Financial Crises: Can They Be Prevented?

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Recently, Paul Krugman, the American winner of the 2008 Nobel Prize for Economics, in his first address after being conferred the award admitted to the whole world that he actually failed to see how big the current economic crisis would get and how bad the US housing crash was going to affect other economic indicators.[1] Alan Greenspan, the former chairman of the Federal Reserve Board and regarded by many economists to be the expert among experts to the point of being an economic sage, in his recent testimony to the American Congress also admitted that he too did not foresee the current financial crisis. And Jeffrey Sachs famously praised the dynamisms of the South East Asian countries shortly before they spectacularly collapsed in 1997.[2]

It is also remarkable that, arguably the worst financial crisis in the history of mankind, is taking place in America, a country that is perceived by many to have the most advanced financial sector, have the most advanced regulatory control systems, have the best finance and economics departments, and have the most number of world-class Nobel laureates in the field of economics and finance. Obviously this topic of financial crises can be quite complex.

Therefore, what else can I say except to express my feeling of being deeply honored to have all of you here listening to me speak on a subject which even people like Paul Krugman, Alan Greenspan, Jeffrey Sachs, Henry Paulson, Ben

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[1] http://www.editorandpublisher.com/eandp/news/article_display.jsp?vnu_content_id=1003873729 (accessed on Nov 1, 2008)

[2] Jeffrey Sachs praised the performance of the South East Asian economies in a series of speeches during his visit to Malaysia prior to the crisis.

Bernanke and experts at those business schools are not able to solve or anticipate. It is my fervent hope that at the end of my lecture today we will all end up more enlightened rather than more confused. But if some of you still feel un-enlightened on the subject at the end of my lecture, don't worry…some very eminent economists are also in the same situation.

I will begin my lecture by explaining the possible reason why people are very concerned about financial crises. Then I will explain the different types of financial crises and also give some examples of each type. I will then describe the history of the finance industry itself and highlight the fact that financial crises at their core are outcomes of over-lending and over-borrowing and are thus integral to the industry itself. My central argument will then be presented that, sadly, the problems are not going to go away as long as the financial industry is legally part of our life.

Ladies and gentlemen, in recent times, financial crises seem to hog the headlines more than other types of crises. People around the world also seem more concerned with financial crises than natural disasters. One possible reason is financial crises seem to be happening more frequently now. Moreover, they have increasingly been more devastating in their macroeconomic effects compared to natural disasters. For example, according to an Asian Development Bank report, the Asian financial crisis of the late 1990s had greater economic effect compared to the tsunami of 2004 because of its prolonged nature as well as its wider impact in terms of geographical scope and the number of economic sectors involved.[3] Another example is of course the current global financial crisis. Even though it started in the US, its effect is being felt in all corners of the world. Millions around the world including in Malaysia will be suffering its negative consequences and nobody knows whether it will get worse and when it will eventually end. It can be a few more months or years or decades. No tsunami or earthquake in history has ever produced such a global and prolonged effect.

Every time a financial crisis takes place there will a plethora of explanations as to its cause. Some are very simple and naïve whilst others are more sophisticated. The former include the theory that they are caused by the Jews. Its proponents surprisingly include one prominent former Prime Minister of Malaysia.[4] (and George Soros became more famous because of that). The more sophisticated types see the phenomena as an outcome of the interaction of a host of factors. In this lecture I have chosen to ignore the former perspective for the simple reason that it is not true. This will become clearer as we go along.

According to Barry Eichengreen, Professor of Economics at the University of California, Berkeley, and an authority on the subject, a financial crisis refers to “a disturbance to financial markets, associated typically with falling asset prices and

[3] Asian Development Bank (2005), “An Initial Assessment Of The Impact Of The Earthquake And Tsunami Of December 26, 2004 On South And Southeast Asia”

[4] Dr. Mahathir stated: "And incidentally we are Muslims, and the Jews are not happy to see the Muslims progress. The Jews robbed the Palestinians of everything, but in Malaysia they could not do so, hence they do this, depress the ringgit." Reported by New York Times, Oct. 16, 1997. http://query.nytimes.com/gst/fullpage.html?res=9B01E1DE153FF935A25753C1A961958260 (accessed on 21 Nov,2008)

insolvency among debtors and intermediaries, which spreads through the financial system, disrupting the market's capacity to allocate capital".[5] A financial crisis is actually a sub-set of economics crisis because economics crises could be caused not only by a financial crisis but also by other non-financial reasons including outbreaks of wars and natural disasters, such as earthquakes, floods, draughts, and plagues.

Financial crises can be further divided into a number of types including currency crisis, banking crisis, and market crashes. Even though they are all inter-related, there are some distinguishing characteristics. A currency crisis is said to occur when the value of a particular country's currency depreciates in a rapid manner relative to other foreign currencies, the most important of which is the US dollar. This can of course possibly lead to other types of financial crises including rapid rise in the cost of imports, rapid rise in the value of foreign debts, asset-market crash et cetera. This can then result in widespread bankruptcies among highly indebted firms thus negatively affecting a country's general economy. One famous example of a currency crisis is the Asian currency crisis of 1997-98. The crisis was caused by over-investment in the Thai real estate sector. In addition Thailand was experiencing a mini economic boom which was largely financed by massive foreign borrowings. As result the economy was suffering from current account deficit. The Thai baht, which was supposed to depreciate under those circumstances, was however being propped up by the Thai government using

[5] Eichengreen, Barry & Portes, Richard, 1986. "**The Anatomy of Financial Crises**," CEPR Discussion Papers 130, C.E.P.R. Discussion Papers

their dollar reserves. Currency speculators soon noticed the fast dwindling reserves and started attacking the Thai baht. Soon the Thai government ran out of dollar reserves and thus was unable to prop up the baht any further. They then decided to float the currency i.e. un-peg it from the dollar resulting in its collapse. The combination of falling currency and massive foreign debts effectively meant that the country was bankrupt. The crisis soon spread to Indonesia, Malaysia and Korea. All these countries experienced a rapid fall in their currencies. In addition their stock and real estate markets, which were also experiencing a bubble, collapsed. Almost all Southeast Asian countries that had huge external debt were facing bankruptcy. Indonesia, Thailand and Korea chose to borrow from the IMF in order to avoid defaulting on their foreign debt repayments whilst Malaysia used internal funds since its foreign debt was relatively small. But all the countries experienced a rapid slowdown in the economy, massive unemployment and widespread business and personal bankruptcies. What is important to note is that prior to the crash, in all the affected countries, there was an economic boom due to massive inflows of foreign funds in the form of either hot money into the stock market or foreign loans.

