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George Cooper

The Origin of Financial Crisis: Central Banks, Credit Bubbles and the Efficient Market Fallacy

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How to stimulate the economy by credit creation without causing financial instability is the main thrust of this book.

In order to accomplish this goal, the author suggests, contrary to the accepted, albeit conventional, academic paradigm, doing away with the Efficient Market Hypothesis and adopt instead the “Financial Instability Hypothesis” championed by Hyman Minsky.

Cooper criticizes applying the concept of “laissez-faire” and the stable equilibrium of goods markets to the labor, land and capital markets, utilizing the same logic and mechanism of attaining stability. As an example of exceptions to the supply-demand paradigm preached by the mainstream economists, he cites conspicuous goods (*e.g.* fine arts) where demand increases when prices increase, and oil where speculative demand increases when supply gets constrained. Thus, he ushers the case of assets in which, contrary to the conventional free market wisdom, higher prices due to the faltering supply may trigger higher demand.

As an alternative theory, the author commends the Financial Instability Hypothesis. The most significant feature of this hypothesis is that it differentiates between the goods market in one side and the financial and assets market in the other. In the goods market one price prevails for the good at the end of the transaction. For example a dealer in a car sale agency offers to sell a certain car with one price, whereas in the financial and assets, however, normally two sets of prices are dealt with by the stock broker, the one offered for purchase of the stock and the other for its sale, a potential source of market instability.

The Efficient Market Hypothesis, as diagnosed by the author, dwells on theoretical as well practical premises. On theoretical grounds, he argues that the Efficient Market Hypothesis stipulates that prices reflect all information and therefore these prices are the right ones and this includes assets prices which should not deviate excessively from the equilibrium prices in the form of bubbles. On the practical side, he mentions that among the most noticeable destabilizing factors in the financial markets, which are inherent in the Efficient Market Hypothesis, are the following:

1. Those in precarious financial position are required to pay higher levels of interest when they default on repayment of their debt, a matter which aggravates the risk of default.

2. Borrowers whose assets have already fallen in value, may not have additional collateral to hand over to the lending banks, and the banks decision to sell their collateral into what is already a faltering market may exacerbate the borrowers and so the banks losses. This situation originates from the fact that the banks resort to checking the values of their held collaterals against the prevailing market prices, in what is known as mark-to-market accounting.

3. The destabilizing effect of guaranteeing a return while putting the funds in risky investments and the probability that this will lead to bank runs. In fact, according to Cooper "bank runs flagrantly violate the Efficient Market Hypothesis" (p. 17).

The most significant challenges to the Efficient Market Hypothesis, which tend to destabilize the asset and credit markets, are according to the author: bank credit creation, mark-to-market accounting, debt-financed asset markets, cyclical dependence of credit spreads, scarcity-driven demand and price-driven demand (p. 109).

The main culprits in the current financial crisis, according to the author, are the academic conventional (orthodox) theory and the central banks. In the academic field, the macroeconomic theory had for decades almost ignored the destabilizing role of debt financed asset markets, implicitly assuming its behavior as similar to that of goods and services. As for central banks their main problem is that they have followed one economic policy during expansion and another when the economy is contracting. Most central banks, particularly in the western world, opted to leave the markets alone when the economy is doing well, while hurrying to cut interest rates when matters starts to falter. This "pre-emptive asymmetric monetary policy" is supposed to stimulate the economy and prevent assets prices from falling. Instead it may lead to larger credit cycles which eventually may result in aggravated contractions. The author, thus, recommends that central banks should let credit cycles run their course within acceptable limits, "with policy response being applied symmetrically in both the expansion and contraction phases of the cycle" (p. 138).

The author argues that the *raison* d'être behind the establishment of central banks was to stabilize capital markets, particularly the credit system, which is inherently unstable. However, the existence of central banks encourages more risky lending, thus destabilizing the system. Since credit creation boosts profits, the temptation is to expand credit to the limit of being excessive. Therefore, since " credit creation is the foundation of the wealth-generation process; it is also the cause of financial instability " (p. 171).

In order to emphasize his main thesis about the failure of the existing financial system, the author raises many vital issues, normally either ignored in the mainstream financial theory literature or dealt with lightly or unscrupulously. These issues can be summarized as follows:

1. The precipitation of the moral hazard problem due to the central banks being a lender of last resort. As the author puts it clearly: "The presence of a central bank, willing to underwrite all deposits equally, will have the effect of putting safer, less leveraged, institutions at a commercial disadvantage relative to the more cavalier institutions (paragraph 1, p. 60), and " the risk management paradigm effectively said: don't worry; we the lender-of-last-resort will come to your aid well before you reach the point of needing to borrow from us. In fact this policy gave *carte blanche* to use the credit card freely" (paragraph 3, p. 60).

2. The current financing practices, condoned by most of the central banks, encourage excessive credit creation. For instance, rising property prices give lenders a false sense of security in increasing lending money, which in turn increases property prices which in turn justifies lending more money and so on.

3. The author mentions several commonly suggested solutions to the crisis, which include allowing markets to solve the problem, infusing more debt spending into the economy and allowing inflation to deplete the outstanding stocks of debt. However, he recommends more subtle, yet, regular, remedies among which are:

a. Controlling of inflation , caused by excessive credit creation, by demonetization of debt.

b. Reining on deficit financing by central banks.

c. Consumer price targeting.

d. Market discipline instead of credit (leverage) building.

4. Monetary and financial authorities , specially in the united States and Britain, were not able to control the frequent credit crunches, because they were using the wrong statistical prediction systems.

5. Contrary to the Efficient Market Hypothesis, which relies on the random-walk premises of financial markets, the author suggests that financial markets have their own memory which effects their behavior. In his words " If, in contrast to the principles of market efficiency, financial markets do exhibit a form of memory-driven behavior and have even a slight tendency to repeat recent actions, these quantitative risk systems will systematically under-represent the true risks in the financial systems" (p. 18).

6. The author find fault with central bank advocating the Efficient Market Hypothesis in combination with intervention in the financial markets, a contradictory policy according to him.

7. Attention by central banks should be directed towards averting excessive credit expansion and asset prices bubbles, rather than consumer price inflation.

All in all, the book is a significant treatise on post financial crisis analysis, rightfully recommended by the Economist as a " must read ". However, from a globalized and comprehensive perspective with regard to the international financial crisis, several issues, deemed to be equally as significant as the ones raised by the author, were not dealt with sufficiently in the book, prominent among which are the following:

a. The role of informal institutions and markets that do not fall under the direct control of regulators, was not addressed.

b. The possible contribution of asymmetric information and the resulting adverse selection by the financial market players was not discussed.

c. Corporate governance as a probable element influencing the development of the financial crisis was almost ignored, particularly the behavior of corporate managers towards risk and their much abhorred payment benefits.

d. Building of economic transactions on financial , mostly paper, instruments rather than on real goods and services, was not stressed enough as to expose the true roots of the crisis. Such practice which precipitated dealings such as the sale of debt and derivatives, were not emphasized enough to show the scope of their significance as prospective causes of the financial crisis.

e. The question as to why the sophisticated early warning systems failed to predict the looming financial crisis, was not answered.

f. The international component of the crisis was almost neglected, save for some mentioning of the United Kingdom Central bank. The analysis of the causes of the crisis would have been enriched if other schools of thought and paradigms , particularly from the Third or Islamic World, were also introduced into the arguments.