Financial Crisis: Economics of Greed, Fear and Recklessness

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'Greed', 'fear' and 'recklessness' are unusual terms in an economist's world. Being professionals, better equipped are they in rephrasing the above with standard terminology. Irrespective of its timing and place of birth, a 'financial crisis' is explicable through standard economic theory. 'Bubble collapse' hypothesis, 'financial panic' hypothesis and the 'Moral-hazard' hypothesis are benchmark terms used by economists in place of the above unusual terms. This paper attempts to theorise the causes leading to a financial crisis bringing in a vast array of economic theories. East-Asian currency crisis of 1997 and the Global financial crisis of 2008 are closely scrutinised in analysing the causes of their emergence from a theoretical point of view.

Currency Crisis in East and South-East Asia in 1997

Countries in the East and South-East region achieved a balanced growth simultaneously maintaining its economic fundamentals strong; high economic growth rates, low inflation rates, high domestic savings and investment levels, low trade balances and budget deficits. High growth rates recorded by Thailand, Malaysia, Indonesia, Singapore, South-Korea exhibited signs of slow down by 1996 due to both internal and external factors. High growth rates were possible owing to unprecedented expansion in the technological sectors. Foreign investors clogged to Asian economies in making short-term gains. High interest rates discouraged investors at home while encouraging inflow of foreign capital transforming the market to a one driven by foreign investors. Capital is perfectly mobile internationally when investors can purchase assets across borders, quickly with low transaction costs, and in unlimited amounts as per the 'perfect capital mobility theory'. An independent monetary policy under a fixed exchange rate regime and perfect capital mobility conditions is extremely impossible as interest rates cannot move out of line with those prevailing in the world market. Assuming an imperfect capital mobility model which is less interest elastic in a fixed exchange rate system, these countries were capable of maintaining interest rates high due to expansionary fiscal policies (Kelegama, 1988; Thenuwara, 1998). According to Mundell-Fleming model, an expansion in the fiscal policy shifts the IS (Investment-Saving) curve to the right, pushing up interest rates and income levels simultaneously. However the interest rate achieved in this instance was far below the rate required for equilibrium on the foreign exchange market, resulting a deficit in the balance of payments. Corresponding increases in income can be maintained as long as the monetary authorities are able to finance the resulting balance of payments deficit and sterilise its impact on the domestic money supply. This became impossible in the long run with the depleting foreign reserves which led to the ultimate devaluation of the Asian currencies. The 'theory of interest rate parity' states that the exchange rate of two countries will be affected by their interest rate differential. In other words, the currency of a high interest rate country will be at a forward discount relative to the currency of a low interest rate country and vice versa under efficient foreign exchange market conditions. However, the currency rates did not adjust automatically in these countries as there was involvement of the monetary authorities in the foreign exchange market (Kelegama, 1988).

Rising labour costs of these countries led to an erosion of competitiveness in their intensive labour-oriented export trade. Thai labour cost in textiles, footwear, plastics and garments were about three times higher than that elsewhere in South- East Asia. Appreciation of the United States (US) dollar came as a blow to Asian exports as most of the East and the South East-Asian currencies were pegged to the US dollar. Besides dollar appreciation, slump in demand for electronics affected Asian economies adversely as most were major exporters of personal computers and semi-conductors. All these factors led to erode the competitiveness of their exports (Kelegama, 1988). 'Theory of comparative advantage' states that a country has a 'comparative advantage' vis-à-vis a second country in the production of the commodity in which it has a lower opportunity cost than the other country. Thailand was inflexible to realise the reversing of their advantageous position in producing

textiles, footwear, plastics and garments in the face of the rising labour costs which led to the erosion of their export margins.