Another type of financial crisis is a `banking crisis' or sometimes known as a `bank run' which is said to occur when there is a sudden increase in withdrawals of deposits from a significant number of banks in a particular country's banking system. Their cash severely depleted, those banks are forced to close and this will in turn affect a large number of people or firms who are the banks' customers. As a result, there will be a shortage of money to keep the economy going. Actually banking crises have been taking place since banks came into existence i.e. for hundreds of years. But interestingly even until today, they are still occurring despite advancements in regulatory frameworks and oversights. One recent example is the Argentinean banking crisis of 2002. Argentina, at the beginning of the 20th century, was among the top ten wealthiest countries in the world with a per capita income much higher than Japan and Italy. Decades before 2002, the country was already sowing the seeds of a crisis. The main cause was fiscal indiscipline i.e. inability to live within its means. As a result of the bad policies of successive governments, the country was saddled with a huge foreign debt which kept growing. In 1983, the country's public debt was USD46 billion. In 1989 it was USD65 billion and in 1999 it had ballooned to USD130 billion.[6] When Fernando de la Rúa became president in 1999, not only was the country facing a severe unemployment problem, it was also hugely dependent on foreign borrowings. Moreover, the fixed exchange rate regime Argentina was following to ensure stability meant that its peso was unable to depreciate even in a situation of severe trade deficit. This terrible economic situation plus other problems such as rampant corruption and an unstable political situation spooked the confidence of investors who started to take their money out of the country. In 2001, Argentineans themselves began to get nervous about the state of the country's economy and the strength of the peso and started to withdraw large sums of money from their bank accounts. They

[6] Adrian Salbuchi How to Solve Argentina's Recurrent Foreign Debt Crises: Proposal for a Long-Term Solution, Global Research, November 7, 2006 (http://www.globalresearch.ca/index.php?context=va&aid=3750) Accessed on 20th November 2008.

also converted the pesos into dollars and sent them abroad, causing a run on the banks. In order to prevent the country's banking system from collapsing, the government froze all bank accounts for twelve months, allowing only minor sums of cash to be withdrawn. This enraged the population who then took to the streets to express their disgust and anger. Riots took place resulting in a number of deaths. The government was unable to meet its debt service obligations and defaulted on its loans to the tune of USD95 billion. The economic situation became steadily worse. Incidences of business and personal bankruptcies soared. Up till now, the Argentinean financial problems have not been resolved. Their foreign debt stood at USD127 billion at the end of 2007.[7] Only a few months ago there were riots when there was a sudden spike in the price of food worldwide.

A more general form of financial crisis is a `market crash'. This is said to occur when the price of assets such as properties suddenly nose-dive within a short period as what happened in the case of the sub-prime mortgage crisis. It can also be due to a sudden fall in the price of stocks as what happened during the `Dot.Com' crash of 2000. The main problem is the assets being over-priced in the first place, because of either over-optimism on the part of the market or excessive speculative demand. Either way, this will result in an artificially high price for those assets, a situation referred to as an `asset bubble'. When the price suddenly drops, the bubble bursts. This problem will have extremely serious effects if those assets were obtained using borrowed funds. Examples

[7] http://www.aol.com.au/news/story/Argentina's-foreign-debt-surpasses-US127-billion-now-higher-than-after-2005-debt-swap/634311/index.html . Accessed on 20th November 2008.

include the Asian Financial Crisis of 1997 which was explained earlier and the Japanese property crash of the 1990s.

In the case of the Japanese property crash, the very interesting lesson to note is the contrast between Japan and Argentina. Argentina as we saw earlier suffered severe financial crisis due to her profligacy, fiscal indiscipline, persistent trade deficits and huge foreign debt. Japan on the other hand could not be more different than Argentina. It is the most successful country when it comes to exporting and as a result was running trade surpluses with many countries including the US. Its people's saving rate was high and it also has skilled and hardworking workforce. But later on it also suffered a severe financial crisis. You can be excused for being puzzled as to how such a competitive country can end up in such a severe mess. Again the story is about banks, over-borrowing, debt and speculation. The only difference is that whereas Argentineans borrowed excessively from foreign sources, Japanese firms and individuals borrowed from their own banks. What happened was that the saved money including those earned from exports were deposited in Japanese banks. The banks had to earn a profit in order to pay the interest on the deposits. This they did by increasing lending. In total the country's banks lent 353 trillion yen to Japanese companies with more than half going to firms in the construction, retail, real estate and financial services sectors, where 85% of the bad debts are to be found.[8] Asset prices in these sectors went sky high so much so that in the 1980s 250 hectares of land surrounding the Imperial Palace in Tokyo was estimated to worth more

[8] http://news.bbc.co.uk/2/hi/business/1472258.stm . Accessed on 20th November 2008

than the whole of California.[9] Of course much of it later turned out to be speculative, thereby creating a massive bubble. The stock market and property bubbles had to burst one day and it did in 1990 and as a result trillions of yen~~s~~ were wiped out in those markets. The Japanese consumer, fearful of the depressing economic situation, refused to spend which further slowed the economy down to a standstill. Many companies went bankrupt and unemployment rose. The Japanese economy was in the doldrums for more than 10 years causing untold sufferings for the poorest and the weakest. The economy only showed some tentative signs of recovery beginning 2003. However the recent crisis has jeopardized everything because the dollar has fallen relative to yen which renders Japanese exports uncompetitive.

With regard to the present global financial crisis, there is widespread agreement that it was a case of a market crash followed by a banking crisis followed by economic slowdown which is spreading globally. The problem has its origins when Federal Reserve Chairman Alan Greenspan wanted to stave off recession following the Dot.com meltdown of the late 1990s. He lowered interest rates and this caused excess liquidity in the financial market. Mortgage brokers, lured by big commissions, convinced home-buyers with poor or weak credit history to accept housing mortgages with minimum hassle. The mortgage brokers did their jobs very well indeed and as a result the size of this so-called `sub-prime mortgage' sector was huge. This resulted in a housing boom. The size became bigger still largely due to the widespread usage of Collaterized Debt Obligations

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[9] Ibid.

(CDOs) where these debts were packaged into portfolios and sold to financial investors around the world including from fast growing exporting economies of Asia, Russia and the Middle East who had lots of money to lend. I will explain a bit more about these CDOs later. Anyway, easy money i.e. easily borrowed money means more demand for houses thereby pushing up housing prices further. Since the houses were used as collaterals, the banks were not initially unduly worried about the high amount of housing and other loans. One estimate put the total UK and US debt to GDP ratio at around 300 % with 20% of total economic output being used to pay interest on those debts.[10]

When interest rates rose from 1% to more than 5% in the period between 2004 and 2006 and house prices went down, the less-than-sound borrowers in the US housing sector got into trouble. As a result the lenders who specialized in the `sub-prime mortgage' went belly-up as well. As of Nov 1, 2008 there have been 17 bank failures so far this year in the US including the collapse in late September of Seattle-based thrift Washington Mutual Inc. which had $307 billion in assets. The collapse of these banks have knock-on effects on other financial investors as well who, we now know, include major financial institutions such as Lehman Brothers in the US as well as outside the US such as those in Iceland.

In trying to reduce future losses and being uncertain of the magnitude of bad loans in the industry, it is natural for banks to reduce lending to each other and to their customers leading to the so-called `credit crunch' or `frozen credit market'. This in turn caused difficulties for firms and individuals ensuring a spreading of

[10] http://news.bbc.co.uk/2/hi/business/7688308.stm (Accessed on 20th November 2008)

the problem from the so called `Wall Street' to `Main Street'. At the time of writing the three major US automakers are reported to be in serious financial trouble and seeking financial support from the US government.

