

## Credit Where Due: A Debate

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### Abstract

This paper reviews earlier work in order to get a single point of consensus regarding current global crises, which overlap the economy of whole world. We find contradictory explanations for the current episode of crises where different methodologies had been adopted in scrutinizing the situation. Overall few put the blame on macroeconomic variables and little on financial vulnerabilities. Some suggest for monetary policy reevaluation and others for fiscal policy to fill in the gap. We find fiscal policy a superior instrument for scheming such circumstances. We propose that interest free financial system would be a better option as an alternative.

**Keywords:** Fiscal Policy, Monetary Policy, Credit Issues, Interest free solution.

### 1. Introduction

In 2009, the developed world predominantly and developing economies loosely observed the largest and sharpest drop in global economic activity causing the global financial crisis and deep recession all over the world. These global financial crises impacts has lay down negative annotation for the proceedings of both monetary policy-makers and financial regulations. Credit and asset price booms leading to ultimately in financial crisis has been observed in history many times. The historical record proposes that policy-makers are usually either unable or unwilling to hold back these unstable expansions. Financial-sector vulnerabilities are not new either. Episodes of banking panic where withdrawal of short-term deposits has resulted in large-scale bank failures has just experienced in eighteenth century.

The absolute definition of financial crises is relatively thorny. A broader definition adopted by Ferguson (2003);, a situation characterized by three basic criteria: that if some important set of financial asset prices diverge sharply from fundamentals , market functioning and credit availability get imprecise at domestic and international level and aggregate spending diverge either above or below from the economy's ability to produce then it indicates financial inaptness.

The definition based on the systemic event (financial or nonfinancial) is provided by Besar *et al.* (2009). They suggest that a systemic event can be defined as one involving 'damage or degradation of the networks of interconnections that link households, firms and financial intermediaries'.

Adrian and Brunnermeier (2009); proposed the concept of 'CoVar', as a measure of an individual institution's contribution to systemic risk. CoVar is defined as the covariance of the returns on an institution's portfolios with the returns on other institutions, conditional on a systemic financial event having taken place. Adrian and Brunnermeier stress the role of 'endogenous risk', i.e. the possibility that a major shock will lead to large-scale forced asset sales, and this in turn results in an amplification of the initial disturbance. As a result the correlation of asset returns increases sharply in a crisis. (Milne, 2009).

Most observers put the charge of financial crises on failures of private risk management and inadequate public regulation. while few considers the role of macroeconomic factors, including possible policy excesses and features of the international monetary system that may have contributed to the build-up of imbalances and vulnerabilities that ended in global crisis. The allegation against monetary policy-makers is that they tolerate an unsustainable growth of bank credit and asset prices to continue uncontrolled for far too long. Financial instability is not only activated by network complexities, but also by the reversal of an unsustainable build-up of debt and asset prices.

Inaccuracy in identifying and retorting to growing system-wide financial risks by Financial and regulatory authorities and flaws in the arrangements for supervising the activities of individual institutions resulted in current episode of crises. The

primary source of problems is considered at Lehman Brothers, which collapsed in September 2008 resulted in changing perceptions of risk by households and by business. Fall down of Lehman Brothers sent signals of anxiety around world financial markets. Banks stopped lending to each other. The risk premium on interbank borrowing rose sharply to 5 per cent. The risk premium on corporate bonds shot up to over 6 per cent. Large capital expenditure (CAPEX) projects were put on ice, the corporate sector virtually stopped borrowing, with falling demand for investment goods and manufacturing durables, trade volumes also distorted.