Irrespective of the declining exports, excessive consumption levels encouraged an expansion in the imports. Rapid growth rates together with high per capita incomes resulted spending lavishly on consumer items, while exhibiting a high propensity for imported consumer goods and services. Thailand became the second largest consumer of Mercedes Benz cars; lavish spending on foreign trips and educating their children abroad became a lifestyle (Kelegama, 1988). As per the Keynesian consumption function (C=C0+cY), consumption (C) increases with the current level of income (Y). The behaviour exhibited by Asian consumers in the face of rising per-capita incomes, resembles the Keynesian consumption function. Keynes believed income as a primary determinant of consumption and interest rates do not play a role in determining the consumption levels. This stood in stark contrast to the beliefs of classical economists who held that higher interest rates encourage savings and discourages consumption. Lower level of domestic investments combined with higher foreign investments makes us believe that the Asians during the crisis were ardent followers of Keynes. An opposing view put forward by Modigliani's 'life cycle hypotheses states individuals plan their consumption and savings behaviour over long periods with an intention of allocating consumption in the best possible manner over their lifetime. Instead of relying on a single value (based on a psychological rule of thumb) for the marginal propensity to consume, life cycle theory (based on maximising behaviour) implies different marginal propensities to consume out of permanent income, transitory income and wealth. Since most Asian countries maintained a fixed exchange rate, many seem to have believed their increase in incomes were of a permanent nature as opposed to a transitory one. According to the 'relative income hypothesis' by James Duesenberry, consumption expenditure of households are dependent on consumption patterns of their neighbours. The large consumption of Benz cars and the adopted pattern of educating their children abroad are all signs to prove the applicability of the relative income hypothesis to these Asian economies.

Freely available foreign funds led Asian banks to go on a lending spree. Commercial banks expanded credit to such extents so as to equal 150% of gross domestic product (GDP) in Thailand, South Korea and Hong Kong and 105% in Indonesia. Foreign borrowings were un-hedged; exposing banks to undue risk. Stable exchange rates made such ignorance possible. Banks were blind to see the importance in hedging foreign loan instalment payments and interest payments. 'Full forward', 'partial forward contracts' or 'money market' hedging techniques were completely overlooked by banks in covering the 'transaction risk' faced. Asian banks thus exposed themselves to the risks posed by arbitrages and speculators. Liberal credit policy of banks led to a property glut. Inadequate supervision by monetary authorities over financial institutions led banks in pursuing a liberal credit policy. Liberal credit found its way to property development sector. In Hong Kong, 50% of the bank loans were for property development; in Malaysia it was about 28% although in some banks, it exceeded 40%. This manner of expansion led to an over supply of property, resulting a fall in property prices. Banks were unable to recover their loans due to the losses in the share market with the drop in the real estate prices and the bankruptcy of property developers. Exposure of the banking crisis and the fuming panicking atmosphere led investors-lenders in withdrawing their loans and investments pre-maturely creating a playground for speculators in making windfall gains in the currency market. Anticipating a devaluation of the currencies, speculators launched an attack by selling local currencies in return for dollars, with a view to selling dollars subsequent to a devaluation of the domestic currencies and making speculative gains. Speculators mounted an attack on the Thai Bhat in May 1997, expecting a large future depreciation of the Bhat. Spill over effects of the crisis was felt by Malaysia, Philippines, Indonesia and South Korea. Currency crisis led gloomy investors abandon the stock markets. Unexpected depreciation of currencies, magnifying foreign debt crippled the banking sector, resulting in a shortage of liquidity, generating a vicious cycle of lower aggregate demand, high rates of unemployment and lower production levels. Monetary authorities initially tried to defend their currency by selling dollars at the official rate. This became futile subsequent to realising that a good part of their foreign reserves had already depleted, leading them to allow their currencies to float. Speculative attacks on Asian currencies ultimately led to a collapse in the banking sector resulting in mergers or closure (Jayasuriya, 1988; Kelegama, 1988).

