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Why a Financial Crisis will always be around the Corner

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Abstract:
This article seeks to explain the nature and main cause of financial crises. It starts by defining what a financial crisis is and then explains the main types that have occurred over the centuries namely, currency crisis, banking crisis, and market crashes. The history of the financial industry is then explained to show that financial crisis is a recent phenomenon in relation to mankind which has been in existence for over two million years. What is highlighted is the fact that prior to the existence of financial industry, humanity has never experienced any financial crisis. They only began to occur when financial industry became established in the sixteenth century. The article then relates in detail some of the most famous financial crises that have occurred since then. They include the Tulip Mania case, the South Sea Corporation panic and the Great Depression. This article concludes by argu-

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ing that financial crises at their core, are outcomes of over-lending and over-borrowing, which are, thus, integral to the financial industry itself, and that the problems of financial crises are not going to go away as long as the financial industry remains legally as part of our life.

Keywords:
financial industry, financial, currency and banking crisis, market crashes, debt, deficit, bankrupt, loan, price, economy.

Introduction

Paul Krugman, the Economics Nobel winner for 2008, admitted to the whole world that he actually failed to see how big the current economic crisis would get and how bad the United States' housing crash was going to affect other economic indicators.[1] Another expert regarded by many economists to be the foremost among experts to the point of being an economic sage, Alan Greenspan, the former chairman of the Federal Reserve Board, also admitted in his testimony to the American Congress that he, too, did not foresee the current financial crisis. Jeffrey Sachs famously commended the dynamisms of the South East Asian countries a few months before they spectacularly collapsed in 1997.

It is also remarkable that, arguably one of the worst financial crises in the history of mankind, is taking place in America, a country that is perceived by many to have the most advanced financial sector and regulatory control systems, the best finance and economics departments, and the most number of world-class Nobel laureates in the field of economics and finance. It, therefore, seems that the topic of financial crises is a highly complex one which even some eminent economists

1 http://www.editorandpublisher.com/eandp/news/article_display.jsp?vnu_content_id=1003873729 (accessed 1 November 2008).

are unable to figure out.

However, this article will explain that, in reality, the problem of financial crises is not that complicated. It will argue that financial crises at their core, are outcomes of over-lending and over-borrowing and are thus integral to the industry itself. Moreover, it will argue that the problems of financial crises are not going to go away as long as the financial industry remains legally as part of our life.

What are financial crises?

In recent times, financial crises seem to hog the headlines more than others. People around the world also seem more concerned with financial crises than natural disasters. One possible reason is that 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.[2] Another example is the 2008 sub-prime mortgage crisis. Even though it started in the US, the effects of the crisis still reverberate throughout the world. The current financial turmoil facing Greece and the European Union is also an outcome of that crisis. As a result, millions around the world, including Malaysians, are still suffering from its negative consequences. At this point, none can ascertain if the situation will worsen or when it will eventually end.

2 "An Initial Assessment of the Impact of the Earthquake and Tsunami of December 26, 2004 on South and Southeast Asia," *Asian Development Bank* (2005).

Every time a financial crisis takes place, a plethora of explanations to its possible causes are given, ranging from the very simple and naïve to the more sophisticated. The former includes a notion implicating the Jews as masterminds strongly believed by the former Malaysian Prime Minister, Dr. Mahathir Mohamad.[3] The more sophisticated reasoning views the financial phenomenon as an outcome of the interaction of a host of factors. This article chooses to ignore the former perspective for reasons which will enfold as this discussion progresses.

Definition of financial crisis

According to Barry Eichengreen, an Economics Professor at the University of California, Berkeley, a financial crisis refers to "a disturbance to financial markets, associated typically with falling asset prices and insolvency among debtors and intermediaries, which spreads through the financial system, disrupting the market's capacity to allocate capital."[4] A financial crisis is, in fact, a sub-set of economics crisis due to it being caused not only by a financial crisis, but also by other non-financial reasons, including outbreaks of wars and natural disasters, for example, earthquakes, floods, and draughts.

Types of financial crises

Financial crises can be further divided into a number of types including currency crisis, banking crisis, and market

3 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*, 16 October 1997, http://query.nytimes.com/gst/fullpage.html?res=9B01E1DE153FF935A25753C1A961958260 (accessed 21 November 2008).

4 Barry Eichengreen and Richard Portes, "The Anatomy of Financial Crises," *C.E.P.R. Discussion Papers* 130 (1986).

crashes. Despite their being inter-related, some distinguishing characteristics are evident. A currency crisis is said to occur when the currency value of a particular country depreciates in a rapid manner relative to other foreign currencies, the most important of which is the US dollar. This can possibly lead to other types of financial crises including rapid rise in the cost of imports, rapid rise in the value of foreign debts and asset-market crash. As a result, highly indebted firms suffer widespread bankruptcies. In turn, a country's general economy is adversely affected.

A noted example of currency crisis is the Asian currency crisis of 1997-1998. The crisis was triggered by an over-investment in the Thai real estate sector. At the time, Thailand was experiencing a mini economic boom which was largely financed by massive foreign borrowings. As a result, the economy suffered from current account deficit. The Thai baht, which was supposed to depreciate under those circumstances, however, was being propped up by the Thai government using their dollar reserves. Currency speculators then noticed the fast dwindling reserves and started attacking the Thai baht. Later, 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, that is, 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. 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 of the Southeast Asian countries that had huge external debts were facing bankruptcy. Indonesia, Thailand and Korea chose to borrow from the International Monetary Fund in order to avoid defaulting on their foreign debt repayments, while Malaysia used its internal funds since its foreign debt was relatively small. However, all of the countries experienced a rapid slowdown in the economy, massive unemployment and widespread business and personal bankruptcies. Significantly, in all of the affected countries prior to the crash 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 country's banking system. With their cash severely depleted, the banks are forced to close which, inevitably, affect their customers who comprise a large number of people and firms. As a result, there will be a shortage of money to sustain the economy. Such crises are certainly not a recent phenomenon. They have been occurring since banks came into existence a few hundred years ago. Ironically, such crises recur despite advancements made in regulatory frameworks and oversights. One recent example is the Argentinian banking crisis of 2002.

