e-Resources Module-III

Paper No. : DSE-xiii

Paper Title: Money and Financial Markets

Course: B.A. (Hons.) Economics, Sem.-VI Students of S.R.C.C.

FINANCIAL CRISES

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In a globalised world, financial crises seem to have become the order of the day in as much as one financial crisis appears to be followed by another and tends to spread like a contagion due to the underlying integration of real and financial sectors at the international level. Typically, all financial crises start with a major disruption in financial markets caused by fiscal imbalances of the Government and poor asset-liability management on the part of the banking sector that tends to aggravate on the problems of adverse selection and moral hazards which invariably culminate into a rise in interest rates and fall in asset prices thereby leading to a failure of financial as well as non-financial firms that could in due course, bring about recessionary tendencies or even a slump in the economy. A lot of uncertainty may get generated in the economy under a financial crisis as reflected by an erosion of confidence of bank depositors, bank runs, bank failures, stock market crashes, financial repression and the like. The inevitable outcome of all such adverse developments during a financial crisis is a sharp decline in the efficiency of the financial sector or an altogether failure of the financial system thereby bringing about severe economic downturns.

Whenever financial markets fail or even work inefficiently, it tends to have spill-over effects on the real sector of the economy thereby leading to an economic downturn. In modern times, such financial crises seem to have become the order of the day in as much as in a globalised world, one financial crisis appears to be followed by another and tends to spread like a *contagion* on account of the integration of real and financial markets at the international level. For instance, in recent years the whole world has witnessed the US Sub-prime lending crisis or North Atlantic financial crises that was followed by the European Sovereign debt crisis.

On closer examination, we find that all financial crises start with a major disruption in financial markets that tends to aggravate on the problems of *adverse selection* and *moral hazards* which invariably culminate into a *rise in interest rates* and *fall in asset prices* thereby leading to a failure of financial as well as non-financial firms that could in due course, bring about recessionary tendencies or even a slump in the economy. Typically, *fiscal imbalances* of the

Government and *poor asset-liability management* on the part of the banking sector lies at the root of such disruptions in financial sector in general and financial markets in particular.

More specifically, it has been observed that in many economies, Governments undertake huge unproductive expenditures that they are not in a position to finance out of tax revenues and eventually pass the burden of resulting *budgetary* and *fiscal deficits* to the monetary policy by printing more currency. Such an *automatic monetisation of public debt* leads to demand-pull inflation as in the absence of any additional rise in the production or productive capacity of the economy, such an increase in money supply only raises effective demand in the economy without altering the supply curve!

When inflationary tendencies gather momentum in this manner, it tends to generate inflationary expectations in the economy thereby making the real rate of interest very low or even negative as a result of which savers divert their savings to unregulated and unorganised credit markets indulging in speculative and other socially undesirable activities whereas genuinely productive economic activities suffer due to a shortage of funds as productive deficit spenders and entrepreneurs keep waiting for loans in organised credit markets. Consequently, the level of investment remains suppressed and sub-optimal in the economy whereas public funds are utilised by the unregulated sector against the interests of the public. Once this happens, it is said to be *financial repression* which is a clear-cut manifestation of “financial crisis” as efficiency of financial system or financial sector in allocating funds from surplus units to deficit units gets very low under these circumstances.

Despite the inflation rate crossing permissible limits under conditions of financial repression, the Governments concerned do not want to raise the nominal interest rate in such economies as they want to keep the cost of borrowing as low as possible for them. Side-by-side, the fiscal authority *viz.,* the Government in these economies tends to make the monetary policy sub-servient to the fiscal policy by indulging in *statutory pre-emption of public funds*. What this essentially implies is that through legal compulsions such as statutory cash reserve requirement, incremental cash reserve requirement, statutory liquidity requirement and the like, the Government in such economies invariably corners a major portion of public funds coming to the banking system thereby hampering the profitability, asset-liability management and autonomy of the banking sector.

Many a times, under statutory compulsions, banks have been observed to hold treasury bills carrying a nil or even negative real interest rate. This in turn has a dampening effect on the

viability of their balance sheets. Under such stressed conditions, it is quite conceivable that lured by the urge to earn more profits so as to partially offset the adverse impact of statutory pre-emption of public funds by the Government, a commercial bank may be induced to advance loans to more risky projects and *bad credit risks* as they generally agree to pay higher interest rates. But as by their very nature, such dubious borrowers have no intention to repay the concerned loans, it is eventually bound to lead to the problem of *adverse selection* in bank lending. The inevitable outcome of such a financial imprudence is the accumulation of bad debts and Non-Performing Assets in the balance sheet of commercial banks that could erode the confidence of their depositors who may come in large numbers to simultaneously withdraw the money in their deposits. As in any case, the commercial banks follow a *fractional reserve system of banking*, this kind of a *bank run* is most likely to culminate into a *bank failure* thereby leading to financial crisis in the economy.

When several banks fail together in this manner, it tends to generate a lot of *uncertainty* in the financial system thereby destabilising and disrupting the economy. Side-by-side, asset prices may decline and stock markets may crash under such uncertainties thereby adding fuel to fire, so to say and aggravating the financial crisis.