



GLOBAL ECONOMIC CRISIS

– SURVIVAL STRATEGIES FOR DEVELOPING ECONOMIES

| *Omane-Antwi K. B.* |

PART I

ABSTRACT

From the debacle of America's toxic subprime mortgage portfolios, to the virtual freezing of credit around the world, plunging stock markets and a sustained slowdown in consumer spending, the global financial crisis that took hold in 2008 shows little sign of let up.

The intensification of the global financial crisis, following the bankruptcy of Lehman Brothers in September 2008, has made the current economic and financial environment a very difficult time for world economy, the global financial system and for central banks.

The down turn is not discriminating against industry sectors, making it difficult to identify areas of strength. It looks like the global economic meltdown could create a long, painful quasi-depression, a period of mass unemployment, a calamitous drop in confidence and a continued credit-squeeze. Africa, apparently, is suffering from the global financial crises.

The paper provides an overview of the proximate cause of the financial turbulence and discusses the impact on

advanced economies, emerging and developing economies. The role of professional accountants in helping to restore business confidence in the midst of the global economic crisis is also discussed.

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Introduction

“The State”, wrote John Maynard Keynes in 1936, “will have to exercise a guiding influence on the propensity to consume partly through its scheme of taxation, partly by fixing the rate of interest, and partly, perhaps, in other ways”.

The shift in economic thinking in the 1930s had the feeling almost of a religious revival. Keynes had uncovered and remedied a crucial defect of the capitalist economy: that equilibrium might be achieved at a level in which capitalists would refrain from investing.

This liquidity trap was not self-correcting: it would lead the economy into stagnation. Government action was needed to fill the gap and stimulate demand.

Keynes's arguments had enormous political traction, but fell into disfavour in the great inflation of the 1970s. Restrictive monetary policy, monetary targeting, privatization, fiscal retrenchment and curbs on trade union power became part of the programmes of resurgent conservatism – especially in the UK, under Margaret Thatcher, and in the US during the Reagan administration. Quite suddenly, with the financial crisis that turned into full-scale panic in the autumn of 2007, the politics of Keynesianism returned. Governments throughout the advanced industrial economies are mounting big fiscal stimulus packages (bailout packages), aggressive monetary easing – and even nationalization of banks.

To some, this represents a welcome supersession of dogmatic free-market ideas of the type popularly associated with the Reagan and Thatcher governments. Less plausibly – and a view we shall discount – is the notion that the whole crisis has been caused not by an absence of regulation, but by government attempts in the US to direct mortgage lending to higher-risk (or subprime) borrowers. Aside from these ideological theses, it is highly tempting also to infer, from the deep recession and economic damage precipitated by the financial crisis, that economic policy tends to go in cycles. On this argument, there was too much intervention in the Keynesian era culminating in the exercise of power by interest groups in the corporatist 1970s. Inflation and trade union power then had to be tamed in reaction, but the era of deregulation of the markets may be ending. None of these interpretations of the current predicament quite covers it, however.

The explanation that we favour takes something enduring from the shift to economic

“Much more stringent regulation is needed to anticipate and prevent future disasters”

liberalism – among social democratic governments as well as conservative ones – in the 1990s. This is not so much an argument for markets as for transparency, rules, and economic openness.

The limits of these approaches are reached, however, when considering the financial system. Asset prices and exchange rates are not priced like any other. They can overshoot fundamental values, in both directions. There is a strong case – one that is not being observed by today's policymakers – for open-border policies regarding the movement of goods and labour. However, the case for the free movement of capital flows is different and weaker. In principle, financial markets allocate capital to the most productive uses. In practice, capital flows will be disruptive if the banking system is not sufficiently developed to cope. That is what has happened in today's financial crisis.

Comparisons between today's crisis and the Great Depression of the 1930s are misleading and, in any case, there is a common misconception about Keynes's analysis of the causes of the depression. This is not a crisis of capitalism so much as a crisis of one particular segment of the market economy: the financial system. It is true, however, that the crisis was born and amplified in the private sector. Much more stringent regulation is needed to anticipate and prevent, such disasters in the future.