At the beginning of the twentieth century, Argentina was among the top ten wealthiest countries in the world with a per capita income much higher than that of Japan and Italy. Decades before 2002, the country was already sowing the seeds of a crisis. The main cause was fiscal indiscipline, that is, inability to live within its means. As a result of the bad policies of successive governments, the country was saddled with a growing huge foreign debt. In 1983, the country's public debt was USD46 billion. Six years later, it rose to USD65 billion. By 1999, it ballooned to USD130 billion.[5] When Fernando de la Rúa became president in that year, not only

5 Adrian Salbuchi, "How to Solve Argentina's Recurrent Foreign Debt Crises: Proposal for a Long-Term Solution," *Global Research*, 7 November 2006, http://www.globalresearch.ca/index.php?context=va&aid=3750.

was Argentina 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. Exacerbating this economic disaster were other problems such as rampant corruption and an unstable political scenario that spooked the confidence of investors who started taking their money out of the country. In 2001, when the Argentinians were worried about the state of their country's economy and the strength of the peso, they withdrew large sums of money from their bank accounts, too, and converted the pesos into dollars and sent them abroad, causing a run on the banks. 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 took to the streets to express their disgust and anger. Riots broke out resulting in a number of deaths. The government was unable to meet its debt service obligations and defaulted on its loans of USD95 billion. The economic situation steadily worsened. Incidences of business and personal bankruptcies soared. As of 2007, the Argentinian foreign debt stood at USD127 billion.[6] To date, their financial problems have not been resolved.

A more general form of financial crisis is a "market crash." This takes place when the price of assets such as properties suddenly plunges within a short period as in the sub-prime mortgage crisis. Another cause can be due to a sudden fall in the price of stocks as in the "Dot.Com" crash of 2000. The main problem to this crash is that assets were initially over-priced because of either over-optimism on the part of the market or excessive speculative demand. This will

6 Accessed at http://www.aol.com.au/news/story/Argentina's-foreign-debt-surpasses-US127-billion-now-higher-than-after-2005-debt-swap/634311/index.html.

result in an artificially high price for those assets, a situation referred to as an "asset bubble." Once the price drops suddenly, the bubble bursts. Extremely serious repercussions will ensue if those assets were obtained using borrowed funds. Examples include the aforementioned Asian Financial Crisis of 1997 and the Japanese property crash of the 1990s.

The property crash in the East Asian nation presents an interesting contrast between Japan and Argentina. As explained, the Latin American country suffered severe financial crisis due to her profligacy, fiscal indiscipline, persistent trade deficits and huge foreign debt. On the other hand, being the most successful exporting country, Japan was running trade surpluses with many countries including the US. The saving rate was high for the Japanese who were skilled and hardworking. Despite these strengths, Japan was not spared of a severe financial crisis. Indeed, the causes were due to over-borrowing, debt and speculation. The only difference between Japan and Argentina is that where the latter borrowed excessively from foreign sources, Japanese firms and individuals borrowed from their own banks. 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 was done by increasing lending. In total, the country's banks lent 353 trillion yen to Japanese companies. More than half of the loan went to firms in the construction, retail, real estate and financial services sectors, where 85 per cent of the bad debts were to be found.[7] Asset prices in these sectors skyrocketed such that in the 1980s, 250 hectares of land surrounding the Imperial Palace in Tokyo was estimated to be worth more than the whole of California. As expected, 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

7 Accessed at http://news.bbc.co.uk/2/hi/business/1472258.stm.

did in 1990. As a result, trillions of yen 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 ten years, causing untold sufferings for the poorest and the weakest. The economy only showed some tentative signs of recovery in the beginning of 2003. However, the crisis had jeopardised everything because the dollar had fallen relative to the yen which rendered Japanese exports uncompetitive.

With the current global financial crisis, many agree that it is a case of a market crash followed by a banking crisis and ensued by an economic slowdown which is spreading globally. The problem has its origins when Greenspan wanted to stave off recession following the Dot.com meltdown of the late 1990s. He lowered interest rates that caused excess liquidity in the financial market. Mortgage brokers, lured by big commissions, convinced homebuyers with poor or weak credit history to accept housing mortgages with minimum hassle. Efforts by the brokers paid off as the size of this so-called "sub-prime mortgage" sector grew huge resulting in a housing boom. The growth continued largely due to the widespread usage of Collaterized Debt Obligations (CDOs) in which debts were packaged into portfolios and sold to financial investors around the world, including those from fast growing exporting economies of Asia, Russia and the Middle East with cash to lend. Thus, easy money, that is, easily borrowed money means more demand for houses, thereby, pushing up housing prices further. Since the houses were used as collaterals, the banks initially were not 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 per cent with 20 per cent of total economic output being used to pay interest on those debts.[8]

When interest rates rose from 1 per cent to more than 5 per cent 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 specialised in the "sub-prime mortgage" went bankrupt as well. As of 1 November 2008, seventeen banks failed in the US, including the collapse in late September of Seattle-based thrift Washington Mutual Inc. which had USD307 billion in assets. The collapse of these banks had knock-on effects on other financial investors as well, which are known to include major financial institutions, such as Lehman Brothers in the US, and 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." In turn, this caused difficulties for firms and individuals which caused the problem to spread from "Wall Street" to "Main Street." Examples in the US of such a problem include the serious financial troubles of the three major US automakers which had to rely on bailout money from the US government in order to survive.

