# Financial Sector And Recent Economic Crisis: Searching for Reasons and Policies for Containment

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***Abstract :***

*Business cycle is the natural occurrence of the market economy originating due to over production dampening the business expectation and reducing investment demand. In recent years , business cycles are occurring due to frantic activities in the financial market. Financial sector and real sectors are interconnected. The financial sector boosts consumption and investment demands in the real sector through credit or asset creation. During boom activities in financial sector is hailed for its ability to create enough liquidity in the economy to finance higher growth while during recession credit chrunch dampens the real economic activities. Recession results into large scale unemployment leading to socio- economic sufferings. The recent global recession has been a great concern world wide. Though some countries are able to cope up with this recession others are still struggling to find long term solutions. Main issue for recent recession was the role of banks in over leveraging the power of credit asset creations through distribution of risks in the asset markets. Asset markets on the other hand could not price the assets due to non transparency and complicated process involved in asset creation. Prices did not match the riskiness of the assets thus the investors were duped by the market. Also regulatory authorities could be flouted by carrying out over the counter transactions. Thus flows of hot money created instability and high risks in the system.*

*This Paper gives detailed analysis of above aspects and then discusses why Financial stimulus of Keynesian type were used as an immediate measure. Then the paper also focused on the suggestions that are being offered for long terms reforms in the financial sector so that inherent moral hazards in the credit and asset markets can be tackled in the long run*

**Business Cycle and economic Crisis:**

Market Economy goes through cyclical patterns of boom and trough in its trajectory of growth. US, Japan and economies of western Europe have been passing through cycles of boom and burst time and again. The during the peak period business expectation soars high as a result of which both investment and consumers demands keep expanding. Then just after

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frantic economic activities in all fronts viz. employment, investment, consumer spending and growth of output, economic activities tend to shrink fast leading to recession. Observed common reason is dampening effects on business expectations due to external or internal economic environment. Economic indicators that reflect the onset of recession are reduction of both consumer and investment demands. In the period of recession economic activities keep shrinking through reduction in consumer and investment spending leading to unemployment and slowing down of output. Intensity of recession could be strong enough to slide the economy into negative growth.

**Transmission of cyclical pattern between financial and real sectors:**

Cyclical behavior of the economy could trigger either from the real or financial sector. Real economic activities such as investment and consumption are actualized through flows of funds for investment and for consumer spending. This linkage between the real and the financial sector creates transmission mechanism between these two sectors.

Central banks being the apex body of banking and non baking sector (Financial sector), introduces several methods to create liquidity in the economy so that both investment demand and consumer spending are financed sufficiently and the economy can have steady growth. The challenge for the central bank as the regulating authority to maintain money supply in accordance to the growth of the real output so that these two spending are not restraining actualization of demands. Banks respond to economy's short term as well as long term demand for liquidity through credit creation. Keynesian economics, explains how the public's demand for money to invest on financial assets gives different dimension to the occurrence of business cycles from the money market. Investment in the financial assets promises uncertain higher returns. Those who are capable or willing to risks of uncertainty in expectation of higher return, invest in the financial assets. Risk appetite of the investors may increase due to better availability of information and improved perceptions due to experience of operating in the risky asset markets. Risk appetite also can increase through the possibility of marketing risks of assets and provide leverage to the credit system. Frantic activities of in the asset markets result into boom in the real economy and then in the next period a crush in asset price could cause stock market collapse and then spreading recession to the real market. High transactions on financial assets in the asset markets could raise asset prices and this in turn may increase real demands due to wealth effects. The table 1 summaries the linkages between real economic activities such as consumption and investment and financial sector. Higher/lower funding costs and risks perceptions reduce/increase investment demand for funds/finance as well as bank's willingness to lend. These also affect credit availability as well as quality of credit. In tern it affects firm's net worth through dampening/ increasing the equity price. On the other hand, households net worth is affected through movements of asset prices. Exchange rate movements induces flight of funds to the safe haven and to the regions of strong currencies which in turn influences trade flows. These interconnection between real and financial sector, transmit high and low activities in these sector cause boon and recession in the economies.