One problem with imagining that there is a Keynesian precedent that augurs now for a Keynesian resurrection is that the “great depression” was not strictly caused by a deficiency of aggregate demand. It was

driven rather by an "idee fixe" of adherence to the gold standard. Monetary policy in the 1930s aimed to defend convertibility of the dollar into gold (from 1879 to 1933 there was a fixed price of one ounce of gold for \$20.67). Adherence to the gold standard reflected a belief that money had to be backed by some asset, otherwise confidence in the currency and in the solvency of the government would be undermined. It was a bizarre notion and a destructive one. It meant that the Federal Reserve, for instance, could not properly act as lender of last resort to the US banking system, because it had to take account of the demand for gold. If it lent money to banks, then there would be more money in circulation, thereby reducing the credibility of the Central Bank's guarantee to exchange paper currency for gold. Consequently, monetary policy was kept cripplingly tight.

A second problem with the Keynesian parallel is that today's crisis is likewise not a fundamental problem with the real economy. The global economy has been pulled into a deep recession by failings in a dysfunctional global financial system. It is true that financial deregulation was advanced as part of the wider liberalizing impulse of the 1980s. But there were sound reasons for, say, abolishing fixed commissions in the stock market (which reduced the costs of trading) and encouraging financial innovation (which allowed companies to manage their risks better, and investors to diversify their portfolios more efficiently). The real danger was that, as the securities industry devised ever more complex products, the risks to the wider financial system were overlooked.

LESSONS FROM THE ASIAN CRISIS

A better parallel for today's crisis is not the great depression but the Asian currency crisis of 1997-8. That crisis was admittedly on a regional and much smaller scale, but the

causes and remedies have similarities. The region had experienced rapid growth through borrowing short-term, in overseas markets, and lending long-term, for capital projects. The crisis had a proximate spark – panic in international markets as Russia defaulted on its sovereign debt. This led to a contagious loss in confidence in the emerging economies. The Asian economies, with underdeveloped banking systems experienced a collapse in their currencies. Their foreign currency liabilities became a crippling burden. Deep recession and intense hardship followed.

Yet the region – with the notable exception of Malaysia, which imposed capital controls and whose political leadership advanced bizarre anti-semitic explanations of the crisis – kept its ties to the global economy and its place in the international trading system. Growth eventually resumed. The determination of Asian leaders – especially in China, which had not been caught up in these ructions – never again to be so vulnerable to turmoil in the foreign exchange markets in fact contributed to the long expansion of the global economy in the 2000s. A huge glut of Asian savings was built up and recycled in the western advanced industrial economies. The US current account deficit was sustained by massive capital flows from Asian into US treasuries. There was so much capital sloshing around the western economies that interest rates were kept below market clearing levels. An unsustainable boom in asset prices and expansion of credit were the consequences.

"The last thing the global economy needs is a resumption of the policies of protectionism"

This is a simplistic and schematic background, but it is a more convincing explanation for today's economic turmoil than any grandiose ideological theses. This is not a crisis of capitalism or the undermining of the principles of economic liberalism. It is a severe malfunctioning of one part of the capitalist economy, its financial sector. Banking crises are periodic hazards because banks are tied to each other through the wholesale lending market. A combination of factors has caused that market to freeze up. Policymakers kept interest rates too low, and - partly owing to an inflation-targeting approach that made no attempt to prick assets-price bubbles - presided over a massive explosion of credit. Regulation in the banking sector, and especially capital requirements, paid too little attention to the need for liquidity. When a shock occurred in the banking sector, namely a realization that an entire class of asset-backed securities was impossible to value accurately, then banks hoarded cash and refused to lend. Hence the vertiginous collapse in economic activity. Whereas there are numerous historical cases of collapses in the prices of particular assets or asset classes, this is a collapse of a credit bubble - and credit, being the lifeblood of the economy, needs to be restored.