Monetary and fiscal policies were prearranged to counterbalance the decline in activity and keep the financial sector buoyant but the downturn in activity has caused unemployment to rise sharply lead to political protection for domestic industry against strict border laws causes' exports barrier as retaliations from importing countries. This phenomenon penetrated to all over world and incident end in worldwide recession. Several other factors are also worth nothing ,including the legal uncertainties; compensation arrangements that encouraged traders to hold large highly leveraged positions; failures in the ratings of complex 'restructured' instruments; gross weaknesses in the regulation, oversight, and government support of some internationally active institutions , accounting standards that encouraged excessive risk exposures and amplified the impact of illiquidity on bank balance sheets; and weaknesses of governance in a number of individual institutions that led to their making some very irresponsible lending and investment decisions .This collapse was driven by 'positive feedback loops', with falling asset prices and deterioration of bank balance sheets generating widespread withdrawal of short-term money-market deposits, which further worsened bank balance sheets and forced them to sell structured securities.(Milne)

The problem is that the shadow of the coming events was casting their influx a decade before such as the bursting of the dotcom bubble in 2001 and the rapid growth of China already redesigning the outline of world trade before the 2007/8 financial crisis punch. Some of these events, such as the large disparities between savings and investment in China and in the United States led to large differences between exports and imports for each nation so that large current account surpluses were accumulating in China and large deficits in America. Some people attribute these growing global imbalances as contributing causes of the crisis. Besides population and productivity trends shaping the baseline for the world, some of the key events over the last decade would be as follows.

First, there was the Asian financial crisis of 1997/8, which saw Asian economies generate large current-account surpluses that had to be invested offshore to keep their nominal exchange rates low. Capital flowed out of Asia into US dotcom stocks, driving up equity prices.

— Next was the bursting of the dotcom bubble, which saw the NASDAQ, booming over 1998–2000, burst in 2001.

— Fearing a downturn and possible deflation, the US Federal Reserve eased monetary policy in 2001 in a series of steps to 2004. Some argue that they eased too much for too long. But, with easy credit and a rising housing market, a boom in house prices followed and a period of high growth in credit and leveraged loans. Risk premia hit low levels and leveraged deals became common as investors chased yields in an environment of lax regulatory oversight.

— Rising demands from China (and, to some extent, India), plus a booming world economy saw commodity prices rise across oil, minerals, and food from late 2004 to late 2007. The shock to the global economy from this commodity price boom was as big as the first oil shock in the 1970s.

— Rising prices and inflation caused monetary authorities to tighten policy from mid- 2004 to June 2006.

Each of these major events set up its own dynamics for the course of the world economy and a foundation for financial crises. (Explained by Mckibbin and Stoeckel. 2009)

## 2. Review of Studies

Previous studies have raised few Fundamental issues regarding the vulnerability of financial markets and drew the underlined conclusion to the regulatory Framework that is intended to preserve its stability.

The study of Wren-Lewis *et al* (2010), Squabble that the 2007/8 credit crunch does not require a fundamental revision of

monetary policy. The crunch occurred because regulation was too lenient. The prior successful result of monetary policy was due to the condition of interest rate which did not hit the zero bound previously. If it so then power of monetary policy parched. Study argues that to put the blame on current account imbalances or mistakes in setting interest rates as a prime cause of the credit crunch is not credible. It will divert the attention away from the need to increase financial regulation. The study concludes that current recession does require a re-evaluation of the role fiscal policy at the time when interest rates hit a zero bound. An expansionary fiscal policy is required because monetary policy-makers are uncertain to assure higher future inflation. Study offers two suggestions. First, although monetary policy should remain the primary tool to stabilize the business cycle, the combination of some precautionary fiscal action may be appropriate during the early phase of some economic downturns. Second, to play this 'backstop' stabilization role effectively, a policy that results in the government debt-to-GDP ratio declining (even if gradually and erratically) in normal times seems appropriate. (See also Eggertsson and Woodford, 2003, 2004, Kirsanova *et al.*, 2009 and Leith and Wren-Lewis, 2007b).