How serious is the problem we are facing? According to one estimate, from Sept 1 to 25th October 2008, about USD16.3 trillion worth of global stock value has been wiped out.[11] The threat of a deep and prolonged recession is hanging over the American economy and all other major economies of the world including China which hitherto was considered the fastest-growing economy in the world. According to a recent report from the Business Week on China, the Chinese property and stock markets are faltering and are likely to collapse soon. [12]

In order to avoid this impending global disaster the US government came up with a record USD700 billion plan to help bail out its banking system. It also forced itself to swallow its great capitalist pride to engage in a socialist-type move of federal ownership of its financial sector. Even that may not solve the problem as banks may continue to be reluctant to lend unless they see the economy moving. Therefore, the US government may need to also spend money directly in the American economy in addition to the bank bailout money i.e. the US government must go for more deficit in its budget.[13] But that is going to be really tough because the US federal government's total accumulated debt is now more than

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[11] http://blacklistednews.com/news-2022-0-13-13--.html (accessed on 1st November, 2008)
[12] http://www.businessweek.com/globalbiz/content/oct2008/gb2008102_592608.htm?link_position=link5 (accessed on 1st November, 2008)
[13] http://www.huffingtonpost.com/jeff-madrick/the-bailout-is-not-enough_b_135904.html (Accessed on 20th November 2008)

USD10 trillion or USD32,895 for every man, woman and child in the United States.[14] But there is apparently no alternative other than to spend more money again. Will it work? Well, based on the experience of Japan, it may not. Lots of spending by the government only resulted in Japan's public debt to be more than 195.5% of its GDP.[15] But the US government's measures have to work since the US economy is the main engine that drives the global economy. Any slowdown there will mean millions of businesses around the world directly or indirectly connected to the US economy will be in serious trouble and may go bust. This will mean that hundreds of millions of people around the globe will be losing their jobs and possibly their homes too. There will likely be starvations in some parts of the world including in the developed countries. We may also see social and political chaos. In other words, we will be witnessing a catastrophe which is un-paralleled in the history of mankind.

You may all wonder why the situation is so bleak and depressing. What has humanity done to itself? Why are we in such a big mess? How did it all start? Some of you may be asking, "Surely a problem of this magnitude could not have started simply from the actions of some smooth-talking mortgage brokers in the US some ten years ago convincing some gullible house buyers to buy houses they could not afford, right?" Yes, you are right. Actually the problem started not ten years ago but about 600 years ago. To understand how this can be so, we

[14] http://www.rushprnews.com/2008/10/02/the-united-states-public-debt-tops-ten-trillion-dollars-for-the-first-time/ (Accessed on 20th November 2008)
[15] http://en.wikipedia.org/wiki/List_of_countries_by_public_debt (Accessed on 20th November 2008)

will have to go back into history and understand the history of finance itself which is what I am going to do next.

According to many historians, human existence started about two million years ago.[16] Therefore, in the context of human history, the finance industry, which I define as an industry that specializes in the provision of credit, either for consumption or business activities, is a relatively young industry. This is because the finance industry only came into being in the 16th century i.e. about 600 years ago. Prior to the 16th century, the industry did not exist because the whole of humanity irrespective of religion condemned the practice of profiting from the activity of lending money i.e. from charging of interest on loans. But it all changed in the 16th century when Europeans reinterpreted Christian teachings on usury and decided that the practice of charging interest on loans is neither usury per se nor abhorrent to Christian teachings. In other words, for 99.97% of human history or for one million nine hundred and ninety nine thousand and four hundred years humanity refused to see `Finance' or `Lednding for Profit' as a legitimate industry. To be sure, the practice of charging a price for loans did exist way before the 16th century as even the Hammurabi Code of about 1800 BC referred to the practice. However, just because a practice or activity existed, it does not mean that it was tolerated or recognised as legitimate. In ancient India it was looked down upon by both Buddhists and Hindus. According to a law formulated by Vashishta, a Hindu lawmaker who lived around 500 BC, Brahmin

[16] John Haywood, Brian Catchpole, Simon Hall and Edward Baratt (1997) “The Cassel Atlas of World History”, Cassel, London.

or Kshatriya castes were prohibited from charging interest on any loan regardless of amount. Buddhist writings around this period also condemned the practice.

Aristotle who lived in the period 384-322 BC was completely against the practice of charging any interest on loan no matter how small the interest is. During his time those who favored legalizing interest-charging tried to argue that usury was also practiced by people during the Sumerian civilizations who asked for calves in return for the loan of cows. Aristotle argued that unlike cows, money is sterile and does not by itself beget more money the way cows beget calves. Aristotle also hated people who practiced usury saying: "...those who ply sordid trades, pimps and all such people, and those who lend small sums at high rates. For all these take more than they ought, and from the wrong sources. What is common to them is evidently a sordid love of gain..." (1122a, ETHICS)[17]

Strong words indeed for people in the modern financial sector to ponder and reflect! But listen to these much stronger words from the Roman statesman and thinker, Cato the Elder. In his book `De Re Rustica' he wrote; "what do you think of usury?" - "What do you think of murder?"[18]

Judaism's view of interest is similarly negative. According to the teaching of the `Halakha' or the collective body of the Jewish religious law, which include Biblical, Talmudic and Rabbinic laws, the charging of interest is forbidden. The

[17] http://www.monetary.org/interest.htm (Accessed on 20th November 2008)
[18] http://www.absoluteastronomy.com/topics/Usury (Accessed on 20th November 2008)

prophet Ezekiel, as reported in the Book of Ezekiel also had strong words against the practice of charging interest on loans, denouncing it as an abomination. Ezekiel also metaphorically equated those who engage in interest-charging as people who have shed blood.[19] The Torah also similarly expresses regulations against the charging of interest to fellow Israelites.

The medieval Christian church was no different from Hinduism and Buddhism in its stance towards interest. Clerics were forbidden from taking usury and laymen were condemned if they engaged in it. In 850 AD, the Synod of Paris excommunicated all usurers. Thomas Aquinas, the influential thirteenth century Italian theologian, author of Summa Theologica and Summa Contra Gentiles and considered by many Catholics to be the Catholic Church's greatest theologian and philosopher, was one of the most vehement opponents of the practice of charging interest on loans. One of his most famous quotations is:

"Now money, according to the Philosopher was invented chiefly for the purpose of exchange: and consequently the proper and principal use of money is its consumption or alienation whereby it is sunk in exchange. Hence it is by its very nature unlawful to take payment for the use of money lent, which payment is known as usury: and just as a man is bound to restore other ill-gotten goods, so is he bound to restore the money which he has taken in usury."[20]

[19] http://en.wikipedia.org/wiki/Loans_and_interest_in_Judaism (accessed on Nov 2, 2008)
[20] http://lonang.com/exlibris/aquinas/sum22078.htm (accessed on Nov. 1, 2008)

Some verses in the Old Testament refer to people who indulge in usurious practices as “shedder of blood, the defiler of his neighbor's wife, the oppressor of the poor, the spoiler by violence, the violator of the pledge, the idolater, extortionists, Sabbath-breakers, those who vex the fatherless and widows, dishonor parents, liar, the unrighteous, the backbiter, the slanderer and perjurer, the meanest and lowest of men and the vilest of criminals. [21]

Muslims too condemned the practice from the very beginning of Islam. Numerous verses in the Koran referred to its evilness. I will only mention two verses here as examples. In Surah Al-Baqarah, verse 275, the Koran stated: “

“Those who charge usury are in the same position as those controlled by the devil's influence. This is because they claim that usury is the same as commerce. However, God permits commerce, and prohibits usury. Thus, whoever heeds this commandment from his Lord, and refrains from usury, he may keep his past earnings, and his judgment rests with God. As for those who persist in usury, they incur Hell, wherein they abide forever”

In the same Surah, verse 276-280, the Koran stated:

“God condemns usury, and blesses charities. God dislikes every disbeliever, guilty. O you who believe, you shall observe God and refrain from all kinds of usury, if you are believers. If you do not, then expect a war from God and His messenger. But if you repent, you may keep your capitals, without inflicting

[21] http://www.biblebelievers.org.au/usury2.htm (Accessed on 20th November 2008)

injustice, or incurring injustice. If the debtor is unable to pay, wait for a better time. If you give up the loan as a charity, it would be better for you, if you only knew."