The seriousness of the sub-prime problem was reflected by the fact that in the period from 1 September to 25 October 2008, about USD16.3 trillion worth of global stock value was wiped out.[9] The threat of a deep and prolonged recession is still 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.

8 Robert Peston, "Audio Slideshow: A Guide to the Credit Crunch," *BBC News*, 24 October 2008, accessed at http://news.bbc.co.uk/2/hi/business/7688308.stm.

9 http://blacklistednews.com/news-2022-0-13-13--.html (accessed 1 November 2008).

According to a Business Week report, the possibility of Chinese property and stock markets faltering and collapsing could not be completely discounted.[10]

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 this did not really solve the problem as banks continued to be reluctant to lend due to the sluggish economy. Therefore, the US government was forced to spend money directly in the American economy, which incurred a large deficit in its budget, in addition to the bank bailout money. However, this will only worsen the future scenario since the US federal government's total accumulated debt is more than USD13 trillion at present.[11] Increasing spending may be the only alternative, but the Japanese experience showed this to be unfeasible as it resulted in Japan's public debt to be more than 189 per cent of its GDP.[12] On the contrary, measures by the US government have to work since the US economy is the main engine that drives the global economy. Any slowdown will adversely affect businesses around the world directly or indirectly connected to the US economy. From this, millions of people around the globe stand to lose their jobs and possibly their homes while some in developed countries are likely to starve. Indeed, the social and political chaos is immense that is unparalleled in the history of mankind.

10 Frederik Balfour, "China's Economy Sputters," *Bloomberg Businessweek*, 2 October 2008, http://www.businessweek.com/globalbiz/content/oct2008/gb2008102_592608.htm?link_position=link5 (accessed 1 November 2008).

11 United States public debt at http://en.wikipedia.org/wiki/United_States_public_debt (accessed 8 July 2010).

12 List of sovereign states by public debt at http://en.wikipedia.org/wiki/List_of_countries_by_public_debt (accessed 8 July 2010).

In hindsight, one wonders if a problem of the present magnitude could have snowballed from smooth-talking American mortgage brokers who convinced gullible people to buy houses they could not afford, to the present bleak and depressing situation? In actuality, the problem stemmed not a decade but about six centuries ago. To understand how this came about, one needs to retrace and understand the history of finance which will be discussed in the following section.

History of the finance industry

According to many historians, human existence started about two million years ago.[13] Taken in this context, the finance industry, defined as an industry that specialises in the provision of credit, either for consumption or business activities, is a relatively young industry as it only came into being in the sixteenth century. Prior to that, the industry had not existed because the whole of humanity, irrespective of religion, condemned the practice of profiting from the activity of lending money, that is, from charging of interest on loans. This changed six hundred years ago when Europeans reinterpreted Christian teachings on usury and decided that the practice of charging interest on loans was neither usury per se nor abhorrent to Christian teachings. In other words, for 99.97 per cent of human history or for one million, nine hundred and ninety-nine thousand and four hundred years, humanity refused to see "Finance" or "Lending for Profit" as a legitimate industry. The practice of charging a price for loans did exist long before the sixteenth century, as the Hammurabi Code (about 1800 BC) referred to the practice. Even if a practice or activity existed, this does not mean that it was tolerated or recognised as legitimate. In ancient India, it was

13 John Haywood et al., *The Cassel Atlas of World History* (London: Cassel, 1997).

looked down upon by both Buddhists and Hindus. According to a law formulated by Vashishta, a Hindu lawmaker who lived around 500 BC, Brahmin or Kshatriya castes were prohibited from charging interest on any loan regardless of amount. Buddhist writings around this period also condemned the practice.

Aristotle (384 BC–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 favoured legalising interest-charging tried to argue that usury was also practised by people during the Sumerian civilisations who asked for calves in return for the loan of cows. Aristotle argued that unlike cows, money was sterile and did not by itself beget more money the way cows beget calves. Aristotle also hated people who practiced usury. In *Ethics*, he said:

> . . . 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. . .[14]

Strong words indeed for modern financial practitioners to ponder and reflect! Yet, sterner was the tone of the Roman statesman and thinker, Cato the Elder. In his book *De Re Rustica*, Cato wrote, "What do you think of usury?" – "What do you think of murder?"[15]

Judaism's view of interest is similarly negative. According to the teachings 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

14 Stephen Zarlinga, *A Brief History of Interest*, accessed at http://mail.google.com/mail/h/1bh10238x2ttr/?view=att&th=11d5205cf18d463e&attid=0.1&disp=vah&zw.

15 Usury, *Absolute Astronomy*, at http://www.absoluteastronomy.com/topics/Usury.

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 had shed blood.[16] 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 as follows:

> 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.[17]

Among the verses in the Old Testament which refers to people who indulge in usurious practices is as follows:

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16 "Loans and interest in Judaism," at http://en.wikipedia.org/wiki/Loans_and_interest_in_Judaism (accessed 2 November 2008).

17 "Summa Theologica: Selected Questions on Law and Justice," *The Laws of Nature and Nature's God*, at http://lonang.com/exlibris/aquinas/sum22078.htm (accessed 1 November 2008).

