PROBLEM OF GLOBAL FINANCIAL INSTABILITY

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ABSTRACT
Global financial instability has been inking since 2009, affecting macro-economic performance and economic policies. The instability has posed a great challenge for emerging economies, especially advancing economies. The crisis has left government and household heavily indebted, many financial institutions dragging behind and the overall economy has not yet recovered (Beattie and Atkins, 2011). For the economies emerging, the financial instability has left a strong domestic demand, large capital inflows and a lot of credit. The key question posed to policy makers today are how they going to reduce the rate of financial instability. Policy actions by banks have left the global banking system vulnerable, despite significant policy change. The elevated policy of going through household leverage posed a risk to the house market industry. The move to rebound capital in-flow still remains an uncertainty due to the risk of rising inflation rates (Posen, 2005). Hence, the policy makers need to look at chances of reducing the high debts and strike a balance in the balance sheet. They are to engineer a steady financial system that will shift the balance in economies from overreliance of microeconomics (Ferguson et al., 2007). Lastly, they should come up with financial policies that support liquidity flow into the markets. This paper will seeks to understand the global financial instability crisis, its causes, implications and what is been done to break the financial instability. Lastly, it will look at the important role the policymakers need to play to successfully control the instability.

KEY WORDS
Financial instability, interest rates, prices, economic growth.
1. INTRODUCTION

Since October 2009, views have been developed that most economies were declining due to the global financial instability (Cappiello et al., 2006). This led to many institutions thinking about the global financial and monetary systems future direction. The analysis has had an adverse impact on financial market trends and the various interest rate systems in the market (Mishkin, 1999). The global financial instability in the 90’s was interpreted in terms of household saving behavior, and the solution then was to depreciate the currency sharply.

This explanation however was challenged when a strong constrain was experienced in 2003 where global and interest rates, exchange rates and inflation rates shot up unexpectedly (Ferguson et al., 2007). The forecast had to change their analysis and forecast methods and that is when the financial markets were made an official measure to analyze the central view. The financial analysis began to show that the real interest rates for the US and the Euro are were gradually rising (Mishkin, 1999). The currency composition would have an advance effect on financial instability, leading to high domestic demand. This would expose the global banking systems to higher risks and lag the emerging economies behind. As a result the balance sheet would be strained because the policies placed would show structural weakness and low capital inflows (Mishkin, 1999; Posen, 2005).

The global financial instability according to the International Monetary Fund report (2008) has left high unemployment rates and a large weight on economic growth. The policy makers are tasked with the challenge of having to improve the instability and put in policies to balance the economic balance sheet. The policies should also encourage the reduction of debt and demand better household goods on demand. Fixed rate systems could also be reviewed to stabilize the fluctuating rates in the financial markets (International Monetary Fund, 2008).

2. FINANCIAL INSTABILITY

Financial instability can be defined in different ways, where financial instability is defined as an antithesis of financial stability; it can be define financial stability and identify its absence. This paper will define financial instability as the absence of financial stability. Mishkin (1999) defines financial instability as shocks that appear in financial systems and disarray the flow of information. The disarray leads to a malfunction in the financial system, interfering with its job of routing funds to appropriate investment in available opportunities (Saccomanni, 2008).

The financial system has the crucial role of availing funds to the real sector, any interference in its central role, causes asymmetrical flow information leading to financial instability (Mishkin, 1999). The
stress is on information, even where stocks are involved, because its interference causes an intermediate cease. This means financial instability is the heightened risk of a financial crisis and it is not systematic. Global financial instability can be translated as a major collapse of the global financial system (Saccomanni, 2008). The collapsed involved the inability to fund or even acquire credit to acquire investment opportunities.