The study which explains macroeconomic factors behind the current crisis is by Faruquee *et al* (2009) explore global macroeconomic trends including sustained strong growth, low real interest rates, and high saving rates create an environment contributing to increased financial risk-taking. Study examines macroeconomic policies and the international monetary system, assessing whether too easy monetary policy contribute to asset price bubbles, whether excessive reserve accumulation contributed to a superfluity of global savings, whether the US dollar's reserve currency status motivated financial excesses, and whether policies in capital-importing countries were countercyclical. Study discovers the contribution of macroeconomic policy choices seems complex and ambiguous. it suggests the rebalancing economies away from export-dominated growth towards more domestic absorption to provide the basis for a sustained rebalancing of the sources of global demand, having monetary policy place greater weight on macro financial stability as well as price stability concerns and the international community should continue to work towards developing mechanisms to provide greater assurance of the availability of external financing in times of stress a tool to control financial crises. (See also Luengnaruemitchai and Schadler, 2007, Pais (2007) Drew *et al.* 2008 and Borio and Shim, 2007).

Milne (2009) examines both the objectives and the available instruments for new macroprudential Policy-making bodies. It squabble that the objective financial stability is best understood as avoiding widespread disturbance of financial flows. Achieving this objective requires that policy-makers carry out two different but related tasks. First they must ensure the resilience of the financial system to external shocks. Second they must respond in a timely fashion to future unsustainable expansions of credit and growth of asset prices. Study concludes Macroprudential policy can be effective in addressing these vulnerabilities but will not remove the major political and institutional obstacles to the effective control of unsustainable credit expansions. This study has discussed the new 'macroprudential' approach to economic policy-making and what this can hope to achieve. It argues that while financial markets and financial institutions are very different from those of 50 years ago, the policy challenges have not actually changed. Policy-makers still need to seek financial stability instruments. While responsibility for price stability would remain the main objective of monetary policy-makers, allowing them to focus on the control of inflation. But raising capital and liquidity requirements, in order to prevent unsustainable credit booms and asset price bubbles. In macroeconomic sense to guarantee financial stability, limiting booms in credit and asset prices requires relatively conservative fiscal policy during booms, and a political willingness to take fiscal, exchange-rate, or other policy actions when credit expansion and asset prices have clearly got out of hand. It does not mean we need additional policy instruments, what we can expect from macro prudential policy is an effective response to the 'endogenous risk' or network interactions within the financial system, such as those activated by maturity mismatch, excessive leverage combined with exposure to common sources of risk, and by hidden or mismanaged counterparty risks. As a final point study thus expect macroprudential authorities to address past vulnerabilities, such as the excessive leverage, maturity mismatch, and counterparty risk that transmitted disturbances in the current crisis; and also to be alert to new sources of systemic financial risk emerging from within the financial sector and take steps to stop happening new potential.

There are two distinct sources of financial instability referred by Borio (2009), the time-series dimension of systemic financial risk and the cross-sectional component of systemic financial risk. when market participants have large common exposures or all rely on short-term funding, then they can react in a similar way to a disturbance and this common response can lead to an amplification of the initial disturbance, maybe because of 'fire sales' of assets at deeply discounted prices. This can disrupt a particular part of the financial system, for example markets for relatively illiquid securities or for short-term money. The main driver is the pattern of assets and liabilities among financial institutions, households, and firms. This is the cross-sectional or network dimension of systemic risk. For this cross-section issue regulators appear to be moving in

another direction, seeking to establish a more discretionary framework that will ensure that firms have sufficient capital to cope with any likely external shock. Models of network vulnerabilities will be used to inform this process, but ultimately this will be a judgmental framework for setting high levels of additional buffers that firms must hold above the minimum required levels of capital. The authorities will then expect firms to use these buffers to absorb risk when they are affected by external shocks. Also, as Bank of England (2009) indicates, the authorities will be especially focused on ensuring that highly interconnected firms, whose failure could have a major impact on other institutions, have sufficient capital to survive a major shock. Many proponents of macro prudential policy seem to have suggestion to manage booms and busts in credit and asset prices. This is what has been referred in the terminology of Borio (2009) as the time-series dimension of systemic financial risk. The suggestion is to use regulatory instruments, such as capital and liquidity requirements, to respond to unsustainable national or sectoral debts or deficits, for example through cyclically increasing bank capital requirements during credit expansions.