> . . . shedder of blood, the defiler of his neighbour'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, dishonour parents, liar, the unrighteous, the backbiter, the slanderer and perjurer, the meanest and lowest of men and the vilest of criminals.[18]

Muslims too have condemned the practice since the dawn of Islām. Among the Qur'ānic verses that refer to its evilness is as follows:

> 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.[19]

Within the same *Sūrah*, the Qur'ān states:

> 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 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.[20]

18 "The Evil of Usury," accessed at http://www.biblebelievers.org.au/usury2.htm.
19 *Al-Baqarah* (2): 275.
20 *Al-Baqarah* (2): 276-280.

Based on the above-mentioned verses, Muslim scholars have unanimously classified usury as a major sin in the same category as adultery, gambling, robbery, and others. It is not a coincidence that the finance industry was non-existent in Muslim lands during the time of the Prophet, the Rightly-guided Caliphs until the Ottoman Empire during the early twentieth century. Had it not been for the colonisation of Muslim lands by Europeans, banks might not have existed in those places.

The European Christians, who initially condemned usury, changed their views in the sixteenth century. It started in 1515 when John Eck, a Christian seminary student of a famous theologian named 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. With the financial backing of a wealthy family called the Fuggers of Augsburg, Eck argued for five hours in support of the charging interest on loans before an assembly at the University of Bologna. (Hence, the scholars-for-dollars phenomenon is not new.) 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 compared to Aristotle's. As an example, he argued, "When I buy a field, does not money breed money?" This, in fact, had been countered long before by Aristotle and the Scholastics Christians who had demonstrated the difference between money and a field—a field grows produce whilst money by itself does not.

Despite these, the tide against the restrictive view on interest grew ever stronger. Since money could be borrowed freely, capital for business activities was easily obtained which helped to spur economic growth. Therefore, condemning the practice and stigmatising it as a lack of charity was more difficult as borrowers comprised prosperous merchants, who were seen as neither oppressed nor victimised by the practice. Moreover, there were also many liberal scholars and philosophers who were promoting capitalism as an ideology. They also argued for the permissibility of the practice of charging interest and attacked the views of Aristotle even though their arguments were not necessarily very impressive.

Two of the most famous of capitalism's champions who argued for the permissibility of interest-charging were probably, Jeremy Bentham and Adam Smith. 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, expanded usury as follows:

> 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 quotation above is undeniably familiar to students of finance and economics who are taught 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 Smith's arguments. The author assumed that the usage of money in business ventures must result in profit for the borrower. That is the reason why a 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. Should a loss occur, the lender would not want to know why. His priority is the repayment of the principal plus the interest payment. The borrower's plight is of secondary importance.

This attitude is displayed to the hilt by a senior executive of the Asian Development Bank. When asked whether the bank would forgive the loans of the poor Indonesian fishermen who lost their boats (and possibly their houses and families, too) during the 2004 tsunami, the matter-of-fact reply was: "Debt forgiveness is NOT in our vocabulary. But we can help them by giving them additional loans."[21] Such a lack of concern is quite typical in the banking and finance practice.

Another aspect of the concept of interest often overlooked is its long-term impracticality. Highlighted in 1836 in *The Importance of Usury Laws An Answer to Jeremy Bentham*, American lawyer, John Whipple wrote of the impossibility of sustaining long-term metallic usury as follows:

> 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.

Moreover, Whipple re-clarified Aristotle's argument which in his opinion was not properly understood by people like Smith and Bentham:

> . . . . 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 pro-

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

> duct of individual industry, but qualified and limited by the special use for which it was designed . . . .

However, Whipple's argument fell on deaf ears. Charging of interest on loans was no longer considered immoral and soon became an organised and legitimate industry. Wealthy families who made money from trading in the past, 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. Realising that only a percentage of the depositors would eventually withdraw their deposits or submit 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.

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 to expand their business and make more revenues and more profits leading to periods of over-lending or over-borrowing. Over-lending or over-borrowing is akin to over-speeding in which accidents are bound to occur down the road. In the finance industry, accidents take the form of financial crashes. They seem inevitable as soon as the industry grows. As the sector develops further, the crashes become more frequent and more serious. At times, the most serious of injuries are sustained by innocent passengers, that is, the ordinary people who are unwitting participants of a system they did not create or develop.

To highlight this point, financial crises from the seventeenth century to the most recent ones are detailed as follows: One of the earliest was the famous Tulips Mania Crisis which occurred in Holland in 1637. 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-coloured tulips which was introduced to Europe by the Turks. Easy availability of credit from lenders caused the demand for the tulips to escalate that the prices of the most popular type were 20 times the annual income of a skilled craftsman. Interestingly, many of the tulips were being bought when they were still on the ground. In other words, the demands were partly speculative in nature. This would have been impossible if credit was not available. However, since the activity of lending-for-profit was then legitimate, lenders readily provided loans demanded by the speculators which, thereby, drove the prices higher. Similar to the US property market, the tulip market eventually realised that the high prices were unrealistic. When lenders became anxious and demanded repayment, some borrowers got into difficulty and started to abandon the market. The price suddenly plunged, leading to bankruptcies and insolvencies among the highly indebted speculators. Lenders, who themselves borrowed money to lend, also went bankrupt. More crises ensued in the Dutch financial sector due to the over-eagerness of the Dutch lenders to lend money to ambitious or desperate borrowers. Eventually, wealthy lenders decided that it was better to operate in a more organised environment. London, thus, replaced Amsterdam as the financial capital of Europe.

