

Return of financial crises: old and new causes

IVÁN BÉLYÁ CZ¹

The financial crisis prevents financial markets from functioning efficiently and results in the contraction of economic activity. The causes of the financial crisis should be explored in order to avoid them in the future. Based on an exhaustive analysis of a certain number of selected bibliographic sources, this paper focuses on the main characteristics of financial and equity crises, the asymmetric information approach, the role of uncertainty in the development of financial crises, the short-term commitment of investors (security holders). Today, there is every reason to expect another (possibly global) financial crisis. Financial markets are tightly interconnected, and a new crisis could emerge anywhere, as the global financial crisis results from an unfortunate interplay of internal and external factors. To answer the question of how to respond to worrying imbalances and problems on the forecast horizon, we can only say that the financial crises predicted by market participants rarely occur where and when they are expected and are assumed to arise due to pervasive uncertainty.

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The emergence of financial crises

According to Mishkin (1991), a financial crisis is defined as a disturbance in financial markets. The situation of adverse selection and moral hazard worsens, and financial markets cannot channel funds efficiently towards the most productive investment opportunities. The financial crisis prevents financial markets from functioning efficiently and results in the contraction of economic activity. In financial crises, the economy can shift from an equilibrium state of high output (in which financial markets function well) to a state where output falls severely as the financial system fails to channel funds toward high-yield targets.

The causes of the 2007-2008 financial crisis should be explored in order to avoid them in the future. Regulators should choose the most cost-effective ways to reduce systematic (market-based) risk. Experience shows that three types of reforms have been implemented since the financial crisis: preventive, rescue and restructuring reforms. The general opinion is that emphasis should be shifted from rescue reforms to preventive and restructuring interventions.

¹ PhD, Professor emeritus, Regular member of the Hungarian Academy of Sciences.
e-mail: belyacz@ktk.pte.hu.

The 2007-2008 financial crisis developments demonstrated the importance of fundamental uncertainty. A genuine environment of uncertainty arises when financial market participants cannot imagine all possible scenarios of future events, either because they do not completely understand the full spectrum of consequences or because they cannot assign a specific probability to each event.

Disaster myopia can be defined as a systematic tendency of financial market participants to underestimate the probability of a shock. The financial and economic shock in general (Guttentag–Herring 1986) and the financial crisis of 2007-2008 in particular were characterised by catastrophic short-sightedness, especially in the housing and credit markets (Cornand–Gimet 2011).

One of the primary explanations for the previous financial crises reflects a monetarist perspective. Friedman–Schwartz (1963) linked the financial crisis to banking panics. The importance of this was stressed because, in their view, it was the cause of the contraction in the money supply, which in turn led to a reduction in aggregate economic activity. Monetarists ignored financial crisis events which, while causing a sharp fall in asset prices and an increase in business failures, did not trigger a banking panic or reduce the money supply.

The monetarist explanation for financial crises does not give a time-determination of the banking panic, i.e. why it happens when it does. On the other hand, asymmetric information analysis treats banking panics due to high-interest rates, corporate failures, or weak business opportunities, with deposit account holders worrying about whether their money is safe with the banks. Deposit account holders can't get out of bad banks without a loss when the information that is damaging to those banks is made public.

Kindleberger (1978) and Minsky (1972) take the opposite view of financial crises; they give a broader definition of the financial crisis than monetarists. In their view, financial crises include a sharp fall in asset prices, the failure of large financial and non-financial corporations, deflation, disturbances in foreign exchange markets, or some combination of these. As they define the emerging financial crisis more broadly, the authors argue that extensive government intervention is warranted when detecting any of these disruptions, as they may have severe consequences for aggregate economic activity.

Information asymmetry: adverse selection and moral hazard

Financial market transactions are subject to information asymmetry, where one party does not know all the information about the other party, which is

necessary to make correct decisions. For example, the borrower usually has better information than the lender about the potential return and the risk associated with the project to be undertaken. Asymmetric information can cause problems in the financial system in two primary ways: before the transaction takes place (adverse selection) and after the transaction takes place (moral hazard).

Since adverse selection is likely to make a loan risky, it is also possible that lenders will not lend even though there are no credit risk problems in the market. This outcome is a feature of the classic “lemon problem”, which was first analysed and described by Akerloff (1970). As suggested by Myers–Mayluf (1984) and Greenwald et al. (1984), the lemon problem occurs in bond and equity markets when lenders have trouble determining whether they are taking a reasonable risk by lending (financing low-risk, good investment opportunities) or, conversely, a bad risk (financing poor investment projects with a high risk).