Global financial instability can be seen through the asset market that went volatile, collapse of the market liquidity and finally the market infrastructure down trend. Ferguson et al. (2007) further characterizes financial instability in three scenarios; one is when the financial assets seem to have taken an outside course from fundamentals. The second scenario is where the financial system cannot afford to pay or acquire credit both domestically and internationally to fund investments. The last scenario is where macroeconomics deviates and demand suddenly rises and the supply is short (Steil, 2007). There are four key issues that are analyzed and help determine whether the financial system is instable. It is important to look into the financial condition of the financial system, by looking into the performance of the different components of the system (Steil, 2007). Evaluating the various non-financial sectors such as business enterprises, small and large and individual households are important indicators. Studying the balance sheet for vulnerabilities in both financial and non-financial sectors also helps identify the current status. Lastly, an analysis of the two sectors and how resilient are the shocks determines the financial status (Steil, 2007).

One of the biggest challenges of identifying a financial instability is to note a systematic risk in all the above indicators. This is because sometimes the crisis could be caused by only one indicator, which may not be felt in the financial system (Ferguson et al., 2007). Trying to determine whether there is a financial market disturbance would mean regular studying of all the indicators regardless of insignificant change. This would help prepare for a financial instability to prevent a crisis like the 2007 financial instability panic which led to banks globally to take action without proper knowledge (Whitney, 2007). The UK had a political intervention during that year only for it to be established as a microeconomic effect on the financial system (Whitney, 2007).

Drawing conclusions that an economy is going through global financial instability will require the combination of value judgment and technical analysis (Rogoff, 1999). There has been an over reliance on the balance sheet, household and market components to define a crisis in the financial market. This can bring about mixed signals, however, experience and analytical judgment is required before policy makers come to meaningful conclusion. An analysis on the instability also helps the policy makers understand the route cause and the implications ahead.

3. WHY FINANCIAL INSTABILITY OCCURS

It has already been established how to define financial instability and above financial instability has been linked with shocks interfering with the financial systems, disarranging the information flow that provides
funding for potential investments (Evanoff et al., 2007). Hence, it is important to know how why financial instability occurs, by identifying the shocks that interfere with the financial system. When the financial systems are interrupted, the system fails to pay for services and cannot attract credit to fund for the various projects. This according to Evanoff et al. (2007) directly affects financial institutions mostly bank, because they play a huge role in the financial system. Banks are active in providing funding for various potential projects to boost the economy. Interference in this then means a decline of funding by the bank to fund the investments (Evanoff et al., 2007). Banks are unable to provide loans and the investment opportunities decline gradually affecting the economy.

When shock hits the financial systems a financial occurs where the funds to pay for the investment are cut. Lending in banks declines and the investment presented cannot be funded due to a shortage of funds. The lack of funding then forces the households and enterprises to cut on their spending, affecting the economic growth (Yan, 2012). At this point the interest rates are bound to be raised to discourage borrowing.

This eventually hikes the price of goods and services, which leads to an increase in inflation rates. The demand of goods and services tends to increase because the cost of production is relatively high and few people are willing to take the risk to invest in manufacturing (International Monetary Fund, 2006). The rate of unemployment also goes up at this juncture with many enterprises wanting to cut down on costs. Most business downsizes and lay off workers to minimize cost and this leaves most people with no source of income to purchase goods and services (Ghosh, 2001).

We will further expound on the four main components that lead to financial instability, as a result of interfering with information flow. The four factors are; increase in interest rates, deterioration of non-financial sector balance sheet, increase in uncertainty and decline of financial sector balance sheet (Ghosh, 2001).

4. INCREASED INTEREST RATES

High interest rates are one of the factors that cause financial instability, as a result of asymmetrical information (Ghosh, 2001). When the financial system is interfered with, there is a lack of credit fund and this automatically leads to increased interest rates. Most people will fail to borrow due to the high interest rates imposed on the principle amount. However borrowers with risk investment projects will go further to borrow regardless of the interest rates with the aim of having high-risk returns on the invested projects (Posen, 2005). The credit lenders however view the loan as a bad credit risk and this leads to financial instability.

Higher interest rates also affect the bank’s balance sheet, causing a negative imbalance. When the banks gives loan and they are short of borrowing then the bank is left with long duration assets as opposed to its liabilities (Ghosh, 2001). During this period the bank takes deposits such as certificate of deposits and gives loans that are bound to be paid in longer periods. The balance sheet in this incidence is
imbalanced because the bank’s net worth is reduced and the bank’s liability is increased. This is because the loans given by the bank take longer to repay as opposed to the bank’s deposits.