Reinhart and Rogoff (2009) documented almost all financial crises have been linked with large scale and eventually unsustainable increases of indebtedness. Extensive availability of credit can lead to extensive rises. Over recent years there has been a growing interest in the possibility that psychological mechanisms such as ‘framing’ or ‘regret’ may allow asset prices to rise to much higher levels than can be justified on fundamental grounds.

Shiller (2005) makes a more general case for supposition that wider social and cultural mechanisms can also fuel asset price bubbles. But asset price rises do not always cause financial instability.

Calvo and Loo-Kung (2009), have argued that asset price bubbles and economic fluctuations are economically beneficial, encouraging socially worthwhile innovation in booms and allowing the removal of unwanted capacity in downturns. In any case, the correction of such departures from fundamentals need not necessarily have much impact on financial flows and expenditure.

McKibbin and Stoeckel (2009a), The study models the global financial crisis as a combination of shocks to global housing markets and sharp increases in risk premia of firms, households, and international investors in an intertemporal (dynamic stochastic general equilibrium or DSGE) global model. To understand the quantitative effects of the global financial crisis, a model that incorporates the interconnectedness within and between economies and the linkages between real and financial effects has been specified. To do this, a dynamic, intertemporal general equilibrium model that fully integrates the financial and real sectors of the economy was used to untangle and understand the mechanisms at work. The model incorporated wealth effects, expectations, and financial markets for bonds, equities, and foreign exchange, as well as trade and financial flows. It proved to be a suitable tool to analyse the impact of the crisis and policy responses on global trade and financial flows. The model used six sectors of production and trade in 15 major economies and regions. The study shows that a ‘switching’ of expectations about risk premia shocks in financial markets can easily generate the severe economic contraction in global trade and production currently being experienced in 2009 and subsequent events. The fallout show that the future of the global economy depends critically on whether the shocks to risk are expected to be permanent or temporary. The best representation of the crisis may be one where initial long-lasting pessimism about risk is unexpectedly revised to a more moderate scenario. This suggests a rapid recovery in countries not experiencing a balance sheet adjustment problem.

The difference between a permanent sharp rises in global risk versus a temporary one was explored by study in detail. The difference was seen to depend on the role of expectations in a dynamic model. Once ‘time’ is formally included in a dynamic economy-wide model, expectations has to be incorporated also. Study has explored the impact of the global financial crisis on the world economy under three scenarios. one where the reappraisal of risk is expected to be permanent, one where the reappraisal is expected to be temporary, and a third where agents initially expect the rise in risk premia to be permanent but then unexpectedly switch to the temporary scenario. Study demonstrated that the current and future fall-out from the global crisis depends on the scenario chosen. Although a temporary scenario where risk premia are returning to more normal levels seems to be unfolding, modeling the effects of such a scenario understates the impacts of the crisis in the model used.

Freixas.X (2009) examines the monetary policy followed during the current financial crisis from the perspective of the theory of the lender of last resort. It is argued that standard monetary policy measures would have failed because the channels through which monetary policy is implemented depend upon the well functioning of the interbank market. As the

crisis developed, liquidity vanished, and the interbank market collapsed, central banks had to inject much more liquidity at low interest rates than predicted by standard monetary policy models. At the same time, as the interbank market did not allow for the redistribution of liquidity among banks, central banks had to design new channels for liquidity injection.

The overall conclusion is that central banks in developed countries have been successful in avoiding the worst consequences of the crisis. By abandoning the separation between prudential regulation and monetary policy. Central banks have adopted a hands-on approach and quickly reacted to the financial institutions' liquidity need. Injecting too much liquidity has a limited cost in terms of possible implicit subsidies to the banking industry. The cost to taxpayers might be high but clearly lower than the cost of a complete banking pack into.