Given the nature of the industry, even an organised and regulated environment was not going to protect it from crises as illustrated in London. Between 1701 and 1714, the British were 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 which proved to be very expensive. By the time the conflicts ended with the Treaty of Utrecht, 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 stocks and promised high returns if given monopoly of trade routes in Spanish South America. When the government agreed, the company obtained the monopoly and was able to attract new investors because of the bright prospect of the company. In reality, though, 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. In other words, it was a "Ponzi Scheme" which required even more new investors to sustain itself, but would collapse once the number of investors slowed down or confidence ebbed away. By 1720, the pyramid was huge such that 30,000 creditors and thousands of stockholders and traders were affected when it collapsed. Five established banks were also involved. Panic struck leading to a bank run and inevitably, a major financial crisis.[22]

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. Yet, appearances were already proven deceiving in 1866 when a bank, Overend, Gurney & Co, over-extended itself and collapsed with debts of £11m.

22 Adrian Ash, "The south sea bubble and the northern rock bust," *Daily Reckoning*, 23 November 2007, at http://www.dailyreckoning.com.au/south-sea-bubble/2007/11/23 (accessed 20 November 2008).

Such an amount was considered massive then. To aggravate the condition, more than 200 other companies linked to the bank went bankrupt. As painful as the experience served to remind others, "accidents" in the fast lane of finance have been inevitable. In 1878, history repeated itself with the City of Glasgow Bank bankruptcy.

In the late nineteenth century, the US was no exception to financial crises. According to Charles Morris in *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 railroad companies by over-eager Europeans. The speculative activities were facilitated by the creative invention of financial products or instruments such as bonds.[23]

With the various crises cited thus far, one would think financial practitioners and regulators would have exercised more caution in their dealings. However, the more developed the financial sector, the more frequent accidents occur. One telltale sign of financial crisis is the rapid rise in prices of stocks which happened in the US stock market in the 1920s. During that period, the stocks of utility companies were especially high. Since the financial system allowed investors to borrow money to invest, they took the opportunity to invest using borrowed money when stock prices were escalating rapidly. Lenders obliged and some brokers were even willing to lend as much as 60 per cent of the face value of the shares being bought. So lucrative were these deals that others joined in droves. Unsuspectingly, in October of 1929, the US stock market nose-dived far too quickly for shareholders to react. On the first day of the crash, almost USD14 billion was wiped off the stock market. Eventually, almost half of the 25,000 banks in the country also became insolvent. This is the period of the infamous Great Depression. Millions of Americans lost

23 Charles Morris, *Money, Greed and Risk* (Wiley: New York, 1999).

their homes and almost 15 million lost their jobs; the suicide rate jumped from 14 to 17 per 100,000. Some went on hunger protest marches but they faced stiff retaliation from the authorities with four protesters fatally shot in one case.

Finally, the Second World War put an end to the financial crisis when the US Government had to spend money and employ people for its war efforts. The pain of the Great Depression was undoubtedly severe as analysed by financial experts, economists and regulators. Americans could be excused if they felt that another financial crisis was unlikely to happen again. Nobody dared to live through utter hardship and would try their best to stop it from repeating.

Obviously, factors leading to financial crises were very difficult to control. In 1987, yet another market crash struck with all its signals. A boom happened 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 practised since the advent of the finance industry, it had earned a stronger air of not only legitimacy, but also respectability in the 1980s. Credits were accorded to the work of two economists, Merton Miller and Franco Modigliani. Winners of the Nobel Prize, both were the founders of the Modigliani-Miller theorem which proposed that the way a firm raised capital, whether by issuing stock or selling debt, was irrelevant. It also justified 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 one another 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. This took a tumble on 19 October 1987 when the value of stocks were wiped off at a staggering USD500 billion.[24] Recall that the amount wiped out on the first day of the 1929 stock market crash was only USD14 billion.

Were lessons learnt of the danger of debts and leveraging due to the pains of the 1987 crash? The answer lies in a crisis which occurred around the same period, that is, from the late 1980s and early 1990s. Known as "The Savings and Loans Crisis," it involved small banks which were essentially set up to help people save money and own their own properties, not unlike Malaysia's MBSB. The only difference is that MBSB is now involved in various financing besides home financing. The reason MBSB is doing so is quite clear which is to increase its revenue and profit. Restrictions in lending will not help MBSB to become competitive compared to other financial institutions which, interestingly, happened to the US Savings and Loans institutions. Due to restrictions imposed on them, their performance became weak and losing depositors. In an effort to increase their revenues and profitability, two politicians, Jake Garn and Ferdinand Germain, sponsored a bill to remove the restrictions. 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. They were involved in funding large, profitable but highly risky 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 could be purchased from "deposit brokers" who would sell them deposits that had been packaged into USD100,000 chunks.[25] But predictably, the real estate boom soon overshot

24 See http://www.stock-market-crash.net/1987.htm
25 The debacle of the S&L institutions was described in great detail by Morris, *Money*.

and by the mid-1980s, the real-estate market collapsed. Part of the reason was probably due to the decision by the Federal Reserve to increase rates to combat stagflation. The most highly leveraged S&L institutions were completely exposed which triggered the crisis. 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.

Other financial debacles of interest include the Long-Term Capital Management failure in 1998 that necessitated a Federal-organised bailout of USD3.625 billion (which, incidentally, also involved two Economics Nobel Prize winners); the Russian currency crisis of 1998; the Mexican crises of 1982 and 1994-1995; the Brazilian financial crisis of 1999; the European crisis of 1992, and the current Greece and EU debt and financial crisis.

Lessons from cases of financial crisis

From the aforementioned cases spanning continents and centuries, lessons can be learnt that can help avert future financial crises. In this section, the author will discuss some factors that are often cited as being responsible for the occurrence of financial crises.