It would be a mistake to interpret the crisis measures undertaken by governments as a refutation of the principles advanced in the preceding two or three decades, precisely because they are limited to repairing the financial system. Keynesian stabilization policy is premised on the idea that capitalism is cyclically unstable and requires the operation of automatic stabilizers - monetary and fiscal policies.

The counter-revolution in economic thought at the end of the 20th century had no difficulty assimilating this insight in practice. Governments are unable to abolish the business cycle, and need to moderate its

fluctuations. That does not imply, however, that government has any particular expertise or role in taking command of important segments of the economy.

Finance is different, because it is not an industry that makes products so much as an essential utility that pervades the entire economy. It cannot be left to fail, because it will bring the entire economy down with it. The financial regime failed in recent years because of misalignment of incentives and poor regulation. Bankers had scant conception of the risks they were taking on; and given that finance is above all a discipline of the efficient management of risk, this was a huge systemic failing. The significant but limited sense in which the non-liberal consensus of the late 20th century failed was in its indulgence of perverse incentives in the financial sector.

Economic and political liberalism need to come to terms with these failures rather than reinvent itself wholesale. The system it haltingly replaced in the 1980s and 1990s had misunderstood the limits of human knowledge and wastefulness of attempts at government planning. The poor regulation and misaligned incentives of today's financial system are an indication not of a renewed statism but of the importance of a framework or rules. In macroeconomic policy, the need for transparency and openness remains an important lesson. The last thing the global economy needs at this time is a resumption of the self-defeating policies of protectionism and the imposition of barriers to trade. The worst inference that politics could draw is that the role of the state is to plan and command rather than to stabilize.

There are three huge tasks ahead for policymakers and economic agents. First, monetary easing needs to be radical enough to stem any incipient deflationary pressures.

Secondly, there needs to be a fiscal stimulus on the part of the US that is big enough to fill the gap left by a collapse in private consumption and investment. Thirdly, there needs to be a decisive and painful write down of assets in the banking system; bad debts must be purged from the system, and the bankers who presided over these failures need to be replaced.

As with Asia in the 1990s, adherence to the principles of economic openness is the only

long-term solution to catastrophic failures born in the financial system. These are difficult times. The global economy faces its sternest test since the 1970s, and possibly since the 1930s. But the levers of economic policy are now better understood. There will be a swing in the regulatory system, and probably an overreaction. But a rebirth of dirigisme or state control would be neither likely nor desirable.

Rocky moments in history

1720 The 'South Sea' bubble bursts, sparking massive panic and a major financial crash in the City of London.

1873 – 1896 The collapse of the Vienna Stock Exchange caused a depression that spread throughout the world.

1918 – 1921 Severe hyperinflation in Europe was caused by the ending of the Great War, and hence wartime production. There were also problems caused by the influx of labour from returning troops.

1929 – 1939 In the Great Depression, stock markets crashed worldwide and sparked a global downturn. The US witnessed a banking collapse.

1973 – 1975 A quadrupling of oil prices by the Organization of Petroleum Exporting Countries led to an economic crisis, coupled with stagflation.

1987 Shocking borrowing figures in the US brought a crash on Wall Street, which subsequently hit major stock markets around the world.

1991 A recession in Japan rocked property markets and halted country's once astronomical growth.

1992 Black Wednesday occurred when the UK was forced out from the European Exchange Rate Mechanism, and the government failed to prevent a devaluation of the pound.

2001 – 2002 These years saw the bursting of the dotcom bubble, along with the 9/11 attacks on the World Trade Center. There were also a number of accounting scandals, including a major fraud at Enron, which led to the collapse of Andersen.

HUMILIATION OF ORTHODOX ECONOMICS

Arguably the single most telling utterance of this global economic crisis is "shocked disbelief". The phrase is Alan Greenspan's. As the man who once seemed to personify our modern-day understanding of the capitalist economy, Greenspan settled upon those words to describe his mental state as he watched that economy calamitously unravel. Many economists are in shocked disbelief, even if not all of them admit it. Orthodox economics has been humiliated.

