Global Finance Journal 22 (2011) 211–216

Contents lists available at SciVerse ScienceDirect

Global Finance Journal

journal homepage: www.elsevier.com/locate/gfj

# The genesis of the 2008 global financial crisis and challenges to the neoclassical paradigm of finance

Adam Szyszka

*Poznan University of Economics, Al. Niepodleglosci 10, 61-845 Poznań, Poland*

ARTICLE INFO

Available online 21 October 2011

*JEL classification:*
G10
G20

*Keywords:*
Neoclassical financial economics
Behavioral finance
Financial crisis

ABSTRACT

In the first step, this paper briefly discusses the macroeconomic background of the 2008 financial crisis. Next, we take a wider approach and we look at systemic changes that global economics, and financial markets in particular, had undergone. We wonder if these transformations, and their effects so dramatically demonstrated in 2008, give grounds to modify the theoretical background of finance. The neoclassical paradigm might be seen as an idealized normative benchmark. On the other hand, behavioral approach helps explain deviations from this benchmark, however itself it lacks the normative character. We conclude that in contemporary circumstances an interdisciplinary approach is needed in the search for an adequate theory, as the financial world is getting more and more complex and dynamic.


## 1. Introduction

2008 abounded with financial markets events on the scale and scope often compared to the Great Depression that happened in the 1930s. Global problems of the financial sector, loss of liquidity by the recently still very credible institutions, drastic devaluation of assets and a significant growth in the volatility of the stock and commodity markets — all these factors give rise to the questions that are very often difficult to answer on the grounds of the neoclassical financial theory.

In the first step, this paper briefly discusses the macroeconomic background of the recent market turbulences. It discusses also market developments and specific financial instruments that greatly contributed to the scale of the crisis.

Later, a wider approach is taken. We look at systemic changes that global economics, and financial markets in particular, had undergone. We wonder if the these transformations and their effects so dramatically demonstrated in 2008, give grounds to modify the theoretical background of finance and to search for a new paradigm that could better describe processes occurring in the global financial market.

*E-mail address:* adam.szyszka@ue.poznan.pl.

1044-0283/$ – see front matter © 2011 Published by Elsevier Inc.
doi:10.1016/j.gfj.2011.10.011

## 2. The genesis of the 2008 crisis

The 2008 crisis can be associated with a number of macroeconomic issues and imbalances in the global economy, originating in the U.S. economy.

One of the material ways in which the U.S. economy influenced the world economy was through its high import demand which led to an increasingly unfavorable external trade imbalance. Such imbalance always appears when the consumption exceeds production in a country. Additionally, it was fostered by the long-term policy of China aimed at maintaining the undervalued exchange rate of the Chinese currency. The deepening trade deficit of the U.S., and the interventions in the foreign exchange market aimed at preventing the RMB appreciation resulted in the fact that significant foreign exchange reserves were accumulated in China, denominated mainly in U.S. dollars. According to the data of the International Monetary Fund, since 2006 China has outrun Japan and has become the largest holder of foreign exchange reserves in the world. It is estimated that at the end of 2008 the value of those reserves amounted to over 1.9 billion USD. The other leading Asian economies (Japan, South Korea, India, Taiwan, Singapore and Hong Kong) gathered reserves of 2.1 billion USD. Hence, together at the end of 2008 Asia held approximately 60% of the entire world foreign exchange reserves, which were estimated to amount to the total of 6.7 billion USD. The IMF estimates that 64% of the world foreign exchange reserves are denominated in the US dollars.[1] The data quoted above does not include the funds accumulated in sovereign wealth funds being the primary destination of the USD surplus from crude oil export.

Beside the increasing external account deficit, the U.S. economy was also threatened by a growing internal budget deficit. Although the US still recorded a budget surplus over 1% in 2000, after the first term of office of G. W. Bush the deficit already amounted to 4.3% GDP and it indicated a further decline tendency. A growing budget deficit was caused by relatively lower revenues resulting from a temporary economic slowdown directly after the dotcom bubble burst and after the terrorist attacks of 9/11, but also by tax cuts introduced by G.W. Bush on two separate occasions. On the other hand, budget expenses were on a significant rise, due to, among others, financing the war in Iraq and the war on terror. Lewis (2004) and Chinn (2005) had warned against the impossibility of maintaining such a twin deficit long-term long before the crisis occurred.

Financing the American budget deficit required vast sales of treasury bills. Nevertheless, investors accepted low yields on American debt because of the credibility of the U.S. Treasury Department. This was mainly the case with the Asian investors who, as a result of the lessons learned from the Asian crisis of 1997 were eager to invest foreign exchange surpluses in U.S. treasury securities. Hence, it may generally be said that the capital that was flowing out of the United States to Asia as the result of the trade imbalance was coming back to the United States, financing its debt relatively cheaply. Warnock and Warnock (2005) estimated that the inflow of the official foreign capital to the United States affected the decrease in profitability of 10-year treasury bills by about 150 basis points.

The expansive fiscal policy of the U.S. government had for a long time been accompanied by the low interest rate Fed policy. The interest rates in the United States were significantly reduced after the dotcom bubble burst in 2000/2001. The reduction was to ensure the economy's soft landing after massive numbers of Americans lost their savings in the dotcom mania. The low interest rate policy was additionally reinforced by the 9/11 attacks on the World Trade Center. To avoid the negative economic consequences that could arise from the anxiety related to terrorist attacks, decisions were made to maintain cheap financing.

On the basis of a combination of the above-mentioned relaxed fiscal policy and low interest rates, the United States created a boom in the economy, much higher than that of the majority of other developed countries. For example during the period 1991–2005, the U.S. economy was developing on average about three times faster per annum than the economies of the 15 states of the so-called old European Union. However, the boom was mainly based on consumer demand and on the expenditure on housing which had been particularly booming since 2006. The American society, with its traditionally low-saving tendencies, took advantage of the benefits of cheap money and continued to go deeper and deeper into debt. Life on credit became standard.

[1] Currency Composition of Official Foreign Exchange Reserves, IMF 2009.