A. Deregulation

One factor that is often imputed when crises occur is "deregulation." Incidentally, this was probably one of the main factors that caused John McCain's defeat to Barack Obama because McCain was quoted as saying that deregulation, which was the trend over the last two decades, was good for the US economy. If, indeed, deregulation affects the economy adversely, by implication, future financial crises can be eliminated with improved regulation and oversight. However, the experience of the US which can boast the best system of regulations with its Federal Reserve Board, FDIC, state banking authorities, the SEC, the CFTC, and others, built up over hundreds of years of experience in regulating the financial industry, does not bear much hope. It is to be noted that before the onset of the current crisis, no significant complaint about the state of the US regulatory systems was ever received. In fact, the only complaint then was that the industry needed more deregulation which was the reason why 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. However, 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. Soon after, the US financial industry and the US economy grew and modernised. Moreover, the individuals who were responsible for the de-regulation efforts, for example, 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. Had the US economy remained strong until today, those individuals probably would still be hailed as heroes. Given the economy collapse, they had become culprits of the situation.

In Malaysia, deregulation has not acquired any adverse connotations since the country's economy is not in a crisis. In fact, Zeti Aziz, the Governor of Bank Negara Malaysia and winner of the Euromoney 2005 Governor of the Year Award, has always extolled the benefits 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. An 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.[26] The fact is that when the economy is going strong, it will be impossible to criticise deregulation efforts.

B. *Growth of sophisticated financial instruments*

Another object responsible 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.[27] These CDSs are then bundled into securities, known as, collateralised debt obligations or CDOs. By using CDOs, lenders are able to reduce the cost of protecting against non-payment. They

26 "Strengthening the Banking Sector for Further Competition," Governor's Keynote Address at the *Dialogue Session with Banking Institutions*, 17 February 2005, accessed at http://www.bnm.gov.my/index.php?ch=9&pg=15&ac=164.

27 "In Defence of Credit Default Swaps," *Economist*, 6 November 2008, accessed at http://www.economist.com/finance/displayStory.cfm?source=hptextfeature&story_id=12552204.

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, which is the main reason for their popularity. For borrowers, the cost of borrowing is also reduced. This lowering of the cost results in a bigger size of potential borrowers. As in the US case, it resulted in a bigger number of house buyers, including the risky ones, known as "sub-prime borrowers." As described earlier, this also served to increase house prices which, when used as collaterals, will in turn, allow more borrowing. These serve to create the huge debt level in the US and elsewhere which, therefore, created the current problem.

Despite this, is it realistic to try to prevent future crises by banning the use of financial derivatives and other instruments? The creation of financial derivatives is known to be a natural outcome of developed and dynamic financial markets.[28] The instruments are created to facilitate the flow of funds from lenders to borrowers, that is, 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 academicians, who teach advanced level finance courses, the usage of derivatives will be widespread. Perhaps, in ten years, derivatives will be used widely when the Malaysian financial industry becomes much more developed in order to sustain the country's rapid drive towards economic growth. This is 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. Undoubtedly, debt levels will commensurate under those circumstances. So, one can expect a more spectacular financial crisis at that time!

28 Ibid.

C. Abandonment of gold standard

Another common object imputed for financial crisis is the abandonment of the gold standard, which, with a reversal, implies that future crises can be prevented. In this author's opinion, stressing the issue of the gold standard denotes a misdiagnosis of symptoms as the actual cause of the problem. As generally known, the gold standard was abandoned through a couple of stages, with the final and complete abandonment in 1971, when the US government under President Nixon announced the inconvertibility of the US dollar to gold in efforts to finance the war in Vietnam. Calls for the reinstatement of the gold standard, whilst others for a modified version known as "Islamic Gold Dinar," were made. But, in fact, the finance industry grew and as lending organisations aggressively sought to maximise revenue and profitability, the abandonment of the gold standard was simply inevitable. This is because maximisation of credit creation requires fractional reserve banking to be practised to its limits, which is the amount of gold reserves in the banking system. A corollary to it is that if a 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 replaces gold reserves in the banking system. This arrangement will be beneficial for both the borrower, the government which wants to have unlimited borrowing potential, and the lender, the banks which will earn potentially unlimited interest on those lending. Hence, the notion that financial crises can be prevented completely with the reinstatement of the Gold Standard is akin to solving road accident problems by simply imposing a speed limit of 60 km/h on all roads and highways. It may help the situation but under the present circumstances and set-up, it will be completely ignored by all.

D. Greed

Time and again, "greed" has always been criticised for any form of crises, particularly of the financial kind. In the Tulip Mania case, speculators scrambled with purchases of the bulbs, even before they were fully bloomed for harvesting, in order to gain as much as possible from the high market prices of the flowers. The lenders were also unreservedly lending them money to engage in the speculative activities. Similarly, during the recent sub-prime mortgage crisis, house-buyers readily bought homes, which they found later they could not afford. The banks had again liberally lent money to them for the purchases. Investors from all over the world snapped up the CDO's offered by the Wall Street people, who gained tremendously from the transactions.