Based on the verses in the Koran, Muslim scholars unanimously classify usury as a major sin i.e. in the same category as adultery, gambling, robbery etc. It is no wonder that the finance industry was non-existent in Muslim lands during the time of the Prophet and the Rightly-guided Caliphs and all the way to the Ottoman Empire during the early 20th century. If it had not been due to colonization of Muslim lands by Europeans, you will not see any banks there.

European Christians, which initially condemned usury, changed their views in the 16th century. It started in 1515 when John Eck, a Christian seminary student of a famous theologian by the name of Conrad Summenhart of Thubingen University, refuted the views of Aristotle and Thomas Aquinas when he declared that the charging of interest on loans was not an evil practice. John Eck, who had the financial support of The Fuggers of Augsburg, a wealthy family, argued for five hours in support of the charging interest on loans before an assembly at the University of Bologna. (So, ladies and gentlemen, scholars-for-dollars is not a new phenomenon.) In 1536, the Protestant reformist priest John Calvin further reinforced the perception of the permissibility of the charging of interest on loans. His arguments were in reality very weak when compared to Aristotle's argument. Calvin argued "When I buy a field does not money breed money?" In reality Calvin's perplexity was answered long before by Aristotle and the Scholastics

Christians who had demonstrated the difference between money and a field – a field grows products whilst money by itself does not.

Nevertheless the tide against the restrictive view on interest was getting stronger and stronger. Since money can be borrowed freely, capital for business activities was easily obtained and this helped to spur economic growth. It was therefore getting more difficult to condemn the practice and labeling it as lack of charity simply because the borrowers were prosperous merchants who on the face of it were neither oppressed nor victimized by the practice. Moreover, there were also many liberal scholars and philosophers who were promoting capitalism as an ideology. They too argued for the permissibility of the practice of charging interest and attacked the views of Aristotle even though some of their arguments were not necessarily very impressive.

Probably two of the most famous of capitalism's champions who argued for the permissibility of interest-charging were Jeremy Bentham and Adam Smith. Jeremy Bentham strengthened the acceptability of interest charging by supporting the opinions of Calvin and Eck in distinguishing `usury' from `interest'. In his famous book `In Defense of Usury' Bentham defined usury as: "The taking of a greater interest than the law allows... (or) the taking of greater interest than is usual."

Adam Smith, in his WEALTH OF NATIONS published in 1776, argued that: "The interest or the use of money…is the compensation which the borrower pays to the lender, for the profit which he has an opportunity of making by the use of the money. Part of that profit naturally belongs to the borrower who runs the risk and takes the trouble of employing it; and part to the lender, who affords him the opportunity of making this profit."

The above sentence is not unfamiliar to students of finance and economics who were taught from very early on the fundamental financial concepts of `opportunity costs' and `cost of capital'.

Surprisingly even the brightest students of finance seem blissfully unaware of the built-in concept of `selfishness' in Adam Smith's arguments. Adam Smith assumed that the usage of money in business ventures must result in profit for the borrower. And that is the reason as to why the borrower must pay for the usage of money regardless of the outcome of the business venture. The risk of loss must be completely borne by the borrower and the borrower alone. If a loss does occur, the lender does not want to know why. His priority is the repayment of the principal plus the interest payment. The borrower's plight is a secondary issue. No wonder when a senior executive of the Asian Development Bank was asked whether the bank will forgive the loans of the poor Indonesian fishermen who lost their boats (and possibly their houses and families too) during the 2004 tsunami, his answer was very simple… "Debt forgiveness is NOT in our vocabulary. But we can help them by giving them additional loans".[22] This attitude may be shocking to some but not to students of banking and finance.

[22] Statement by ADB representative during a radio interview in 2004 shortly after the Tsunami tragedy.

Bright students of finance also fail to see another aspect of the concept of interest which is its long term impracticality. This was highlighted by an American lawyer by the name of John Whipple. In his 1836 book, “The Importance of Usury Laws – An Answer to Jeremy Bentham’, Whipple brilliantly highlighted the impossibility of sustaining long term metallic usury. He wrote:

"If 5 English pennies ... had been ... at 5 per cent compound interest from the beginning of the Christian era until the present time, it would amount in gold of standard fineness to 32,366,648,157 spheres of gold each eight thousand miles in diameter, or as large as the earth."[23]

Moreover, Whipple re-clarified Aristotle’s argument which in his opinion was not properly understood by people like Adam Smith and Jeremy Bentham. He wrote:

"…the purpose of money is to facilitate exchange. It was never intended as an article of trade, as an article possessing an inherent value in itself, (but) as a representative or test of the value of all other articles. It undoubtedly admits of private ownership but of an ownership that is not absolute, like the product of individual industry, but qualified and limited by the special use for which it was designed...."[24]

But Whipple’s argument fell on deaf ears. Charging of interest on loans was no longer considered immoral and soon became an organized and legitimate

[23] Quoted in Stephen Zarlenga (2002) The Lost Science of Money, Valatie, New York, American Monetary Institute, pages 345-46.
[24] http://www.monetary.org/usurytalk.htm (Accessed on 20th November 2008)

industry. Wealthy families who in the past made money from trading found that not only was the business of lending money and charging interest less risky compared to trading, it was also more profitable. All they had to do was sit back and let others do the hard work of engaging in trades and other manufacturing industries. Thus was born the business of lending or the finance industry, comfortably ensconced in the Capitalist and Free Market ideology that dominated Western Europe. It rapidly grew in size when the lenders began to use paper receipts for evidence of deposits and traders started issuing paper IOUs drawn on actual physical goods stored with the lenders. Realizing that only a percentage of the depositors would eventually withdraw their deposits or submits claims based on their possessions of the paper receipts, the lenders started to grant loans far greater than the actual amount of specie (normally gold or other valuable metals) in their custody.

But from its beginning the business of lending had shown its proneness to suffer from periods of crisis. The reason is fairly straightforward. When lending became a legitimate business, two groups of people emerge - lenders who are over-eager for interest income and borrowers who are over-eager to borrow in order to expand business and make more revenues and more profit leading to periods of over-lending or over-borrowing. Over-lending or over-borrowing is like over-speeding… there is bound to be an accident down the road. In the finance industry, the accidents are in the form of financial crashes and as soon as the industry grows, it seems that the crashes seem unavoidable and as the sector develops further, the crashes become more frequent and more serious with the most serious injuries sometimes being suffered by innocent passengers i.e. the ordinary people who are unwitting participants of a system that they did not create or develop.

Let me now relate to you the stories of financial crises from the 17th century onwards to the most recent ones to highlight my point. One of the earliest episodes was the famous Tulips Mania Crisis which occurred in 1637 in Holland. About one hundred years after Europe considered it legitimate to engage in the business of lending, the Dutch became besotted with the beauty of the multi-colored tulips which was introduced to Europe by the Turks. Easy availability of credit from lenders caused the demand for the tulips to go so high that the prices of the most popular type were 20 times the annual income of a skilled craftsman. The interesting thing was that many of the tulips were being bought when they were still in the ground. In other words the demands were partly speculative in nature. This would have been impossible if credit was not available. But since the activity of lending-for-profit was now legitimate, lenders gleefully provided loans demanded by the speculators which thereby drove the prices higher still. Just as what happened in the case of the US property market, the market eventually realized that the high prices were unrealistic. Lenders got anxious and demanded repayment. Some borrowers got into difficulty and started to abandon the market. The price suddenly went down leading to bankruptcies and insolvencies among the highly indebted speculators. Lenders who themselves borrowed money to lend also went bankrupt. There were more crises to follow in the Dutch financial sector due to the over-eagerness of the Dutch lenders to lend money to ambitious or desperate borrowers. In the end wealthy lenders decided that it was better to operate in a more organized environment which was London. London therefore replaced Amsterdam as the financial capital of Europe.