5. DECLINE IN FINANCIAL SECTOR BALANCE SHEET

In periods where financial institutions fail to acquire enough funds to give loans to borrowers the institutions always have various choices. The institution could decide to cut back on the loans being issued by the institution (Great Britain treasury, 2008). This means that the institution finds ways to discourage borrowers like rising interest rates and inculcating restrain measures to cut back the borrowers. The other choice an institution can opt for is to find other ways to raise capital to issue out loans to borrowers. The option to raise capital is often challenging because funds are limited and scarce meaning the financial institution does not acquire the capital at a reasonable price (Posen, 2005).

This slows the lending activity and hence slows the economy, because the institution’s balance sheet is contracted. A weak balance sheet leads to capital crunch which could lead a financial institution to go through bankruptcy. Where the government fails to cover the banks net, it could lead to banking panic across the various banks (Rogoff, 1999). This will discourage the bank customers from depositing for fear of losing their money in case of closure, leading to more capital shortage (Posen, 2005).

Once a bank faces closure, information flow is interpreted as loss of financial intermediary which could lead to financial instability. The other banks react by declining even more to lend loans even to potential investment, leading to a drag in the economy sector. The financial balance sheet of the bank then reduces its net worth and the liability increases, which as a result causes instability (Posen, 2005). Figure 1 in the table of figures below shows how the market asset percentage has declined in EU banks from 2006 to 2009 causing financial instability (Posen, 2005). The bank lacks enough capital flow and the liquidity level is cut back making it harder for the bank to operate with a stable balance sheet.

![Figure 1: Prime Money Market Exposure to Banks (% of Total Assets)](image-url)
6. INCREASE IN FINANCIAL UNCERTAINTY

Financial uncertainty is one of the factors that lead to financial instability because it stems from a drastic change in financial assets that edge individual risk (Smith, 2011). Financial markets should be well evaluated together with the possible increases in financial instability. In these changing economies the probability of risks is also high and a framework built has to forecast the future economies. Smith (2011) observes that financial innovation introduces financial uncertainty in both emerging and advanced economies. Uncertainty depends on economic behavior as a result of interruption of information flow in financial markets.

The complexity of uncertainty can bring up financial instability in a market, for instance in the lending cycle (Smith, 2011). A creditor may fail to make payments where necessary and this may affect the market where the creditor is seen as a debtor. This economic behavior can lead to uncertainty in the market due to transfer of default from one market to the next. New financial assets can also lead to uncertain behavior in the economy as it changes with financial innovation.

Lenders in such situation will decline to lend to borrowers on basis of the uncertain risks ahead. The decline in lending means a decline in investments by the borrowers because of lack of funding. Uncertainty tends to also scare away the high-risk takers who can afford to borrow with high interest rates in the market (Smith, 2011). This turn of events leads to market instability where both the lender and the borrower are reluctant to act due to high risks involved.

In the 19th century the economist Walter Bagehot stated that in a state of panic within financial markets, there moments in time when a large number of people invest in a great deal of cash. This investment however leads to a lot of speculation, and speculation in such a market leads to panic. In this situation the panic is never substantial. Before the 2009 global recession many people believed in basic principles such as lending, banking and underwriting (Yan 2012). However, after the credit crunch people began to realize that sustainable cash flow was an unpredictable financial innovation. Borrowers had to rethink about mortgaging and refinancing a business through debt and lenders had to think about redesigning and underwriting their products (Dunning and Lundan, 2008).

In extreme cases the economy is highly affected because the level of investment declines. Here uncertainty is connected with the economic behavior in the market (Dunning and Lundan, 2008). The economy is run by financial innovations and this creates a lot of defaults that transmits and enlarges the uncertainty. The benchmark set for uncertainty is often reviewed every time there is a new set of financial innovations in the market.
7. DECLINE OF NON-FINANCIAL SECTOR BALANCE SHEETS E.G HOUSEHOLDS

In this case the individual plays a role in causing financial instability; here the borrowers cause an imbalance in the balance sheet due to the market problems (Canuto and Gingale, 2010). The lenders cause an imbalance due to the increase of liabilities and decrease of assets. While the borrowers cause an imbalance due to the high interest rates as a result of lack of funding. The borrowers could decline the lender’s loan due to high interest rates and this reduces the cash flow in the lender’s balance sheet (Canuto and Gingale, 2010).