**Table 1**

**Connecting the Financial System to the Real Economy**

| Channel | Mechanism |
|---|---|
| Funding costs | Higher interest rates, higher spreads and lower equity prices increase funding costs, reducing investment |

| Risk aversion<br>willingness to lend | banks' and other financial institutions' risks perception affects |
|---|---|
| Credit availability<br>quality credit availability. | Higher risk aversion drives up risk premium and leads to flights |
| Firms' net worth | Lower equity and property prices drive down firms' net worth, increasing the problems of adverse selection and moral hazard |
| Household net worth | Lower equity and property prices reduce individuals' net worth worsening creditworthiness, making borrowing more difficult |
| Exchange rates | Flight to "safe haven" currencies, and reversals of capital flows, affect exchange rates, which have trade effects |
| Confidence<br>curtailing of their activities | Consumer, business and investor confidence fall leading to a |

**Source:** Cechetti, Stephen G et al (2009), Financial Crisis and Economic Activity, August, BIS

The Glass-Steagall Act of 1933 in USA prohibited commercial banks from engaging in investment on financial assets specially which are of speculative in nature. Investment banks' activities may create instability and bubbles through financing assets and hedge funds on various markets such as foreign exchange markets, land markets and housing markets. The risks in areas are high for moral hazards arising out of asymmetric information of quality of assets traded in those markets . These are specialized activities of investment banks. The act was repealed in 1999 and now commercial banks offer credits for trading and stock market activities. This has enabled the commercial banks to enter into asset markets and though this had increased their profitability, their risks exposure have increased to a great extend.

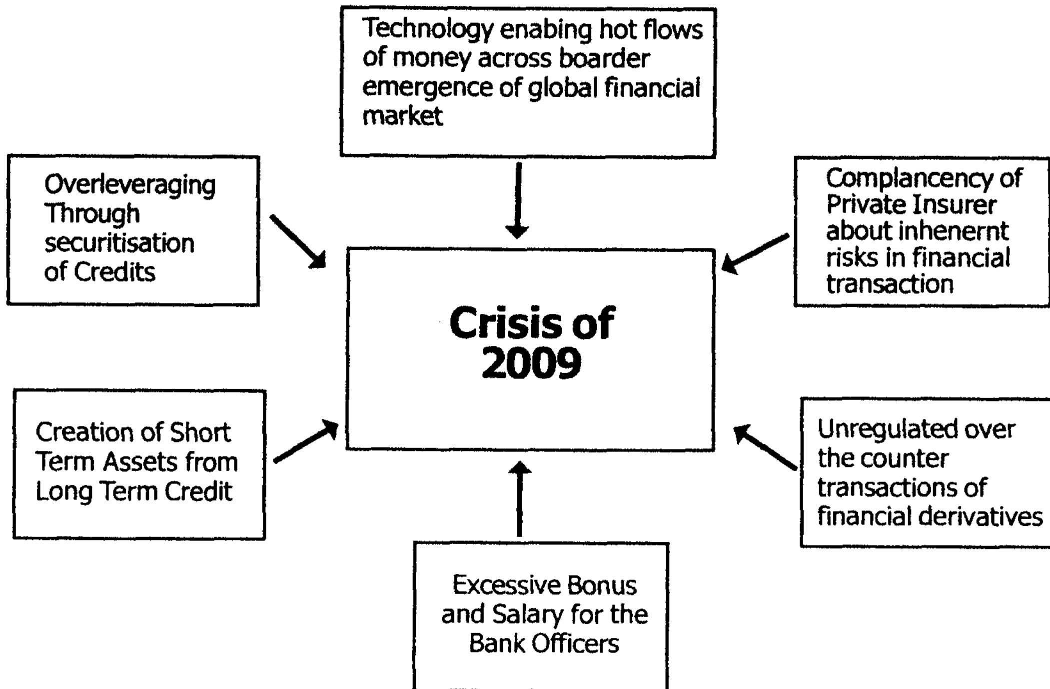
### Recession of 2009: possible reasons offered by different schools of thoughts:

Recent recession is described to be worse since 1930's depression rocked the world. The intensity and the spread of this recession have been attributed to interrelated factors described in the flow diagram.