Families bought houses they could not pay for, often with drastic consequences. Consumers, egged on by cheap credit, made purchases they would later regret. Sophisticated financial minds hopelessly miscalculated the value of assets. Top investment banks took ruinous commercial decisions. These mistakes were replicated and repeated. Orthodox economics, meanwhile, says economic agents take independent, rational decisions that maximize their own self-interest!

Shocks have the capacity to change beliefs irrevocably and we should hope this one does exactly that. For orthodox economics has acted like a vice on the mind of our political elite. For several decades, the assumption that people behave as rational, self-interested individuals spread and embedded itself in all manners of policies. It became the accepted basis of much consumer and competition policy; a driving force of public service reforms and privatizations; the excuse for skyrocketing executive salaries; a core belief behind the 'flexible' labour market mantra; a conservative influence on taxes, environmental policy and the regulation of business activity.

"Shocks have the capacity to change beliefs irrevocably and we should hope this one does exactly that"

Textbook economics installed itself in our political operating system. The economic crisis may well be the moment when we finally recognize and decide that our global economic system is overdue for an update.

For economics, the present crisis has shown the old ideas to be scarily unsound and simultaneously provided credibility to new approaches that seem to give a better account of what has occurred. Some of the smartest and most ambitious politicians, Barack Obama included, are hungry for new economic ideas to replace now unpalatable old ones. They are latching on to behavioural economics.

Behavioural economists, like the rest of the profession, did not foresee the scale and severity of the crisis. As a professional accountant, I possessed no alternative model of the economy that began flashing a red alert in 2004. But I do not share Alan Greenspan's feelings of shocked disbelief. By studying real economic behaviour, I have come to believe that markets do not work in the efficient way that the textbooks assert. So when events make that painfully apparent, I am neither shocked nor disbelieving. Knowledge of people's economic instincts helps to understand how this crisis happened.

There are now hundreds of studies showing that people are prone to systematic biases when making economic decisions. They frequently fail to take the option that is apparently most beneficial to themselves. Examples include valuing the same object more highly when it belongs to them, getting disproportionately influenced by the first suggestion they encounter and being very sensitive to seemingly irrelevant contextual details. These biases and mistakes appear to be very deep. They are most likely to crop up when there is doubt about the value of what is being traded, which was probably the norm for economic

activity throughout most of human evolution.

One such bias is that when individuals try to decide what something is worth, they tend towards the valuations of everyone else. Marketing professionals know this well, which is why they prize 'testimonial' adverts in which real consumers talk about mundane household products like they have just fallen in love for the first time. It seems almost bizarre to think that supposedly sophisticated traders in the world's largest financial institutions could fall prey to such simple human frailty, but they did. Once some traders enthusiastically led the way in buying up innovative and complicated mortgage-backed securities, the herd followed. More and more bright, numerate financial professionals started buying what appeared, back then, to be financial hot cakes, but what we now refer to as toxic assets.

To a behavioural economist, the cleverest financial professionals in the world behaving as irrationally as consumers hearing stories about the brilliance of the latest washing powder, is not a surprise. Clever people are still instinctively human.

Behavioural economists are also inclined to distinguish between 'risk' and 'uncertainty', because experiments show that people instinctively react differently to each. The distinction is that when facing risk, you know the odds you are up against, but when facing uncertainty, you do not. A risk is playing roulette; uncertainty is playing roulette without knowing how many red and black numbers are on the wheel. In the build up to the crisis, traders relied on increasingly sophisticated risk management models, which balanced risk across different assets in a mathematically sound manner, but started from the assumption that accurate probabilities could be assigned to returns on each asset. In truth, the probabilities were incalculable. Historical patterns permitted an educated guess, but that was all. This hubris,

the belief that the risk models were accurate representations of an uncertain world, was a big factor in the subsequent collapse of these firms of international pedigree (e.g. the collapse of Lehman Brothers on September 15, 2008).

Interestingly, once it became apparent that the calculations of default probabilities were hopeless, perceptions changed. Nobody knew which firms were holding the most toxic assets. Traders suddenly decided that the task of calculating the odds of default for their fellow banks was impossible. Having perceived lending money to poor people to buy houses as a manageable risk, the markets stopped lending to the biggest financial institutions on the world, because they perceived uncertainty. This behaviour is utterly irrational, but quite understandable if you know how people typically perceive and react to risk and uncertainty.

