ Seguir

+68,900.77 (1,729.68%) ↑ en los últimos 5 años

13 mar., 5:30 p. m. UTC · [Renuncia de responsabilidad](#)

1D | 5D | 1 M | 6 M | UAHF | 1A | 5A | Máx.



Bank of Amsterdam
1609 - 1820
(An early stablecoin)

The Bank of Amsterdam

- Established to provide monetary exchange at fixed rate
- Became a wholesale deposit bank
 - Backed by silver and gold coins
 - Introduced the book-entry system
 - Enabled customers to settle payments
- Reserves fully covered outstanding notes
- Invulnerable to major panics: Louis XIV's invasion (1672)

- A “rigid” stablecoin

From a “rigid” to an “elastic” stablecoin

- “Rigid” stablecoin is poorly suited as the foundation for a modern monetary system
- Settlement liquidity provider
 - Overdrafts to key stakeholders
 - Redemptions by depositors through “receipts”(repo)
- A “elastic” stablecoin
 - Central role in supporting the economy for long time
 - Value is sustained by trust in the unit of account
 - Stability relayed on the general strength of the balance sheet

Stable?

- Massive loans during the Fourth Anglo-Dutch War of 1780-84
 - Dutch East India Company
 - City of Amsterdam
 - Economic downturn worsened and confidence ebbed
 - Massive defaults
 - A series of runs depleted the bank's reserves
-
- No a fully fledged central bank/stablecoin
 - Did not have the full fiscal backing of the sovereign

Sound money still needs sound governance

- Tech underlying money has advanced in the digital era, yet Economics underlying money have not
 - “Rigid” stablecoin was poorly suited in 17th century
 - “Elastic” stablecoin may affect confidence
 - In modern central banks explicit fiscal backing supports flexible yet robust systems

(More in Frost, Shin and Wierds (2020) “An early stablecoin? The Bank of Amsterdam and the governance of money.” BIS Working Paper 902)

Innovations by John Law

1716 - 1720

Lots of economic ideas

- 18th century France
 - Depressed economy
 - Large government debt
 - High taxes
 - Controlled the colony of Louisiana
- Stimulate the economy by abolishing taxes on roads/canals
- Set up state-owned monopolies
- Banque Générale: replace gold by fiat paper money
- The Mississippi Company scheme

Banque Générale (1716)

- Bank could issue paper money supported by gold reserves
 - Initially strict control that paper money had gold backing
 - Bank would finance the Regent (Philippe d'Orléans)
 - French like paper money!
 - Paper money can be used to pay taxes
-
- Bank gave John Law the possibility for grander schemes

The Mississippi Company (1717)

- Monopoly right to trade with Louisiana colonies (up to Canada)
 - Must transport 6.000 settlers and 3.000 slaves
-
- Funding
 - Issue shares against cash
 - Issue shares against French government bonds
 - Made happy the Regent
 - Guaranteed a steady cash flow to Company
 - Offered collateral for new financing

Expansion (1718 - 1719)

- Banque Générale becomes Banque Royale
 - Paper money became legal tender
 - Crown further guaranteed the bank's note issue
 - Company expanded to Africa and China
 - Company bought rights to collect French taxes
 - Publicity: There is gold, there is Silver in Louisiana
 - Law becomes Controller General and Superintendent General of France (Governor of the central bank)
-
- December 1719 Company's dividends: 40%

Culmination (1720)

- Dividend of 40% deemed too high related to revenues
 - Rumors that gold mines in Louisiana were inexistent
 - Many nobles want to withdraw their money
-
- Panic as investors rushed for liquidity
 - Share prices plummet
 - Banque Royale liquidated
 - Stock market closed
 - Profound crisis because loss of trust in government

On the role of financial innovation

- Historically, financial innovation has been observed together with big financial troubles
- But beware of:
 - Overconfidence
 - Positive contagion
 - Herding behavior among investors
 - Rumors and fake news

On the role of (fake) news and rumors

Bulgarian banks

Digital rumours

What caused the run on two of Bulgaria's largest banks?

Jul 5th 2014 | SOFIA | From the print edition



- Run on Corporate Commercial Bank
- Fake anonymous e-mails, social-media posts and mobile-phone messages fanning fears about other banks
- Run on First Investment Bank

The “This time is different”
syndrome

IN HISTORY

when all Europe guessed wrong

The date—October 3rd, 1719.
The scene—*Hotel de Nevers*, Paris.
A wild mob—fighting to be heard.

"Fifty shares!" "I'll take two hundred!" "Five hundred!" "A thousand here!" "Ten thousand!"

Shrill cries of women. Hoarse shouts of men. Speculators all—exchanging their gold and jewels or a lifetime's meager savings for magic shares in John Law's Mississippi

Company. Shares that were to make them rich overnight.

Then the bubble burst. Down—down went the shares. Facing utter ruin, the frenzied populace tried to "sell". Panic-stricken mobs stormed the *Banque Royale*. No use! The bank's coffers were empty. John Law had fled. The great Mississippi Company and its promise of wealth had become but a wretched memory.

Today you need not guess.

HISTORY sometimes repeats itself—but not invariably. In 1719 there was practically no way of finding out the *facts* about the Mississippi venture. How different the position of the investor in 1929!

Today, it is inexcusable to buy a "bubble"—inexcusable because unnecessary. For now every investor—whether his capital consists of a few thousands or mounts into the millions—has at his disposal facilities for obtaining the *facts*. Facts which—as far as is humanly possible—eliminate the hazards of speculation and substitute in their place sound principles of investment.



STANDARD STATISTICS

200 VARICK ST.

New York, New York (now the home of Chipotle Mexican Grill)

Saturday Evening Post, September 14, 1929

- “We are doing things better than others”
- “We have learnt from other’s mistakes”
- “This boom is built on sound fundamentals: structural reform, tech innovation, financial understanding”



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A couple of examples

- Defaults of 1930's
 - Fact: Governments were heavily indebted
 - Belief: No more war and political stability
 - Crash reason: Bubble explosion of stock markets
- Debt Crisis of the 1980s
 - Fact: High commodity prices → huge gains in LA countries
 - Belief: Western banks are experts in lending, loans go to infrastructures, commodity prices will remain high
 - Crash reason: Collapse of commodity prices, higher interest rates in western countries to fight inflation

Other two examples

- Debt Crisis of the 1990s in Asia
 - Fact: Currency quasi-pegged to the dollar
 - Belief: Because of peg to dollar, investing in Asia is safe
 - Crash reason: Confidence crisis and no enough reserves
- Financial Crisis of 2007
 - Fact: Housing prices doubled, equity prices soared, huge borrowing
 - Belief: Finances are safe and inflation controlled
 - Crash reason: Subprime payments could not be made, bank failures

Final thoughts

Financial stability events ...

... are correlated to:

- Lack of regulation, supervision and control
- Over indebtedness
- Innovations
- Behavioral biases

... materialize when:

- There is lack of confidence
- Information crystallizes in some manner

Where are we?

- Recent scars
- Growing activities outside the regulatory perimeter
- Increasingly interlinked with regulated activities
- Speedy innovation
- Financial vulnerabilities in the real and financial sectors
- High public debt in several countries
- Geopolitical fragmentation
- Digitalization

Köszönöm!