### 1. Technology and New trends in Monetary Economics

Magnitude and depth of present financial crisis and it contiguous effects are much stronger due to trend in the New Monetary Economics (NME) evolved in recent times.In the new Financial System, tangible money ( Paper Currency ) has increasingly being replaced by book keeping 'accounting money' which is inherently free from the control and regulation of apex institutions. This system has increased the power of the investment banks to take risks exposures. Accounting money enabled the banking system to enter into international transaction at an unprecedented speed. Banks have been operating offshore transaction deals in search of safe haven and high interest rates. Some of the possible factors behind the current global financial crisis may be traced into the deeply flawed institutions and practices in the global financial and domestic systems of many countries.

**Diagram 2**




2. **Securisation of credit- A new leveraging System:**
Banks and Non banking financial institutes have also leveraged their lending through complex method of securitization of credit. New financial instruments such as Asst Based derivatives and CDS created through securitization of credits were offered to the public. Apparently, financial institutions described the process of securitization as marketing risks of the financial assets to those who are less risks averse and ready to accept higher risks for higher return. But the system was evolved with fault concealed in it. For instances

(a) This process was engineered by highly paid intermediaries having no stake in the risk bearing. The Asset Based Security market emerged both in America and Europe and in limited ways in the emerging economies which leveraged capacities of both banking and non banking sectors in credit creation. Securitization was introduced in the credit card market, car loan market, durable household good market and housing sector. Banks and financial institutes offered in some occasion 100 per cent credit without insisting for mandatory margin requirement for the borrower. Easy terms and condition of loans made investment in the housing sector more attractive. Excessive loan creation to those lacking creditworthiness led to non payments of debts. In the housing sector, crisis turned serious as the housing price started falling which eroded the asset base of the financial institutes.

(b) These assets were not shown in the balance sheets of the banks for which financial weakness of banks could be concealed from the regulators and the investors. Result was that erosion of capital base of lending bankers which could be concealed until the moment of reckoning came up and they had to declare bankruptcy.

(c) As the leveraging process picked up Banks and financial Institutes changed their

strategies and entering into more riskier market and adapting lower capital base.

3. **Long term credit converted into short term derivatives** :

   Derivatives were created to transform long term credits into short term assets so that they can be sold through over the counter. Shadow Banking system of investment banks, hedge funds and other bank created special instruments which were short term in nature. According to Bank of International Settlement the gross value of over the counter deals of short term unregulated financial assets increase to $33,8899, in 2009 from $791billion in 2006.

4. **Bank CEOs paid exorbitant salary and bonus.**

   This brought about distortion in allocation of human resources most of the skills were going to the financial sector for introducing innovative instruments in the sector to create financial assets from least liquidity backing.

5. **Risks of the assets insured by private Insurance companies:**

   Regulatory authorities could not give any guarantee to the buyers of these securitized assets while insurances were provided by only private insurers. Most of these derivatives were bought and sold on bilateral basis further weakening the process.

**Role of unregulated credit rating agency**:

In this situation the market did not reflect the risks because unregulated credit rating agencies did not project the riskiness of the securitized assets. Prices of assets were overvalued and riskiness were concealed thus depriving the investors to take rational decision on their investments. In other words they were taken for a ride through existence of information gap.