"Hundred of studies show that people are prone to systematic biases when making economic decisions"

Behavioural economics therefore offers an account of the behaviour of financial market traders that illuminates the cause of the crisis. It also has much to say about the contribution to the crisis of consumers and house buyers.

UNDERSTANDING THE 'TRUST GAME' CONCEPT

There have actually been more than 40 house price bubbles across the OECD countries over the past 50 years. The economic instincts that cause bubbles are quite well understood. Countless studies show that people value the immediate

future too highly, and that they are excessively influenced by the most recent trends.

There are many, many more findings that help us to understand why things frequently do not work out as orthodox economics says they should. For instance, after years of policy prioritizing consumer choice and information, behavioural economists have shown that people actually take worse decisions if they have too much choice and information.

Behavioural economists have also shown that lump sum payments are more likely to be saved, while instalments spread more evenly over time are more likely to be spent. The economic climate is so receptive to new thinking that some radical interventionist solutions, unthinkable just two years ago, are being discussed. One idea is to use our bias towards default options to try to prevent credit bubbles. Every company offering mortgages or credit card would be required to offer a standardized default product, clearly identifiable as such, in addition to any more innovative offerings.

Following the work of Richard Thaler and Cass Sunstein, these kind of policy interventions, in which no options are closed off to people, but certain options are presented more favourably, have become known as 'nudges'. In more academic writing, the somewhat less catchy phrase is 'libertarian paternalism'. The idea is that the state does not tell you what you can or cannot do, but rather nudges you in the direction it thinks is best for you, while ultimately leaving you to decide. A whole new policy jargon is emerging, with reference to 'asymmetric choice architecture' and the like.

If the impact of behavioural economics turns out to be not more than a series of polite nudges from the government, then my claim of a revolution in economic thought falls. But,

in my view, while nudges may prove very helpful, the notion is but a staging post in an ongoing journey of economic thought. Behavioural economics shows not only that our economic decision-making is apparently irrational, but that it is powerfully influenced by other people. Many of the nudges work not because they suddenly illuminate the rational option, but because they provide information about how our fellow citizens behave in the same situation.

Successful economic transactions are underpinned by mutual trust, cooperation and a sense of fairness. Societies in which transactions work most efficiently are those in which these social forces are strongest.

This may sound like common sense, but it is scientifically revelatory. Since Adam Smith, economists have taught that an economic agent who, as Smith put it, "intends only his own gain" is "led by an invisible hand" to produce what "may be of greatest value". But it is a logical error to confuse the notion that trade between self-interested individuals may nevertheless be socially beneficial, with the claim that trade is most beneficial when conducted between self-interested individuals. What behavioural economics is showing is that the most beneficial trade may occur between mutually supportive and trusting individuals. Suspecting as much, the late American economist, Arthur Okun, rather brilliantly coined the phrase the 'invisible handshake'.

Returning to the current crisis, it is not hard to relate these findings to the unsuccessful transactions between lender and borrowers that have produced such dire consequences. The financial services industry, awash with money from years of continuous growth, became greedy. Selling families mortgages that anyone with a financial training can see they would be better off without, undermines trust between buyer and seller. It

destabilizes the economic atom. Little wonder that so many people, on both sides, now regret that such transactions ever took place. It will take time to re-establish that trust and the associated loss of market efficiency will be with us for years. Orthodox economics is not only humiliated by current events, but refuted by current science.

IMPACT OF THE NEW SCIENCE ON CONSUMER POLICY

Governments are opting to go Keynesian, borrowing and pumping money into the economy to raise demand, but we know that doesn't always work either. There are many other policy areas where behavioural thinking can overturn economic orthodoxy. One associated area is the inflation target. Because it is reductions in nominal wages that are perceived as renegeing on the deal, a little inflation actually gives companies more flexibility on real wages, which is what affects their profitability. Would a somewhat higher inflation target therefore be good for employment?