However, the nature of the industry is such that even an organized and regulated environment is not going to protect it from crises as illustrated by the next story which took place in 1720 in London. Between 1701 and 1714 the British was involved in conflicts called the War of the Spanish Successions. The conflicts or battles were funded by the British using borrowed money through the issuance of government bonds. But they proved to be very expensive and by the time the conflicts ended with the Treaty of Utrect, more than one-third of the government's tax receipts was used to pay interest on the debt. The South Sea Company offered to convert British government bonds into South Sea stock and promised high returns if given monopoly of trade routes in Spanish South America. The government agreed and the company obtained the monopoly and was able to attract new investors because of the bright prospect of the company. But in reality the company was not able to generate the promised high returns for investors. The returns for the existing investors were given from money obtained from the later investors. It was in other words a "Ponzi Scheme" which required even more new investors in order to sustain itself but will collapse once the number of investors slow down or once confidence ebbs away. This happened in

1720. But by then the pyramid was huge and when it collapsed there were 30,000 creditors and thousands of stockholders and traders. Five established banks were also involved. Everybody panicked, a bank run ensued and a big financial crisis took place.[25]

Despite the problems caused by the collapse of the South Sea company, the finance industry continued to grow. More regulations were put in place and the British banks appeared strong and stable. But appearance can be deceiving and that was proven in 1866 when a bank by the name of Overend, Gurney & Co over-extended itself and collapsed with debts of £11m.[26] It must be borne in mind that £11m in 1866 was a massive amount and since the bank was linked to many other smaller banks and companies, more than 200 other companies went bankrupt as well. You may think that such a painful experience will serve as an important lesson to other banks but, as I said earlier, `accidents' in the fast lane of finance are unavoidable and in 1878, again there was a bank run which bankrupted the City of Glasgow Bank.

During this period of the late 19th century there were no shortages of financial crises in the US too. According to Charles Morris in his book "Money, Greed and Risk", perhaps a third of all railroads were in bankruptcy by 1890 and many investors lost money. Most were related to over-investment in the newly established rail-road companies by over-eager Europeans. The speculative

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[25] http://www.dailyreckoning.com.au/south-sea-bubble/2007/11/23/ (Accessed on 20 November 2008)
[26] http://www.guardian.co.uk/money/2007/sep/19/business (Accessed on 20th November 2008)

activities were facilitated by the creative invention of financial products or instruments such as bonds.[27]

One would have though that lessons learnt from these crises plus the crises that took place in Europe will teach financial practitioners and regulators to behave in a manner that will be beneficial for all involved. But alas, it seems that the more developed the financial sector, the more likely there will be accidents. One telltale sign will be a rapid rise in prices of stocks. That was what happened in the US stock market in the 1920s. During that period, the stocks of utility companies were especially high. Since the financial system allows investors to borrow money to invest, it would be silly not to invest using borrowed money when stock price was rising so high and so fast. Lenders obliged and some brokers were willing to lend as much as 60% of the face value of the shares being bought. People who were doing this were making tons of money and soon others could not resist joining in the fray while the going was so good. In October of 1929, the US stock market nose-dived. When the prices fell, it fell really quick. On the first day of the crash, almost USD14 billion was wiped off the stock market. Eventually almost half of 25,000 banks in the country also became insolvent. This is the period of the infamous `Great Depression'. Millions lost their homes and almost 15 million Americans lost their jobs; the suicide rate jumped from 14 to 17 per 100,000. Some people went on hunger protest marches but the response by the authorities was quite severe with one case resulting in four protesters being shot dead by soldiers.

[27] Charles Morris (1999), "Money, Greed and Risk", Wiley, New York.

It took the Second World War to end the crisis because the US Government had to spend money and employ people for the war efforts. The pain of the Great Depression was undoubtedly severe. Financial experts, economists and regulators analyzed the episode in great detail. Therefore, Americans could be excused if they feel that another financial crisis was unlikely to happen again. Nobody in their right mind would want to live through a depression and will try their best to stop it from happening again. But obviously factors leading to financial crises are very difficult to control. In 1987 there was yet another market crash. Again the signs were all there. There was a boom in the stock market five years prior to 1987. The financial sector was more developed and techniques for obtaining borrowed money were getting more sophisticated. Even though `leveraging' or the financing of business activity by debt was nothing new and had been practiced since the advent of the finance industry, in the 1980s it had earned a stronger air of not only legitimacy but also respectability, thanks to the work of two economists by the name of Merton Miller and Franco Modigliani, names which are very familiar to finance academics and students. Both economists were winners of the Nobel Prize and both were the founders of the Modigliani-Miller theorem which proposes that the way a firm raises capital, whether by issuing stock or selling debt is irrelevant. It also justifies near limitless financial leverage or borrowings. The 1980s was therefore an era of leveraged buyouts, mergers and takeovers and junk bonds. Companies were growing by taking over each other using borrowed funds and paying very high interest. Initial Public Offering or IPOs were also commonplace especially in the fast-growing microcomputer sector. Many investors were using borrowed funds to purchase the shares of these companies. But it all came crashing down on October 19, 1987. The value of stocks that were wiped off was a staggering USD500 billion.[28] If we can recall, the amount of money that was wiped out on the first day of the stock market crash of 1929 was only USD14 billion.

Were lessons learnt of the danger of debts and leveraging due the pains of the 1987 crash? The answer was provided by a crisis which occurred around the same period, i.e. from the late 1980s and early 1990s. It was known as `The Savings and Loans Crisis' and involved small banks which were essentially set up to help people save money and own their own properties, not unlike our own MBSB. The only difference is that our MBSB is now involved in all sorts of financing besides home financing. The reason MBSB is doing so is quite clear which is to increase revenue and profit to MBSB. Restrictions in lending will not help MBSB to become competitive compared to other financial institutions. Well, interestingly that was what happened to the US Savings and Loans institutions. Due to restrictions imposed on them, their performance was weak and therefore they were losing depositors. In an effort to increase their revenues and profitability two politicians by the name of Jake Garn and Ferdinand Germain sponsored a bill to remove the restrictions. To cut the story short, the bill enabled the institutions to operate in a bigger market, offer larger loans as well as other more complex financial services. This attracted many people to enter into the sub-sector and soon they were involved in funding large, profitable but very risky

[28] http://www.stock-market-crash.net/1987.htm (Accessed on 20th November 2008)

projects including large-scale expensive real-estate projects such as shopping malls, office space, industrial parks, and medical complexes in the Sun Belt cities of the US. If deposits were not enough, they can be purchased from `deposit brokers' who will sell them deposits that have been packaged into USD100,000 chunks.[29] But predictably, the real estate boom soon overshot and by the mid-1980s the real-estate market collapsed. Part of the reason was probably due to the decision by the Fed to increase rates to combat stagflation. The most highly leveraged S&L institutions were completely exposed and that was the start of the crisis involving the S&L institutions. Approximately 1,000 or a quarter of the total S&L institutions went bankrupt. Since they were insured by the Federal government, they had to be bailed out and this eventually cost the Federal government USD150 billion.