King (2009), states that Inflation targeting is a necessary but not sufficient condition for stability in the economy as a whole. When a policy is necessary but not sufficient, the answer is not to abandon, but to augment it. Indeed, the overarching lesson of this crisis is that the authorities lacked sufficient policy instruments to take effective actions. Policy-makers worldwide are now seeking to develop a new macro prudential approach to policy-making to help prevent a repetition of the mistakes of the recent past.

One lessons that we can draw from this episode are therefore primarily about how we regulate the financial sector, and there appear to be good economic arguments that such regulation should include incentive structures within the industry (Thanassoulis, 2009). Achieving the objective of financial stability requires two things: first, policy-makers respond in a timely manner to unsustainable growth of credit and asset prices; second, that they take steps to ensure the elasticity of the financial sector to external shocks. Neither of these is a new concern.

Crux of this review is that, it is yet inconclusive that easy monetary policy in advanced economies throws in asset price bubbles or excessive reserve buildup in some emerging economies put in worldwide savings glut, whether the reserve currency status of the dollar aggravated financial excess in the United States or policies in capital importing countries were countercyclical. Overall conclusion from these studies may be that objectives of monetary policy should be altered to include financial as well as price stability. Rather than being focused purely on control of inflation, interest rates should also be used to reduce unsustainable credit expansion and asset price growth. As William White puts this argument in a recent paper (White, 2009), monetary policy should be used pro-actively to 'lean' against the credit cycle, instead of just being used to 'clean', i.e. to deal with a collapse of credit and asset prices after the event. Few studies argues that if the economy is hit by such a shock, and interest rates hit the zero bound, the power of monetary policy dries up. In the itinerary of the past, few notices that, contrary to the classical macroeconomic assumption about the demand for money, interest rate plays no role, the liquidity need is independent of interest rate. Few suggest macroeconomic policy regime based on monetary policy trying to hit a flexible inflation target is fundamentally sound, and should not be discarded as a result of recent events. However the credit crunch shows that this policy needs to be supported in two ways. First, it need much more effective regulation and control over financial markets. Without this regulation, at best the ability of monetary policy to stabilize the business cycle will become seriously distorted by an aversion to asset price rises, and at worst the current crisis will recur. Second, the zero bound to interest rates means that fiscal policy has to play a major stabilization role in severe recessions. The combination of fiscal implementation lags and uncertainty means that some precautionary fiscal action may also be appropriate during the early phase of some economic downturns. This leaves fiscal policy to plug the gap

## 5. Conclusion

After evaluating the literature we stumble upon a situation where we might say that the current recession does require a re-evaluation of the role fiscal policy can play when interest rates hit a zero bound. An expansionary fiscal policy is required because monetary policy-makers are reluctant to promise higher future inflation, and the impact of quantitative easing is likely to be small, also explained by Wren-Lewis (2010), this study modify a consensus assignment. The consensus assignment charges monetary policy with the task of controlling inflation by managing demand, while aggregate fiscal actions focus on controlling government debt (Kirsanova *et al.*, 2009). However the zero-bound constraint for interest rates places an important caution on that consensus. The consensus assignment needs meet the criteria in two important ways. First, it is sensible to use fiscal policy in a counter-cyclical manner when there is a significant possibility that interest rates might hit the zero bound. (It should certainly be used once the lower bound has been hit.) Second, there may be many cases

in which it is useful to use changes in specific taxes when they operate on the same margin as distortionary shocks, or when they can change relative prices that are away from efficient levels because of nominal inertia. So we might say on this ground that Fiscal regulations are better than monetary policy tools.