Viewed in these contexts, how is "greed" defined and what are the ways of eliminating it? In the movie *Wall Street*[29] (and the 2010 sequel), the greedy character, Gordon Gekko, had no qualms breaking insider trading laws in order to be at the top and wealthy. However, in many real financial crises, there has never been an obvious case of illegal activities proven. As in the Tulips Mania case, nobody broke the law. To certain quarters, the people involved were not greedy. Rather, they were merely optimistic risk-takers trying to benefit from opportunities available in the market. Arguably, neither were the speculators during the Asian financial crisis greedy. They were merely market opportunists taking advantage of the currency-pegging by the Southeast Asian central banks. One of the so-called "greedy" speculators, George Soros, was once railed by Mahathir. Ironically, both have ended their enmity and been on amicable terms. Regardless of the anger directed

29 *Wall Street*, directed by Oliver Stone, 20th Century Fox, 1987.

at them, currency speculators still exist and will continue to be for many more years to come. In fact, when the stock market is bearish, the government welcomes all investors, including speculators. Hence, the perception of "greed" as being responsible for the current global financial crisis, is a misplaced one.[30]

Moreover, putting the blame entirely on greed is only a problem that is stated after the fact. When the economy was growing and the Wall Street firms were gaining profits without breaking any law, greed was never mentioned. Instead, the players were praised highly for their brilliance in spotting market opportunities, for creating new products, for willing to take risks, amongst others. Often photographed on the covers of *Business Week*, *Fortune* and *Forbes*, Wall Street senior executives were once hailed as paragons of success. Even in Malaysia, bank CEOs are heaped with praises for expanding their organisations' operations and market share. Thus far, none has been sullied as greedy bankers. Hypothetically, should a financial crisis strike Malaysia and Malaysian banks find themselves over-extended and insolvent, the fate of the same CEOs may change by critics, who will level accusations of greed against them. Similar fate had befallen Richard S. Fuld Jr., the ex-CEO of defunct investment bank, Lehman Brothers; Charles Prince, the ex-CEO of Citigroup; and John Meriwether, the former CEO of Long-Term Capital Management. All three individuals used to be highly admired until crisis tarnished their reputations.

From my point of view, accusations of greed are unfair. Greed is justified as the main factor when clear evidence shows that laws were broken, as in the cases of Nick Leeson of the Barings Bank, and probably Jeffrey Skilling of Enron. Both

30 Barry Eichengreen, "The Best of Intentions Go Bust," *The Guardian*, 2 October 2008, accessed at http://www.guardian.co.uk/commentisfree/cifamerica/2008/oct/02/wall.street.economy.us.

were localised crises whose impact was largely limited to the organisations involved. In most major financial crises of the systemic kind, the reasons are beyond greed. Thus, to pin the blame of a large scale global crisis, for example, the current sub-prime mortgage crisis that involves trillions of dollars and countries spanning several continents 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."[31]

Upon analysis of the different crises mentioned earlier, researchers have found common factors between them. A well-known study, conducted by Carmen Reinhart from the University of Maryland and Kenneth Roggof of Harvard University, compared the 2007-2008 U.S. sub-prime mortgage financial crisis with 18 earlier post-war banking crises in industrialised countries. They found interesting qualitative and quantitative parallels, in terms of asset prices, real economic growth, and public debt.[32] Specifically, both found that the increase in U.S. equity and housing prices closely tracks the average of the earlier crises. In addition, Reinhart and Roggof also indentified an output growth of the inverted v-shape curve type just before the eve of any crisis. Lastly, both found that prior to all crises is a run-up in U.S. public debt.

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31 Ben Steverman and David Bogoslaw, "The Financial Crisis Blame Game," *Bloomberg Businessweek*, 18 October 2008, accessed at http://www.businessweek.com/investor/content/oct2008/pi20081017_950382.htm?chan=rss_topStories_ssi_5.

32 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.

A discussion on financial crises is incomplete without mentioning Charles Kindleberger, an economic historian and the Ford International Professor of Economics, at the Massachusetts Institute of Technology, who carried out a very detailed analysis of previous financial crises.[33] This author will relate what Kindleberger found from his analysis of past crises and attempt to identify whether the patterns mirror the current financial crisis. According to Kindleberger, an exogenous "shock" will occur prior to any crisis. In the past, it could be new technology or new industry, for example, the US railway industry or the utility industry prior to the US Great Depression. The probable shock, with regard to the current crisis, is probably 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 as evident in the US, European and Asian economies which went through a growth period during the last decade. The growth is fed by increasing money supply, thereby, resulting in high debt situation. Such is certainly true for the US and British economies which had debts to GDP ratio of around 300 per cent. Kindleberger explained that the rapid economic growth period leads to speculation that initially has positive feedback. Speculators earn money and invest more. In turn, this will encourage more people to invest. In the case of the current financial crisis, speculation was rife in the US housing markets and the derivatives market related to it, leading to a situation of excessive growth of economic activity. The MIT professor used the term "overtrading," for this situation. Originally coined by Adam Smith, "overtrading" can be caused by pure speculation

33 Charles P. Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises*, 3rd ed. (New York: John Wiley & Sons, 1996). The first edition was published in 1978.

or by overestimation of the true expected return and excessive gearing or high leverage. The current financial crisis has the derivatives market at its height, which is 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 per cent of GDP. "Overtrading" will be quickly followed by a realisation that the situation is unsustainable. Price will then drop suddenly which occurred in the US in June 2007, when real estate prices started falling. This situation spreads from one market to another and also to another country or countries. For the current financial crisis, the problem is being transferred to a host of sectors, including the US auto industry, when the top executives went begging to the US Congress for USD25 billion bailout. Internationally, the situation is spreading fast from the US to Europe, Japan and Asia.