**Consumer borrowing leverage :**

American Economy went through the spree of over consumption due to easy availability of loans and false sense of wealth arising out of increase in asset prices e.g. stock prices and housing prices. Some of them invested in the housing sector and stock market. Most of them borrowed from the financial institutes to buy durable consumer goods such as cars, TVs , refrigerators etc thus proving their present consumption in order to pay back in future. Yet multiplier effects of demand boost could not be retained in the economy due to globalization. Emerging economies were benefited through demand boosts in the US economy. In US Saving as a share of disposable income fell steadily from around 10 per cent early in 1980s to around 1 per cent recently. This created worldwide imbalance. Emerging economy such as China has very high rate of saving and export surplus which was invested in US Govt. securities. On the other hand US economy experience heavy deficit in trade balance. Export surplus generated in emerging economies were invested in the US pubic Securities Currently External Debt forms 25.60% of total debt in 2008 which was 17.30% in Sept 2001. It is ironical that a large part of this flow resulted from the investment of reserves from developing countries such as China, India, and petro-rich countries like Saudi Arabia and Russia. This is referred as imbalance in the world economy created through the systemic fault in the global financial sector.

**How was the point of no return reached**

Gradually the process of securitization through conversion of long term credits into short term assets became complex and connection between original credit and assets were turned into long process to be checked by the system. Some of the banks became too big and controlled the global financial system and transactions on financial instruments. These super firms being those able to generate cash with minimal capital, went into housing loan sector to finance subprime creditors. When housing prices collapsed much of these "safe assets" turned toxic, the system crumbled. Since banks were operating with minimal liquidity and their fellow bankers were unwilling to trust the asset base securities any more, some of the big banks were on the verge of bankruptcy. The loss of capital valuation of financial assets world-wide may

have reached well over US $ 50 trillion in 1998. This loss in capital stock has been very significant, amounting to about equivalent of one year of world GDP.

**Management of Crisis: Two Tools - monetary and fiscal:**

Management of recession has been suggested by two schools of thoughts namely monetarists and Keynesian economists. While monetarist suggested cuts in interest rates to boot the investment and consumption demands, Keynesian economists believe that fiscal policy and govt. intervention can only solve the problem. Monetarists believe that fiscal stimulus and govt. regulation will only worsen the long term prospects of recovery as govt. deficit financing would soar thus forcing the govt. to reduce its expenditure in future and hence possibility intensification of demand recession starting due to contraction of govt. spending. Monetarists view the Keynesian approach as mismanagement rather than management of recession.

Yet during the present recession, monetary policy did not work in most of the developed economies. These economies were in liquidity trap due to grim future expectation of the market as well as lack of creditworthiness of the consumer. As P Krugman lamented, investors are not investing and consumers are not spending even though interest rate was reduced to near zero. This made it imperative for governments to rely on fiscal policy to stimulate the recession stricken economies. Govts. injected astronomical amount of bail out money to support the liquidity positions and save some big banks from bankruptcy (table-2 below). Some govts. even had chosen to partially nationalize the ailing banks. Some of the medium and small banks were allowed to liquidate themselves. Though Keynesian fiscal measures exhibit some recovery, the process has been weak in most of the developed economies. The policy created another problem and the seed of another crisis due to high govt.'s deficit financing. Economies of Euro zones such as Greece, Spain and Italy have now very high deficit spending to GDP ratio, though economic crises are far from over.

**Table 2**

**Astronomical sums will be spent in different countries to boost economy**

| Country | Amount US $ | % of GDPI | Country | Amount US $ | % of GDPI |
|---|---|---|---|---|---|
| United States | **787.0** | **5.8** | Australia | **36.4** | **4.0** |
| Canada | **28.7** | **2.0** | China | **586.0** | **15.0** |
| United Kingdom | **30.8** | **1.1** | India | **14.3** | **1.3** |
| Germany | **102.9** | **3.1** | Russia | **14.2** | **1.1** |
| France | **38.9** | **1.5** | Brazil | **2.6** | **0.2** |
| Italy | **90.5** | **4.3** | Other Countries | **80.6** | |
| Japan | **87.6** | **2.0** | Total | **1 900.5** | |