Collateral affects the market stability in form of collateral because it reduces the lenders assets value. If a borrower fails to pay a loan, the next option is to sell the collateral to cover the loan deficit. If asset prices fall within the period, then the lender’s asset value drops and this later affects the balance sheet (Canuto and Gingale, 2010). When asset prices fall the economy is also bound to fall leading to increase in unemployment. This affects the purchasing power of an individual and results to the individual’s decline in demand of goods and services. Figure 2 and Figure 3 illustrate the GDP per capita and the composition of total revenue in 2009 (Smith, 2011). This illustrates how adversely the economy is affected as a result of reduction of GDP per capita.

Figure 2: Expenditure Components of GDP, Euro Area 2009 (% Share of GDP)

Figure 3: Composition of Total Revenue in 2009 (%)
For borrowers lending against their net worth, an adverse reaction is expected, where a borrower has a high net worth in a firm and fails to clear the loan borrowed (Saccomanni, 2008). If the lender takes up the high net worth this causes an imbalance because the lender acquires a higher stake. The demand for a high net worth by lenders discourages borrowers to borrow against a higher net worth, for fear of losing too much in case of default.

The crashing of stock market can lead to a drastic financial instability in the existing market. A drop in stocks means that the net worth of stocks been exchanged in the market has depreciated. This is seen as an incentive by borrowers because of the potential to buy stocks at a low price. However this causes instability for lenders who have stocks for collateral this means that the stocks are far less worth their value (Beattie and Atkins, 2011).

When interest rates increase it affects directly household and enterprise payments, because a rise in rates decreases the cash flow. House mortgages and rent is bound to go high due to the increase in real estate markets (Dunning and Lundan, 2008) Firms will have to pay more for the production of goods and services’ meaning the firm has to increase the selling price to break even and even realize profits. The GDP per capita is gradually reduced once interest rates shoot up because the purchasing power of households is reduced due to high exchange rates in the market (Beattie and Atkins, 2011). Figure 4 illustrates the GDP at current market prices from 2003 to 2009 (Smith, 2011).

![Figure 4: GDP at Current Market Prices (Euro 1000 Million)](image)

8. HOW TO RESPOND TO GLOBAL FINANCIAL INSTABILITY

While there are the four indicators that assist policy makers predict a financial change in the market, sometimes-financial instability is unheeded. However, there are numerous measures that policy maker can put in place to prepare for financial institutions. Some of these measures include: forming a fundamental and theoretical policy to provide for monetary and fiscal management. The financial institutions should consider reviewing the various incentives among its distributors and borrowers, to ensure a steady supply and demand.
The market analyst should differentiate between free and deregulated markets, to establish market fundamentalism. This would help raise the knowledge base of participants in the market eliminating financial market panic. Banks need to place in risk management measures to forecast and calculate the level of risks in the future to prevent an imbalance in the balance sheet. To limit the level of financial emergence the level of credit should be monitored and banks should boost their vetting technique before issuing out loans.

9. CONCLUSION

The main factors that lead to global financial instability are not new phenomena and can be controlled sufficiently to regulate financial markets. The regulatory frameworks that oversee investments need to be reviewed to regulate effectively investment opportunities in the market. Financial institutions ought to work jointly to supervise and regulate the financial market.

Compliant systems should be conformed take into account systematic risks forming ways to eradicate them before they occur. The systems should be updated and stay formidable to ensure that capital requirements are always met across financial institutions.

The systems goal is to ensure financial stability meaning the financial system should not be disrupted by any of the above factors. Using of counter-cyclical control measures ought to bring a good approach of analyzing the stated indicators to secure a free and stable financial market.

REFERENCES