Kindleberger was convinced that, at the height of this downward spiralling situation, some players would leave the market, thus, creating a "financial distress." Merrill Lynch, Lehman Brothers and AIG, amongst others, are seen as players in the present debacle. He added that news of a bankruptcy leads to the final stage, which is the rush for liquidity. In the case of the current financial crisis, the rush to liquidate stockholdings led to the massive drop in the Dow Jones Index and the massive drop in property prices, following the announcements of bank insolvencies. According to Kindleberger, the banking system would be vulnerable or fragile because of the "feedback" nature of the cycle where bad news leads to further bad news. This is evident in the US banking system, where the initial fall in prices of properties reduced the value of collateral and induced banks to call off 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. Further decline in collateral leads to more liquidation. If firms fail, so too will some banks and the loans they serviced. Depositors will then withdraw their money which will worsen the situation. Significantly, the same scenario almost happened to the US banking system recently, except for the intervention of the US government with the USD700 billion bailout to stem the problem. Whether the problem has been completely eliminated, is still uncertain.

Even though Kindleberger's book was written in 1978, his description of the process of a financial crisis perfectly described the current sub-prime financial crisis. Similar to Reihart and Rogoff's research, Kindleberger has proven that financial crises of the past and the present share many similarities.

One important aspect highlighted is the impact of psychological mechanisms in the whole process. When conditions are favourable, 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. A fall in prices can be magnified by psychological forces via the "feedback" process to result in banks calling off loans or refusing new ones, in households selling off stocks and cutting down on spending, and in businesses postponing expenditures and borrowings, amongst others. 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. On many occasions, this requires making statements that are at best misleading or at worst outright lies. Bankers, in fact, 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 to withdraw their money simultaneously, the banks simply cannot honour those requests and will have to close their doors, as seen in the Argentinian banking crisis described earlier. Even political leaders have to adopt similar tactics. For example, on 20 October 2008, the then Finance Minister, Najib Tun Razak, was reported to have said that Malaysia was insulated from the worst effects of the crisis. This is, indeed, a strange statement for Malaysia is known to have very strong trade links with the US, Europe, China and many other countries. Hence, logically, it cannot avoid the effects of the global recession. Weeks later, though, Nor Mohd Yakcop publicly admitted the vulnerability of the Malaysian economy. The Second Finance Minister could have realised that the economic data was getting worse and he would not be able to hide the truth. As this incident exemplifies, when the country's welfare is predicated on the well-being of the finance industry, politicians, in particular, are compelled to be less than forthright about the true nature of situations and have the tendency to make misleading statements at times.

In actuality, financial experts, be they practitioners, policy-makers, regulators or academics, are all too familiar with Kindleberger's works, which are shown to have been cited by 885 studies by Google Scholar. In hindsight, Krugman and Greenspan made no mention that financial crises would never happen. Rather, they contended not to have accurately forecasted the timing and magnitude of the current crisis. Indeed, they and many others, are the ones well-versed with the processes or stages of financial crises. Thus, Paul Samuelson, Nobel Laureate and Professor Emeritus at MIT, in his comment about Kindleberger's book, noted that, "Sometimes in the next five years, you may kick yourself for not reading and re-reading Kindleberger's *Manias, Panics and Crashes*," implying the inevitable nature of financial crises.

Despite their understanding of the processes involved in a financial crisis, the same financial experts are still incapable of instituting policies to avert or prevent future crisis. Some of the ideas being floated about to solve the problem, for example, lower interest rates to encourage borrowing and encouragement to banks to lend to businesses and individuals, regardless of sectors are, in fact, 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 that is knowledge and understanding are of little value to stop crisis from happening. This problem is akin to drug addiction. While eradicating it poses a challenge to society, freely tolerating the vice would aggravate the situation. Hence, the need for stringent punishments meted out to offenders. Similarly, financial crises and the rest of the problems are well understood by all economists in their analyses of historical evidences. There is a tacit concurrence that the problems are not going to go away as long as the financial system does not change and the lending-for-profit or finance industry is prevalent. The only difference between drugs and finance is that the former is prohibited whilst the latter is not. Therefore, the occurrence of other financial crises in the coming years is inevitable.

At the height of the sub-prime crisis in 2008, Andy Serwer, the managing editor of *Fortune Magazine* said, "The party is over on Wall Street–until it comes back again," and 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."[34]

Conclusion

While all financial crises will eventually bottom out, it may take a few more years and much human suffering before the recession will recover. Following that, the economy will pick up again, possibly very strongly. Perhaps, that will just be a prelude to yet another hard-hitting crisis because it will definitely be more serious than the one previously experienced. This is because, if the steps taken to tackle a 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 the society, which would have been the main cause of or the prelude to the previous crisis. Therefore, in reality, we are not solving the problem but simply putting off the reckoning to a later date and to the following generation.

Given the circumstances of financial crisis that have taken place, can the next one possibly be predicted? It is quite unlikely even when a Nobel Prize-winning economist was unable to do so at the onset of the 2008 sub-prime debacle. Should another one occur, not in this lifetime, hopefully, the government may provide bailouts and stimulus packages large enough to prevent major bankruptcies. Unfortunately, this will incur a huge debt which, implicitly translates into problems that are transferred to the following generation to inherit. While these people may be too preoccupied with their lives

34 Abbie Boudreau, David Fitzpatrick and Scott Zamost, "Wall Street: Fall of the Fat Cats," *CNN.com.us*, 17 October 2008, accessed at http://edition.cnn.com/2008/US/10/17/siu.wall.street/index.html?iref=mpstoryview.

in the fast lanes of material development chasing unfulfilled dreams to ponder the source of their predicaments, little do they realise that their predecessors are the ones responsible for their convoluted turmoil. Similarly, the present generation, with its current lifestyle, chasing similarly unfulfilled dreams, are uninformed of the likes of John Calvin, Adam Smith, and Jeremy Bentham, who were the progenitors of the current financial problems. Hence, whatever reaction one has of the crisis is for one's own conscience to decide.