"The implications of behavioural economics are presently dawning on consumer agencies. Enlightenment has begun"

By offering a more sophisticated view of the transaction, behavioural economics also suggests radical new takes on: how organizational pay schemes affect productivity; why globalised transactions across great distances are likely to be less efficient; why profitable companies still appear to discriminate against minorities; and why market mechanisms fails to price environmentally preferable solutions highly enough. As our understanding of the economic atom changes, so does our under-

standing of every market, because all markets consist of transactions.

The ultimate impact of this new science on consumer policy is therefore likely to be particularly dramatic. The old model dictated that policy should merely ensure that consumers were adequately informed about products and prices - the market would look after the rest. We now know this to be wrong.

Behavioural economics is a revealing phenomena that bias consumer decisions can be exploited by marketing techniques, making everyday markets less efficient; potentially very much so. This knowledge justifies much greater consumer protection. There is a strong case for stricter regulation and for taxes on marketing activities. These implications of behavioural economics are presently dawning on consumer agencies in Europe and America; enlightenment has begun.

The almost two decades of steady economic growth that preceded this crisis were not a period when such radical ideas received much airplay. Even the present turmoil may not be sufficient to sweep away the old thinking and the vested interests that benefit from it. But things really have changed. Back in 1998, one of the pioneers of behavioural economics, Berkeley's Matthew Rabin, wrote in a leading journal that the attitude of some economist colleagues towards his sub-disciplines was one of "aggressive uncuriosity" - a phrase that has stayed with monetarist, which tend to spread the word about the importance of behavioural economics for consumer policy, and where our sub-discipline was swimming in the influential mainstream.

A NEW FINANCIAL SCOURGE - SUBPRIME MORTGAGE

The most common type of subprime mortgage in the US is the 2/28 loan, which comes with a low, fixed-interest rate for the first two years and a much higher, adjustable rate for the next 28. In other words, the loan works a lot like a credit card: it lets people get a home for virtually nothing up front, but then hits the borrower with high interest payments at some point in the distant future. By the time the housing market went bust in the summer of 2007, subprime loans like the 2/28 accounted for almost 20% of all mortgages. (Poorer neighbourhoods in the US fared much worse, with more than 60% of all mortgages falling into the subprime category).

Unfortunately, this popularity comes with a steep cost. The structure of the loan ensures that subprime borrowers are five times more likely to default than other borrowers. Once the rates start to rise - and they always do - many people can no longer afford the monthly mortgage payment. By the end of 2007, a whopping 93% of completed foreclosures in USA involved adjustable rate loans that had recently been adjusted. While 2/28 loans tempt consumers with low initial payments, that temptation turns out to be extremely expensive. In fact, subprime loans even proved tempting for people with credit scores that qualified them for conventional loans with far better financial terms. During the peak of the housing boom in the US, 55% of all 2/28 mortgages were sold to homeowners who could have got prime mortgages.

"Even when we are committed to our long-term goals, like saving for retirement, we are led astray by momentary temptation"

FALLOUT OF THE GLOBAL CRISIS (FOOD FOR THOUGHT)

(I) HOW OUTRAGEOUS RISKS AND ENDLESS GREED LED TO THE CURRENT RECESSION

Every day the media report grim stories about the economy. The news is about spiking unemployment statistics; an unstable, weakening stock market; and rampant fraud.

Many people are now saving their spare change instead of spending it, and some are desperate to find new jobs. Meanwhile, economists venture to explain the causes of this latest recession. Could fraud have been partly to blame? News headlines of corporate corruption innuendo certainly seem to suggest it. In my opinion, fraud was more symptomatic of a larger problem: bad business decisions and poor oversight.

Whether businesses are guilty of fraud, people simply do not trust them with their investments anymore. If one were to list all the factors causing our current economic condition, in my opinion, fraud would be a major factor in each one; fraud is like cancer - once it starts, it grows, spreads, and if left untreated, destroys its host. Because of the way mortgages and bonds are securitized, once the cancer of those frauds began spreading throughout the banking, mortgage, and home-building sectors, those frauds affected us the most.