There are many more interesting stories on financial crises including the Long Term Capital Management failure in 1998 which necessitated a Fed-organized bailout to the tune of USD3.625 billion which incidentally also involved two Nobel Prize winners of economics, the Russian currency crisis of 1998, the Mexican crises of 1982 and 1994-95, the Brazilian Financial crisis of 1999, the European crisis of 1992 etc. But I think we will skip them for otherwise we will be here until midnight.

[29] The debacle of the S&L institutions was described in great detail by Charles Morris (1999), "Money, Greed and Risk", Wiley, New York.

Let us now try to discuss some lessons that we can learn from the cases mentioned earlier which spanned continents and centuries. Hopefully we can discover some factors that can possibly help us prevent the recurrence of future currency crises.

One factor that is often blamed when crises occur is `deregulation'. It is probably one of the main factors that caused John McCain's defeat to Barack Obama. McCain was quoted as saying that deregulation, which was the trend over the last two decades, was good for the US economy. That was obviously a bad blunder because of its current state. If on the other hand deregulation is deemed a bad thing, then the implication is that future currency crises can be eliminated by just having improved regulation and oversight. Sadly, the experience of the US, the country with the best system of regulations with its Federal Reserve Board, FDIC, state banking authorities, the SEC, the CFTC etc., etc. built up over hundreds of years of experience in regulating the financial industry, does not give us much hope. We also need to note that before the onset of the current crisis, there was no significant complaint about the state of the US regulatory systems. In fact the only complaint then was that the industry needed more deregulation which was the reason the Glass-Steagall Act, passed in 1933 following the Great Depression, was repealed. The Act banned commercial banks from underwriting securities, forcing them to choose between being a simple lender or an underwriter. Furthermore, a related act called the Bank Holding Act was passed later to restrict bank operations by disallowing bank-holding companies owning two or more banks from engaging in non-bank activity and from buying banks in another state. But when the US financial economy eventually recovered from the Depression and the economy was in need of finance capital in order to grow, both the Glass-Steagall Act and the Bank Holding Act were perceived negatively by many parties especially those who were involved in the financial industry. Both were eventually repealed in 1999 to be replaced by the Financial Service Modernization Act. And as soon as they were repealed the US financial industry and the US economy grew and modernized. Moreover, the individuals who were responsible for the de-regulation efforts such as Alan Greenspan, the former chairman of the US Federal Reserve Board, Robert Rubin, the former US Treasury secretary and Sanford Weill, the former CEO of Travelers and Citigroup were all complimented for helping to make the US financial industry and economy strong and dynamic. If the US economy had held strong for only a few more months and not collapsed at the height of the campaign period recently, McCain's support for deregulation would probably have ensured him victory. But obviously God had other plans which possibly include denying Sarah Palin from becoming the first female US Vice President.

In Malaysia, since we are not in a serious crisis yet, currently deregulation is not a dirty word at all. In fact Dr. Zeti Aziz the governor of Bank Negara Malaysia, winner of the Euromoney 2005 Governor of the Year Award, has always extolled the benefit of deregulation and liberalisation in creating a more competitive environment. A policy of gradually deregulating and liberalising the banking system is an integral part of Bank Negara's Financial Sector Master Plan. One example of this is the deregulation of pricing under the new interest rate framework which Dr. Zeti publicly stated as being the catalyst for more efficient pricing in the Malaysian financial system.[30] The fact is when the economy is going strong, it will be impossible to criticize deregulation efforts.

Another object of blame for economic crises is the growth of financial instruments or credit derivatives. The market for one type of derivatives called Credit-Default-Swaps or CDS rose from almost nil a decade ago to USD62 trillion at the end of 2007 indicating its popularity and importance.[31] These CDSs are then bundled into securities known as collateralized debt obligations or CDOs. By using CDOs, lenders are able to reduce the cost of protecting against nonpayment. They are tailored to the needs of a wide group of investors ranging from hedge funds to insurance companies. More importantly they offer higher returns compared to bonds and that is the main reason for their popularity. On the borrowers side the cost of borrowing is also reduced. This lowering of the cost of borrowing results in a bigger size of potential borrowers. In the case of the US this resulted in a bigger number of house buyers including the risky ones known as `sub-prime borrowers'. As described earlier, this also served to drive up the price of houses

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30 "Strengthening the Banking Sector for Further Competition", Governor's Governor's Keynote Address at the Dialogue Session with Banking Institutions, 17 Feb 2005, http://www.bnm.gov.my/index.php?ch=9&pg=15&ac=164 (Accessed on 20th November 2008)

[31] "In Defence of Credit Default Swaps", Economist, nov 6, 2008. http://www.economist.com/finance/displayStory.cfm?source=hptextfeature&story_id=12552204 (Accessed on 20th November 2008)

which, when are used as collaterals, will in turn allow more borrowing. All these serve to create the huge debt level in the US and elsewhere which therefore created the problem we are currently witnessing.

But is it realistic to try to prevent future crises by banning the use of financial derivatives and other instruments? We all know that the creation of financial derivatives is a natural outcome of developed and dynamic financial markets.[32] The instruments are created to facilitate the flow of funds from lenders to borrowers i.e. to create efficiency. In underdeveloped financial markets like Malaysia the number of financial products is limited because they are quite complex and difficult to understand. But once they are better understood, possibly through efforts of various people including our academicians who teach advanced level finance courses, then the usage of derivatives will be widespread. So don't be surprised if in ten years time, when the Malaysian financial industry becomes much more developed in order to sustain our country's rapid drive towards economic growth, there will be widespread usage of derivatives too. As stated earlier, it is just a natural progression of the development of the finance industry and the economy. By then the global market for derivatives could likely amount to quadrillions. Of course debt levels will be in quadrillions too under those circumstances and we can therefore look forward to a much more spectacular financial crisis when it comes at that time!

Another common object of blame is the abandonment of the gold standard with the implication that going back to the gold standard will prevent future crises. In

[32] Ibid

my opinion, stressing the issue of the gold standard denotes a misdiagnosis of symptoms as the actual cause of the problem. We all know that the abandonment of the gold standard happened through a couple of stages with the final and complete abandonment taking place in 1971 when the US government, under President Nixon in his efforts to finance the war in Vietnam, announced the inconvertibility of US dollar to gold. Some people are calling for the reinstatement of the gold standard whilst some others call for a modified version of it called `Islamic Gold Dinar'. But the truth is as the finance industry grows and as lending organizations aggressively seek to maximize revenue and profitability, the abandonment of the gold standard is simply inevitable. This is because maximization of credit creation requires fractional reserve banking to be practiced to its limits, the limit being the amount of gold reserves in the banking system. A corollary to it is that if government wants to engage in deficit spending by borrowing, a gold standard will prove a hindrance as the amount of borrowing will be limited under such a system. An unlimited expansion of credit is only possible when paper reserves replace gold reserves in the banking system. This arrangement will be beneficial for both the borrower i.e. the government who wants to have unlimited borrowing potential as well as the lender i.e. the banks who will earn potentially unlimited interest on those lending. So the notion that financial crises can be prevented completely if we go back to the Gold Standard is like thinking that we can completely solve road accident problems simply by imposing a speed limit of 60km on all roads and highways. It may help but unfortunately under the present circumstances and set-up, it will be completely ignored by all.