Global Financial Crisis in 2008

Slump in the US real estate sector manifested as a global economic crisis spreading to both rich and poor countries. Crisis emerged from a point of excessive consumption patterns by the US. Collapse of the core created a chain of negative reactions to the rest of the economies highly dependent on the US. Growing US trade deficits over the years were financed by resorting to trade surpluses of China, Japan and other Asian countries who were eager in accumulating dollar denominated assets. Large capital inflows together with the relaxed monetary policy enabled the US in maintaining low interest rates. Theoretically, the relaxation in the monetary policy shifts the LM (Liquidity Preference Money Supply) curve to the right in the IS-LM model pushing the interest rates down, simultaneously increasing the income levels. Under a flexible exchange regime, lowering of the interest rates will be followed by depreciation in the dollar as a result of the capital outflows, making imports expensive. Low interest rates made consumers seek alternative sources of investments to boost income levels, and this quest was filled by the attractive rates offered by the 'real estate sector'. High demand for real estates drastically pushed up its prices. Real estate prices by mid 2007 had raised by 70% compared to 2005 and a speculative 'bubble' was visible as a result of the 'greed' in their rat race for real estates. Banks realising the opportunity, followed a liberal policy in extending loans to real estates. Banks resorted to a technique of 'securitisation', pooling their loan holdings and selling to investors around the globe to make their balance sheets attractive. Things were on a smooth run until the crumbling of the asset prices (Kelegama, 2009). Borrowers speculating to sell their properties and utilise proceeds in settling loans while making a profit, were shattered due to the declining asset prices as a result of the bursting of the bubble. The 'Bubble collapse' hypothesis assumes that the speculators purchase a financial asset at a price above its fundamental value with a view of selling it at an inflated value at a subsequent date with the successive capital gains of the asset in speculation. In each period the bubble grows or collapses with a positive probability until at an unexpected date the bubble explodes creating chain negative reactions in the economy. Collapse though unexpected, market participants are aware of the existence of the bubble and the probability distribution regarding its explosion. As per the asset pricing theory, the value of an asset is dependant on the net present value of the expected future cash flows of that specific asset. In arriving at this, the cash flows from the asset in question are discounted at the required rate of return of the asset derivable through the 'capital asset pricing model'. Low interest rate policy adopted by the US monetary authorities led to the depreciation of the dollar. Dollar depreciation and the creeping global inflation compelled the US to revise interest rates upwards. This led the mortgage rates to increase and triggered a chain of events. Mortgage holders who could not payback their loans defaulted; leading to a collapse in the real estate bubble resulting in a loss to those who invested in debt securities. With this the inter-bank lending frozen, panic created in the market led people withdrawing their deposits resulting in a loss of liquidity leading to a series of bank closures.

'Fear' among depositors and investors resulting in 'financial panic' led to the withdrawal of their investment, crashing the market due to illiquidity. 'Financial panic', is an adverse equilibrium where the creditors withdraw their money unexpectedly from a solvent borrower due to adverse information regarding the status of the borrower. Failures of major institutions such as Lehman Brothers and Merrill Lynch together with the continuous flow of adverse news regarding the earnings and liquidity situations of many international and regional financial institutions aggravated the crisis, and built up suspicion among the borrowers and lenders, resulting in an illiquid market. The entire credit and the financial market are based on trust. Loss of trust led to a drastic decline of the credit volumes and the credit flows. Lending rates increased as never before, implying significant shortages. Unwillingness to lend or invest led stricter lending and investing standards.

In the theory of 'Asymmetric information', problem of 'Moral Hazard' is another phenomenon that led to the global financial crisis. Moral hazard refers to a situation where one side of the market cannot observe the actions of the other. For this reason, it is sometimes called a hidden action problem. It is the 'recklessness' of the institutions that leads to a moral hazard problem. Depositors invest their moneys in banks and other financial institutions with a presumption that adequate care would be exercised by the management to invest these in a diversified portfolio as to minimise the risk of financial collapse. Depositors are not in a position to monitor closely the actions of the managers to whom they have entrusted their money. Liberal

policy of the US banks in furnishing loans to the property sector was taking undue risk and a sign of failure of their stewardship. Other market participants, auditors and credit rating agencies, had also not been trustworthy in verifying and reporting on the financial statements of these institutions which was one of the leading factors resulting in a financial crisis.

Conclusion

In practice, all markets operate under asymmetric information conditions. Such an environment breeds speculators in search of fast money leading to market bubbles. Appetite of economies around the globe, moving in the direction of trade liberalisation and relaxation of rules and regulations adds more to the risk of making market predictions. With unexpected bubble bursts', financial crisis lifts its ugly face with the creeping financial panic.

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most powerful state economically and politically.

The geopolitical reality today is much different. The bipolar world that emerged since the Second World War is dead and gone. Also the unipolar world that emerged after the demise of the USSR and other socialist states has undergone significant changes. What is emerging today is a mulch-polar world where China and India are emerging, as new giants. In another two decades, China is to replace the US as the world's biggest economy. Already, real production has shifted from the developed world to the BRIC nations, Eventually, the centre of gravity of the world economy will shift to China which would generate tectonic shifts in the world balance of forces.

These developements are likely to have their repercussions on the world financial architecture. The crisis has already made the G -7 an anachronism. The G-20 is increasingly filling the vacuum, but it is the G-192 which should ultimately take the controls at the helm.

In the short-term, we could see a relaxation of IMF conditionalities in loan disbursement. This will be proportionate to, the strengthening of the developing nations in geopolitics and the growing strength of their position in the world economy.

In the long-term, whether IMF would discard its neo-liberal policies or not would depend on the economic and political developments in the world. The reform of the IMF would also be protracted and long just as it would be a long process for the world economy to get out of the present crisis.

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