Moral hazard occurs in financial markets when the loan has already been issued, and the lender is exposed to risk because the borrower commits undesirable (immoral) acts from the lender’s point of view, which increases the risk of failure. Moral hazard arises due to asymmetric information because the lender has no knowledge of the borrower’s actions, which allows the borrower to commit moral hazard.

One way to solve the problems caused by asymmetric information is to use collateral in financial markets. The collateral reduces the consequences of adverse selection or moral hazard by mitigating the lender’s loss in the event of default. If the borrower defaults, the lender takes title to the collateral and sells it, eliminating credit loss. Accordingly, if the collateral is of reasonably good quality and the fact that there is asymmetric information between the borrower and the lender is no longer important, the loss is recovered (in whole or in part) for the lender because the loss on the defaulted loan can be substantially reduced.

In a persistently low-interest rate environment, the fight for yields has found another attractive source in the deceptive appearance of collateralised loan obligations. This construction bears many similarities to the now infamous mortgage-backed securities of the previous crisis.

During the mortgage-backed securities boom, banks that bundled loans with different credit ratings took the risk off their balance sheets. Over time, this practice fuelled low-quality lending, as banks did not have to bear the consequences of bad loans. The pooling centres (financial institutions) that now

bundle corporate debt continue the same practice. The financial institutions that benefit from the increasing volume of corporate debt do that at the cost of a slide down the quality scale of debtors. Not only are new loan requests coming from low-quality companies, but the commitments are also associated with an erosion of collateral quality.

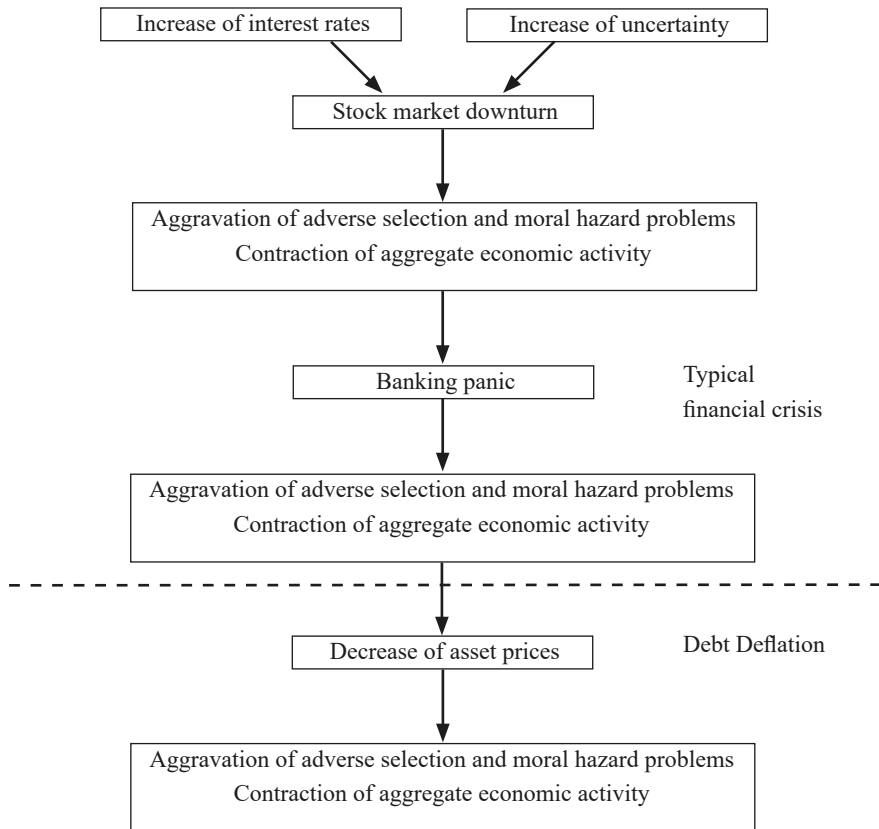
The analysis of financial crises shows that the asymmetric information approach provides a more plausible explanation for the facts than the monetarist view. Although it attributes a vital role to banking panics, the asymmetric information view of financial shocks does not consider them as financial disturbances with negative effects on the macroeconomy. A financial crisis with a negative impact on the economy as a whole can occur even if there is no threat to the banking system. The asymmetric information analysis suggests that the lender of last resort role may become necessary to provide liquidity to the non-bank sector in the financing system in which the asymmetric information problem has evolved. It further suggests that financial disturbances outside the banking system can have serious adverse consequences on the macroeconomy. These negative consequences can only be averted by swift action by the central bank to expand the role of the lender of last resort (Mishkin 1991).