We suggest a financial system to avoid such crisis in future, which may be interest free, because nip the evil at the bud is best strategy. The prime cause of current crises is considered to be interest rate issues in USA since 2001; all other events are sequential byproduct of that. The concept of interest free banking and financial system is not a new one. It has been implemented by different Islamic countries already and has established thriving effect. In terms of deposit and loan financing, interest free financial system has shown increasing and more resilient trend compared to conventional system. We capture the example of Malaysian banking system where BIMB's (Bank Islam Malaysia Berhad (BIMB) was the first Islamic bank in Malaysia and was established in 1983 under the Islamic banking Act.) deposit increased to RM4.44 billion in 1997 from RM325 billion in 1984. BIMB's loan financing and services also increased to RM0.9 billion (Abdus Samad & M. Kabir Hassan, 1998). At the end of 2000, total deposit at interest free banking system was RM31 billion while total deposit in conventional system was RM381 billion. In the case of loans financing, RM21 billion was extended by interest free banking system, and RM416 Billion was given by conventional system (Norafifah Ahmad & Sudin Haron, 2000). The amount of interest free Bank's deposit increased up to RM154.86 in 2008, while total deposit in conventional Banks was RM 619.43 billion. Loans financing also increased to RM86.7 billion compared to the conventional banks that was RM773.4 billion (Bank Negara Malaysia Monthly Statistic Bulletin). Annual growth of Interest free banks deposit was 22.6% compared to conventional banks deposit (7.16%) in the commercial banks from 2000 to 2004 (Sudin Haron & Wan Nursofiza Wan Azmi, 2005). In loans financing, Interest free banks contribution increased from 5% in 2000 to 11.2% in 2007. The explanations above reveal that the products and services offered by Interest free banking system had attracted the depositors, customers, investors and others.

The benefits expected from this interest free financial system are numerous. For example, in lieu of a lender-borrower relationship, it relies on equitable risk sharing between the person who provides the capital and the entrepreneur. Interest free long-distance trading will decrease the cost of commodities for investors as well as consumers, resulting in a net welfare to community. There will be no need left for loan financing in this system because an active involvement in a company through profit-sharing is a superior way to direct capital into productive outlets without putting an additional financial burden on the community. The economic foundation for profit sharing will bring distributive justice, efficiency, economic stability and growth. As far as allocative efficiency is concerned, it is at ease because debt financing usually goes to the most creditworthy borrowers and not necessarily to the most productive and potentially profitable projects.

As far as stability matters, the argument is multifarious that an interest-based economy has a built in tendency towards inflation because creation of money is not linked to productive investment at the level either of central banks or of commercial banks. Furthermore interest charges decrease the supply of risk capital and therefore hamper economic growth.

There is also widespread hoarding by muslim countries, which considered conventional banking with suspect. It has been estimated that \$80 billion are still inactive, if interest free banking could attract broader segments of the population, it could mobilize this capital into productive outlets. So, the need is only to modify the rules for interest free banking systems in the same infrastructure of conventional banks.

The last possible suggestion according to our analysis is change the rule of game. As Economics is behavioral science and behavior is impulsive always, Psychology of the people altered with feedback and demonstration effects, most of them would like to trail their society and their other counterpart. The burst of bubble is owing to diffusion of investors, which are in fact chasing each other. People are inherent rational and risk averse.

The concept of rationality lies at the foundation of modern economic theory. The notion of the rational agent is the basic building block of modern economics. Economic theorists perpetually assume that economic behavior consists of the actions of agents seeking to optimize with respect to some well-defined objective function.

Rationality in economics is viewed in instrumentalist terms: the choice of the optimal means to achieve some given ends. Rational behavior defined as *people trying to do what they perceive as best for them to do*. Rationality plays different role. In normative economics rationality is the assumption that agents ought to optimize. As such, rationality is relative to the aspiration of the agent. It requires only that the agent has a well-defined objective function. Different objective functions

lead to different rationalities. In positive economics rationality is the maintained hypothesis of consistency, necessary in any analytical science.

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