Many people have also mentioned `greed' as one of the main features of all crises and as such is the main cause of financial crises. During the Tulip Mania case we saw speculators falling over each other trying to buy the bulbs while they were still in the ground in order to make as much money as possible from the high market prices of the flowers. The lenders were also happily lending them money to engage in the speculative activities. During the recent sub-prime mortgage crisis, we also saw house-buyers recklessly buy homes which they found out later they could not afford. The banks were again happily lending them money to buy those properties. Investors from all over the world were snapping up the CDO's offered by the Wall Street people who were making tons of money from the transaction. The question is how do we define `greed' and how do we get rid of it? In 1987 a movie was made entitled `Wall Street'. It was directed by Oliver Stone and starred Michael Douglas and Charlie Sheen. Michael Douglas played the character of `Gordon Gekko' who was a really greedy person. How do we know that? Because he was willing to break insider trading laws in order to become successful and wealthy. However, in many financial crises there was no obvious case of illegal activities. If we look back at the Tulips Mania case nobody broke the law. In some people's mind the people involved were not greedy. They were just very optimistic risk-takers trying to benefit from opportunities available in the market. In the case of the speculators during the Asian financial crisis, it can be argued that they were also not greedy. They were just taking advantage of market opportunities presented by the practice of pegging of currencies by the Southeast Asian central banks. Dr. Mahathir did rail against George Soros, one of the so-called `greedy' speculators. But ironically Dr. Mahathir himself later even became good friends with George Soros. Anyway, the currency speculators are still around and will continue to be for many more years. In fact when the stock market is down, the government will welcome all investors including speculators. And in a recent article entitled `Best Intentions Go Bust', Barry Eichengreen of Berkeley argued that the perception of `greed' as being responsible for the current global financial crisis is a misplaced perception.[33] Eichengreen argued that the roots lie in the unintended consequences of sound policy decisions. Whether the policy decisions were sound or not are debatable but I do agree with the first part of Eichengreen's proposition.

Moreover, the problem with blaming the whole thing on greed is that this is only stated after the fact. When the economy was growing and the Wall Street firms were making tons of money without breaking any law, greed was never mentioned. Instead the players were praised for their brilliance in spotting market opportunities, for creating new products, for willing to take risks etc. The senior executives of Wall Street firms were all praised for their performance. Their faces graced the covers of Business Week, Fortune and Forbes every other week as paragons of success. This happens everywhere including in Malaysia. People like Nazir Razak of CIMB and Amirsham the former CEO of Maybank are being

[33] http://www.guardian.co.uk/commentisfree/cifamerica/2008/oct/02/wall.street.economy.us (Accessed on 20th November 2008)

praised by everybody for their ability to expand their organization's operations and market share. Currently nobody dares call Nazir Razak a greedy banker. But what if the crisis in Malaysia worsens and CIMB find itself over-extended and insolvent? I have a strong feeling Nazir Razak will then be a subject of much criticism and be accused of being one of the greedy culprits responsible for the crisis. After all this is what happened to Richard S. Fuld Jr., the ex-CEO of defunct investment bank Lehman Brothers; to Charles Prince, the ex-CEO of Citigroup; and to John Meriwether, the former CEO of Long Term Capital Management. They were all highly admired individuals who later ended up being labeled as greedy when a crisis broke. But for me that accusation is unfair. For me, we are justified to say that greed is the main factor when there are clear evidence that laws were broken, as in the cases of Nick Leeson of Baring Bank and probably Jeffrey Skilling of Enron. But those were localized crises the impacts of which were largely limited to the organizations involved. In most major financial crises of the systemic kind, there were more to them than just some greedy individuals. To pin the blame of a large scale global crisis such as the current sub-prime mortgage crisis that involves trillions of dollars and countries spanning several continent on some individuals' greed is not only misplaced but also giving too much compliment or credit to those individuals in terms of their power to influence things. Georgetown University finance professor Reena Aggarwal cannot be more succinct in her explanation of the source of the problem when interviewed by Business Week. She said."It's so difficult to pinpoint one person or two people," and added, "It really was the whole system."[34]

If we analyse the many different crises mentioned earlier, we will be able to spot common factors between them. But in reality we don't have to do the analysis ourselves. This is because some researchers have undertaken very rigorous historical analyses of past crises including those we discussed earlier to see if there were similar features between them. One well known study was conducted by Carmen Reinhart from the University of Maryland and Kenneth Roggof of Harvard University. They compared the current 2007-2008 U.S. sub-prime mortgage financial crisis with 18 earlier post-war banking crises in industrialized countries. They found interesting qualitative and quantitative parallels in terms of asset prices, real economic growth, and public debt. [35] Specifically, they found that the increase in U.S. equity and housing prices closely tracks the average of the earlier crises. They also found that just before the eve of any crisis, there was output growth of the inverted v-shape curve type. Lastly they also found that prior to all crises there is a run-up in U.S. public debt.

But a discussion on financial crises is incomplete without mentioning the name of Charles Kindleberger, an economic historian, who was also the Ford International Professor of Economics at MIT who carried out a very detailed

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[34] http://www.businessweek.com/investor/content/oct2008/pi20081017_950382.htm?chan=rss_topStories_ssi_5(Accessed on 20th November 2008)

[35] Carmen M. Reinhart And Kenneth Rogoff, "Is The 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historical Comparison", NBER Working Paper 13761

analysis of previous financial crises. His analysis was presented in his classic book, `Manias, Panics, and Crashes: A History of Financial Crises' published in 1978.[36] What I plan to do is relate what Kindleberger found from his analysis of past crises and try to see whether the patterns mirror the current financial crisis. Kindleberger said that prior to any crisis an exogenous `shock' will occur. In the past it could be new technology or new industry such as the US railway industry or the utility industry prior to the US Great Depression. The probable shock with regard to the current crisis is probabaly a combination of innovations in high technology industry, China's embrace of free-market system and ensuing economic dynamism and the creation of CDOs mentioned earlier. The `shock' creates profit opportunities leading to a rapid economic growth period. This is what we saw in the US, European and Asian economies, which went through a growth period during the last decade. This growth is fed by increasing money supply thereby resulting in high debt situation. This is certainly true in the case of the US and British economies which had a debt to GDP ratio of around 300 %. Kindleberger says that the rapid economic growth period leads to speculation that initially has positive feedback. Speculators earn money and invest more and this will encourage more people to invest as well. In the case of the current financial crisis, a lot of speculation took place in the US housing markets as well as the derivatives market related to it. This then leads to a situation of excessive growth of economic activity. Kindleberger uses the term "overtrading" for this