However, according to the asymmetric information approach, the reduction in the money supply that occurs in the wake of the financial crisis does not tell the whole story of how the financial crisis affects the functioning of the economy as a whole. Instead, a much broader view of the financial crisis is needed, and a different perspective is required when it is more about the real economy.

The chain of events above the dashed line (Figure 1) happens in almost every financial crisis, while those below the line will emerge only if the financial crisis grows into debt–deflation.

Crisis of liquidity or crisis of return on equity?

Governments and central banks worldwide tackled the 2007-2008 financial crisis by saving liquidity, thus laying the foundations for the next potential financial crisis. To do that, more money had to be created to solve the liquidity problem. What if excess liquidity were the primary source of the financial crisis? There are many indications that some of the previous financial crises were not liquidity crises but return-on-equity and equity shortfall crises.



Source: Minsky (1991. 12)

Figure 1. Chain of events in the financial crisis

If people create money by borrowing from the private sector, that puts the central bank in a “bad bank” position because that is the place where the bad loans accumulate. Instead, commercial banks accumulate new money reserves in record amounts. Since the financial crisis of 2007-2008 was identified as a liquidity crisis, its cure ultimately led to the global financial system being flooded with a waterfall of money.

If the capital return crisis is misdiagnosed as a liquidity crisis, then monetary bailouts, corporate bailouts, and flawed investment management will continue, and corporate and macroeconomic capital structure will become even more distorted.

What would happen if the next financial crisis turned out to be a return-on-equity crisis? It would prove that the financial crises of the past decades were primarily return-on-equity crises. These financial crises, equity crises, were temporarily treated with more liquidity, which proved to be a symptomatic treatment. Although all financial crises appear to be liquidity crises in their external form, at the heart of the crisis lies a slow rate of return or a complete lack of return on equity.

The expansion of global liquidity has led to debt accumulation by a wide variety of actors. Excessive government spending has created a massive mountain of debt in the public sector in many countries. In the private sector, credit is easy to obtain for the expansion of production, and the aim is also to encourage consumers to borrow. Companies have accumulated debt at low interest rates because mediocre and weak projects are also attractive in such an environment. In any such case, the process of indebtedness is unsustainable. Many borrowers know this, but the temptation to increase debt at any cost is strong because low interest rates are so attractive that they are hard to resist.

Low interest rates have not only encouraged domestic borrowers – governments, companies, and consumers – but have also attracted foreign borrowers to emerging economies, especially governments and companies.

Global debt, fuelled by central banks' monetary surpluses, has increased the fragility of the financial system. The number of financial market operators is growing, and their equity capital is too low to compensate for the unexpected fall in asset values. Too many of these institutions are banks in need of rescue – especially in times of crisis. They operate on the basis that, in case of trouble, the state must hear their cry for help. The managers of indebted companies and financial institutions say that the whole financial system will collapse if the state does not help.

This was the practice during the 2007-2008 crisis. As a result, the intervening governments accumulated internal debt and entered a state of fragility themselves. The question is who will rescue the rescuers in the next financial crisis? (Mueller 2018)

If – as is the case today – the managers and executives of international banks and funds and the credit rating agencies focus on economic growth rates, investment rates, and price levels, they can diagnose the state of the economy on these bases and pay less attention to the quality of assets and liabilities, the level of indebtedness, its changes, and therefore be exposed to misjudgements again.

The state and the central bank seem to be healers of last resort, unlimited lenders of last resort. The state is hailed as the saviour even though, together with the central bank, it plays a significant role in creating financial crises through an expansionary monetary policy. One of the great delusions of our times is portraying economic and financial crises as failures of the free market, ignoring the crucial roles of the state and the central bank and the strict state regulation of financial markets. The fact is that the destructive boom and bust cycle can only be broken if the state withdraws from both investment management and money creation.