The exuberance in the marketplace to produce volume was so contagious that lenders did not follow what policies they had in place. There were very few regulations and minimal guidelines for lending during the 1980s. The market was good, the economy was growing, and lenders were making loans betting on the market and economy increasing. But those bets did not

pay off in the end. That was the whole problem with the subprime fraud for housing. The markets just got insanely high.

When the default rate started to climb in the subprime without compelling economic reasons to do so, Wall Street investors became nervous and the whole thing fell apart. "Things fall apart, the centre cannot hold" (W.B. YEATS: 1919). Understanding the red flags of fraud are imperative to prevention. Training is essential not just in identifying the red flags, but for explaining what they mean and how they should be addressed.

THE SKY IS FALLING!

So it seems mortgage fraud was a leading cause of the subprime crisis, which led to massive foreclosures. Banks and mortgage lenders could not recoup their losses from homeowners who had been bled dry in the subprime meltdown and simply had no money left to give. That, in turn, staunched the once-fluid cash flow into the economy.

Soon, large corporations like Lehman Brothers and Bear Stearns were filing for bankruptcy or selling shares dirt cheap and transferring ownership. Emotions soared and the stock market took a nosedive right into the hardest crash the United States has experienced in nearly 80 years.

The Bureau of Labour Statistic (BLS) in the USA reported that 598,000 American jobs were lost in January 2008 the worst month for job losses in 35 years. Overall, a total of 11.6 million Americans were unemployed in January, and about 3.6 million of those have been unemployed since the recession began in December 2007. Consumer spending has declined in the world's largest economy, which has decreased demand for imports and thrown global markets into deep financial crises.

When the flow of money circulating around the world began to slow severely in late 2008, long-term frauds were left exposed for all to see. This led to high-profile global fraud examinations. The revelations of significant frauds in trusted companies have shattered the public's confidence and trust in the market, fostering a perception of gambling with cheaters and causing investors to wonder why they should play. Consequently, they bail out of the market at the first sign of trouble.

When financial difficulty strikes, businesses tend to cut back on the fundamentals of fraud prevention - internal audits, internal controls, and other checks and balances, with tremendous pressure to maintain a positive image to customers and investors. Executives are forced to make tough decisions. Unfortunately, some will choose to fraudulently alter their financial statements.

More than two decades after the savings and loan crisis of the 1980s, Americans are suffering yet another mortgage debacle. This crisis apparently led to banks and investment firms going belly-up, which eventually led to the stock market crash of October 2008, which then culminated in a worldwide financial downturn.

Of course, fraud is not all about executives. Employees are also feeling the economic crunch, many of which will take advantage of their employers to improve their own economic situation. The end result is increased fraud during the economic recession.

(ii) WHAT DO ACCOUNTANTS MAKE OF IT ALL?

The problem, of course, began in the US, where demand for cheap home loans

resulted in banks lending money to high-risk borrowers. These so-called subprime mortgages were then repackaged by the banks into securities known as collateralized debt obligations and then sold to other financial institutions.

The subprime borrowers began to default on their debts and the banks, unsure of who was nursing heaving losses, stopped lending to one another. The European central bank injected billions into its money markets, but it was not enough to save even the Northern Rock, which relied on the wholesale markets to raise money for loans.

ONGOING UNCERTAINTY

One year on, and the situation is still fraught with uncertainty. So how do accountants and economists – who have to deal with things as they are, not how they would like them – view the situation? How can they help? Andrew Ratcliffe, an audit partner at Pricewaterhouse-Coopers in UK, says the issue of 'going concern' reviews are now important, not just the financing of the audit client itself.

From an audit point of view, the important things are the valuation of property and the valuation of receivables – fair value accounting conundrum!

(iii) DOWN BUT NOT OUT- SPORADIC COLLAPSE OF CONFIDENCE

The latest financial crisis is nothing new. Despite the general gloom, there are many upsidés, such as new businesses replacing tired institutions. There is probably no answer to boom and bust!