**Search for long term reforms for stability:**

In the second stage of management of crisis, there have been serious thinking and suggestions on policies that could ensure a long term economic stability through either self correcting mechanism or through govt. intervention. Of them, debates on reforms regulating fin systems emerge as the single most important issue. Observations show that financial regulation was both inadequate in certain areas and fragmented. Hence regulatory structure needs to be rebuilt to revive the confidence of global investors and customers. Suggestion can be categorized in two: Firstly broadening the scope and secondly tightening the noose of regulation were supported by a large section keeping in view that irresponsible behaviors

of the fin institutes that brought the whole world at the brink of collapse. Others are of opinion what ever regulations are introduced, the systemic weakness is going to arise leading the globe to another crisis which could be more serious. This is because regulations work only when this is in the interests for those who are regulated. Hence it is the need of time to evolve a model so that onus of irresponsible behaviors falls on those who execute them. In other words self regulatory mechanism is the answer to the stability of the economic system.

Those who believe in direct financial regulatory system suggest the following:

1. Regulatory system needs to expand its perimeter to regulate over the counter deals, hedge funds, commodity and other derivatives. Trading in these short term derivatives were completely beyond the control of regulatory bodies and thus created flows of hot money in around the globe. It is also necessary to establish comprehensive supervision of financial markets. Major financial markets must be strong enough to withstand both system-wide stress and the failure of one or more large institutions.

2. Regulation of securitization are suggested including new requirements for market transparency, stronger regulation of credit rating agencies, and a requirement that issuers and originators retain a financial interest in securitized loans.

3. Also for protecting consumers and investors from financial abuse, it is necessary to promote transparency, simplicity, fairness, accountability, and access. A new Consumer Financial Protection Agency to protect consumers across the financial sector from unfair, deceptive, and abusive practices should be introduced.

4. Raise international regulatory standards and improve international cooperation. International reforms in co-ordination with domestic regulatory system, including strengthening the capital framework; improving oversight of global financial markets; coordinating supervision of internationally active firms.

**Reforms to introduce self regulation:**

1. 1. Restriction on Bank sise:

   America raises objection to the big size of investment banks and wants to curb the size as concentration in financial business is looked as the source of non transparency. The "Volcker Plan" and the "Obama Levy" are proposed to curtail the size of the bank and their risks exposure. The president Obama is also in favour of restraining the salaries of the top official of banks.

2. Macro-prudential regulation such as counter-cyclical charges and minimum liquidity buffers: Risk related to leveraging can be reduced in two ways (1) introducing risks weighted capital requirements and (2) introducing leverage ratio i.e. capital divided by assets including off balance sheet items to limit overall leverage in financial institutions during an upswing.

3. **From bail out to bail in:** In an article in Economist two authors, Paul Calello, the Head of Credit Suisse Investment Bank, and Wilson Ervin, the former Chief Risk officer of the same institute propose a new bail in process for resolving failing Banks. They explained how instead of using tax payers money to bail out ailing banks there could be internal process of recapitalization. According to them if done correctly it should strengthen market discipline on banks and reduce the potential for systemic risk. This procedure is followed in recapitalizing airlines other big firms.

**Conclusion:**

Though business cycle is a common phenomenon for the market economy, present cycle of recession appeared with unprecedented intensity and spread after 1930's depression. Two economic policies namely monetary and fiscal that were used to manage cyclical behavior since the great depression have not been working rather creating further unmanageable situations. Examples for Greece and

US have provides enough lessons that fiscal stimulus of any large amount will only increase govt. deficit and create another situation of govt's bankruptcy leading to further recession. Greek economy is labouring under a budget deficit of 13.6% and a stock of debt equal to 115% of GDP

Developed economies may take long term to correct the imbalances created in the economies that led to negative savings for the economy, balance of trade deficit and govt. expenditure deficits. Developed economies need to boost productivity of labour proportionate to the rise in income. These are real sector reforms which some of the economies are contemplating. Emerging economies are in better position to manage recession with their rise in productivity, capacity generation in the capital goods sector and expansion of domestic market. However, lesson of recession that no economy emerging or mature can neglect trends in real sector for management of recession.

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