Government bailouts of some companies may have the significant disadvantage of keeping inefficient companies alive and may increase the risk that some companies might (undeservedly) rely on those bailouts. In essence, this will lead to a re-emergence of the asymmetric information problem, as governments are unlikely to be able to separate insolvent companies from temporarily illiquid ones. Furthermore, political pressure may influence decisions to bail out companies and banks at the expense of economic efficiency.

Uncertainty, bubble, noise trading

Uncertainty plays a role in the development of financial crises. Risk and uncertainty are often misinterpreted as the same phenomenon, but there is a significant difference between them. Risk refers to calculating the probability of a future event, while uncertainty refers to the lack of perfect foresight about any unforeseen event that may occur in the future. In other words, when decision makers have high confidence in their estimates, it is pure risk, and when they have low confidence, it is uncertainty.

A special place among the arguments for uncertainty is given to the so-called “black swan” occurrence, which refers to very rare and unexpected events. Because of their low probability, decision makers do not expect them at all and thus tend to neglect them. A source of uncertainty can be the situation when little is known with certainty about the future payoffs of investment decisions made today. In financial markets, a random walk indicates that asset movements do not follow any trend or run-off pattern and that past price movements are inappropriate for inferring future price movements.

An important manifestation of investor uncertainty is that it is never possible to know with absolute certainty whether the investments traded on the market are overvalued or undervalued.

Adding to the uncertainty is the growing number of so-called “noise traders” among financial market investors seeking to raise and spend funds ad hoc and the decreasing number of market participants relying on information and analysis.

A growing proportion of investors are security holders with a very short-term commitment, which implies a short-term orientation and increases financial market uncertainty (Reinhart 2019).

Mishkin (2009) argues that valuation risk plays a vital role in the emergence and deepening of the financial crisis. This risk also determined the re-pricing of structured credit products during the 2007-2008 financial crisis, as investors sought to understand how subprime mortgage bonds with high potential losses could have passed through the complex valuation process. Placing the problem in a broader context, Trichet (2008) argues that the deeper cause of the relevant financial crisis was the widespread and massive underpricing of risk by markets, financial institutions, and countries. He attributes this to two critical factors. The first is that the probability of certain events was misjudged; that is, these events were considered too unlikely, if not downright impossible. The second is that the effects of increasing fundamental uncertainty were neglected across all versions of asset classes.

The disruption of efficient financial market functioning and the emergence of financial asset price bubbles are symptoms of financial crises. In such cases, asset prices rise much faster than fundamental values, which can eventually burst as prices fall. Reinhart–Rogoff (2008) points out that the technical explanation for the phenomenon of financial bubbles differs significantly from the everyday perception. Fama (2014) points out that financial market bubbles are relatively easy to identify based on the facts but almost impossible to predict in advance. A good decade after the mortgage-backed securities bubble burst and despite tighter regulations, the hot market that led to the emergence of the asset price bubble is still active today. With a rapid increase in the global supply of financial assets, the potential for bubbles to form is increasing, supported by strong investor interest. There are four main stages in the formation of speculative financial bubbles: stealth, awareness, mania, and blow-off (Dedu et al. 2012), but the financial crisis can also be analysed based on behavioural, structural, and cyclical factors. Highlighting behavioural factors, biases, heuristics, and emotions contribute to the breakdown of ethical behavioural standards in financial markets. For example, optimism and wishful thinking, overconfidence, enthusiasm and resignation,

avoidance of responsibility, the “times are different today” syndrome, or any combination of these can have an impact.

Epilogue

Today, there is every reason to expect another (possibly global) financial crisis. The effects of the pandemic and the brutal war on the production process, the disruption of supply and value chains, the isolationist and self-sustaining tendencies that defy globalisation, the accelerated inflation, and the rise in interest rates could all contribute to the contraction of liquidity. Financial markets are tightly interconnected, and a new crisis could emerge anywhere, as the global financial crisis results from an unfortunate interplay of internal and external factors.

When we look for an answer to the question of how to respond to worrying imbalances and problems on the forecast horizon, we can only say that the financial crises predicted by market participants rarely occur where and when they are expected and are assumed to arise due to pervasive uncertainty. The mood of market participants can shift from euphoria to fear, and vice versa, as a permanent transformation. The sudden burst of fear or euphoria is a phenomenon that no one can foresee.

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