[36] Charles P Kindleberger (1978) Manias, Panics, and Crashes: A History of Financial Crises. John Wiley & Sons, New York, 1996 (third edition, first in 1978)

situation, a term originally coined by Adam Smith. Kindleberger said that this "overtrading" situation can be caused by pure speculation or by overestimation of the true expected return and excessive gearing or high leverage. In the case of the current financial crisis, the derivatives market was at its height estimated to be around USD600 trillion. In terms of leverage, the UK and US economies markets were very high with total debts estimated at 300% of GDP. Kindleberger says that the "overtrading" situation will quickly be followed by a realization that the situation is unsustainable. Price will then drop suddenly. That was what happened in the US in June 2007 when real estate prices started falling. Kindleberger said that this situation spreads from one market to another and also to another country or countries. In the case of the current financial crisis, we are witnessing the problem being transferred to a host of sectors including the US auto industry which is now in very serious trouble where last week the top executives went begging to the US Congress for USD 25 billion bailout. Internationally, we are seeing the situation fast spreading from the US, to Europe, Japan and Asia. Kindleberger said that at the height of this downward spiraling situation some players leave the market and there is "financial distress". In the case of the current financial crisis, the players include Merrill Lynch, Lehman Brothers and AIG etc. Kindleberger said that news of a bankruptcy leads to the final stage which is the rush for liquidity. In the case of the current financial crisis, we have witnessed the rush for people to liquidate their stockholdings leading to the massive drop in the Dow Jones Index as well the massive drop in property prices following the announcements of bank insolvencies. Kindleberger said that the banking system will be vulnerable or fragile because of the `feedback' nature of the cycle where bad news leads to further bad news. This is what we saw in the US banking system where the initial fall in prices of properties reduces the value of collateral and induces banks to call loans or refuse new ones, causing property companies to sell their holdings, households to sell securities, industry to postpone borrowing, and prices to fall still further. Kindleberger said that further decline in collateral leads to more liquidation. If firms fail, bank loans go bad and some banks will fail. Kindleberger said that as that happen depositors will withdraw their money which worsens the situation. This is what was going to happen to the US banking system recently. However, the US government stepped in with the USD 700 billion bailout to stem the problem. But whether the problem has been completely eliminated is still uncertain.

Even though Kindleberger's book was written way back in 1978, we can see that his description of the process of a financial crisis perfectly describes the current sub-prime financial crisis. Just like what Reihart and Rogoff did, Kindleberger proves that financial crises of the past and the present amazingly share a lot of similarities

One important aspect highlighted by Kindleberger is the impact of psychological mechanisms in the whole process. When the going is good, positive psychological forces encourage investors to engage excessively in business transactions resulting in the so-called `over-trading' phase. The excessiveness is made possible by the ability to borrow money to engage in the transactions. If money was not available to be borrowed in the first place, then `excessiveness' would not have occurred. Anyway, a fall in prices can be magnified by psychological forces via the `feedback' process to result in banks calling up loans or refusing new ones, in households selling off stocks and cutting down on spending, in businesses postponing expenditures and borrowings etc. Therefore, another very fundamental aspect of the financial system is the importance of `confidence'. In that sense the financial system shares many similarities with a pyramid investment scheme. As long as confidence exists, the system will be stable and be able to grow. However, the moment some market players lose confidence and exit the system or market, the system will quickly collapse like a house of cards. Therefore, one of the most important tasks required to maintain the system is to maintain confidence among depositors, investors and the society in general. In many occasions this requires making statements that are at best misleading or at worst outright lies. Well, for bankers they have been doing this for hundreds of years because they have always promised depositors that deposits can be withdrawn fully at any time when that is patently untrue under the fractional reserve banking system. If all depositors decide at the same time to withdraw money, the banks simply cannot honour those requests and will have to close their doors as we saw in the case of the Argentinean banking crisis. But now even political leaders have to do the same too. For example, on 20 October 2008, Finance Minister Najib was reported to have said that Malaysia was insulated from the worst effects of the crisis. If Najib was not lying then he must be quite ignorant of the fact that Malaysia has very strong trade links to the US, Europe, China and many other countries and therefore cannot avoid the effects of the global recession. Tan Sri Nor Mohd Yakcop, Najib's deputy did publicly admit the vulnerability of the Malaysian economy weeks later. Maybe he is not a good politician? Or maybe he realized that the economic data was getting worse and that there was no point in hiding the truth. Anyway, what is obvious is that when the country's welfare is predicated on the wellbeing of the finance industry, people are compelled to be less than forthright about the true nature of things and sometimes even make misleading statements.

Actually many financial experts, whether they are practitioners, policy makers, regulators or academics are very familiar with Kindleberger's work. If you do a Google Scholar search, you will see that his book is cited by 885 other studies. If you look back at the statements by Paul Krugman and Alan Greenspan mentioned at the beginning of this lecture, you will realize that they did not say financial crises will never happen. They only said that they did not accurately forecast the timing and magnitude of the current crisis. Actually they and many others are quite well versed with the processes or stages of financial crises. Paul Samuelson, Nobel Laureate and Professor Emeritus at MIT, in his comment about Kindleberger's book said "Sometimes in the next five years you may kick yourself for not reading and re-reading Kindleberger's Manias, Panics and Crashes" implying the inevitably nature of financial crises.

Nevertheless we have seen that despite their understanding of the processes involved in a financial crisis, they are still incapable of instituting policies to avert the crisis or to prevent it from happening again. In fact some of the ideas being floated about to solve the problem, such as lower interest rates to encourage borrowing and encouragement to banks to lend to businesses and individuals regardless of sectors are really seeds for future problems since, at their core, financial crises are problems of over-leveraging, over-lending and over-borrowing. This highlights another fundamental aspect of the financial industry which is that knowledge and understanding is of little value when it comes to the ability to stop the crisis from happening. In a way it is something like the problem of alcoholism. Everybody knows the causes and consequences of alcoholism and that the problems related to alcoholism such as drink driving, sexual assault and other violent crimes will never go away as long as alcohol consumption is freely tolerated. Similarly, financial crises and the rest of the problems are well understood by all economists in their analyses of historical evidences. They all also know that the problems are not going to go away as long as the financial system does not change and the lending-for-profit industry is still around.

Andy Serwer, the managing editor of Fortune Magazine was recently quoted by CNN as saying ""The party is over on Wall Street -- until it comes back again," Serwer then added, "I've been around long enough to see that we have these cycles. These guys get their cigars and champagne. They have a great time. The whole thing blows up. But then they re-emerge years later. This one is a really, really bad one. But I don't think Wall Street is dead." [37]

Ladies and gentlemen, this financial crisis will eventually bottom out one day. It may take a few more years and a lot of human suffering but the recession will eventually sort itself out. After that the economy will pick up again, possibly very strongly. But that will just be the prelude to another crisis which will hit us harder because it will be a really massive one, much bigger then the one we are currently facing. This is because if the steps taken to tackle the current crisis involve the lowering of interest rates to encourage borrowings and fiscal stimulus or government bailouts through deficit spending in order to prevent large scale bankruptcies, such measures will ultimately increase overall debt in our society which, as we all know was the main cause of or the prelude to this present crisis in the first place. Therefore, in reality we are not solving the problem but simply putting off the reckoning to a later date and to a later generation of citizens. So when is the next one coming? Well, if even a Nobel Prize-winning economist was unable to predict the onset of the current crisis, please don’t expect me to predict the onset of the next one. All I can say is if you are lucky you will already have left this world by then especially if a series of government bailouts and stimulus packages are large enough to prevent major bankruptcies. Unfortunately that will

[37] http://edition.cnn.com/2008/US/10/17/siu.wall.street/index.html?iref=mpstoryview (Accessed on 20th November 2008)

also mean that we will be saddled with a huge debt which means that all we would have done is to transfer the problems, the suffering and the miseries to our children and grandchildren. They therefore have every right to curse us all in our graves. Fortunately, they may be too busy in their life of the fast lanes of material development chasing unfulfilled dreams, and have little time to ponder the source of their predicament. They may therefore not realize that we, as the predecessor of their existence, were the ones responsible for their problems, just as we, in our own current life of living in the fast lane, also chasing unfulfilled dreams, are unaware that it was people like John Calvin, Adam Smith, and Jeremy Bentham who were the progenitors of the current financial problems facing us. Whether that will make you feel happier or guiltier is for your own conscience to decide.