The lesson of the current economic difficulties is that sporadic collapses of public confidence are natural and inevitable. They force investors to recalibrate their appreciation of

risk and regulators to catch up with evolutions in markets, hence, revived interest in Schumpeter and Hayman Minsky, two renowned economist who believed in cycles, Schumpeter theorized that long periods of stability, such as the one that ended in 2006, embolden investors to borrow increasingly heavily to pay for assets of progressively declining value. Financial innovation fuels the speculation. Eventually, the overburdened credit system hits a stumbling block and takes a disastrous tumble, an event referred to as 'a Minsky moment'.

This is what happened in the sub-prime housing market in the US in August 2008. The seeds of the crisis, according to many commentators, were sown long before by the relaxed credit policies that the US Federal Reserve chairman, Alan Greenspan, adopted in the wake of the dotcom crash. Lenders doled out mountains of capital to so-called 'ninja' borrowers – those with no incomes, no jobs or assets. Mortgage salesmen motivated by short-term bonuses connived at fraud with some homebuyers and misled others over repayment terms. Lenders were reassured by the fact that they could package up their risks as tradeable securities and sell them on to other investors. These in turn believed the risks of the securities were reasonable because they had been endorsed by credit-rating agencies whose objectivity may have been compromised by a scramble for new business.

"It's as pointless to bemoan the periodic crises that are part of market capitalism as it is to bewail the weather"

The pattern is an old one. Fertile conditions for financial crises are often created by low inflation, low interest rates, and steep increases in asset prices. When Bertrand

Russell observed that "since Adam and Eve ate the apple, man has never refrained from any folly of which he was capable", the philosopher could easily have been describing financial speculation. Investors have thrown away their cash on everything from tulip bulbs to ostriches.

According to research by Lehman Brothers, there were 11 banking and financial crises in the 18th century. There were 18 in the 19th century, including the collapse of Overend, Gurney & Co, a bank that had invested in the characteristic Victorian industries of ship-building and railways. The total rose to 33 in the 20th century, a period within which the 1929 Wall Street Crash and the ensuing Great Depression were key events. The last 30 years, a brief period in the scale of things – has been punctuated by an emerging markets debt crisis, a US junk-bond debacle, the collapse of Japanese financial engineering, a UK commercial property catastrophe and credit routs in Russia, Asia and Scandinavia.

(iv) DROWNING BY NUMBERS

Was the banking crisis caused by an over-reliance on risk models based on inherently unpredictable or unforecastable future events?

Keynes is best remembered today for the economic policies derived from the General Theory, which are widely regarded as the most relevant to the resolution of our current crisis. Another group of Keynesian ideas are central to understanding the origins of the crisis.

Keynes' fellowship dissertation at King's College, Cambridge, was submitted in 1909 but published as *A Treatise on Probability* only in 1921. Keynes defined an approach to risk and uncertainty that put him in opposition to another, younger Cambridge scholar – Frank Ramsey, whose brilliant career was cut short

by his death at the age of 26; Keynes and Ramsey each coincidentally, had seconders from the University of Chicago. The Keynesian position was similar to that taken by Frank Knight in a book that appeared in the same year. Jimmie Savage extensively developed Ramsey's ideas.

Ramsey and Savage won the debate. The structure they proposed, which we would now describe as "the theory of subjective expected utility (SEU)", is the basis of virtually all quantitative modeling in financial markets today. That theory assumes that we can describe uncertainty with the aid of attaching probabilities to all possible outcomes, updated as new information becomes available. We value alternative outcomes by multiplying our subjective assessment of their value by these probabilities. Extended at the University of Chicago in the 1950s, this approach paved the way for a systematic study of financial economics. The growth of markets for derivatives – the first exchanges was established in Chicago – was made possible by the development of scientific models for valuing these new constructs. The same approach informs the risk model used in almost all financial institutions. The most widely used template in the banking industry was elaborated by J.P Morgan, which published the details and subsequently hived off a business Risk Metrics, which still promotes it.

These risk models are based on analyses of the volatility of individual assets or asset classes and – crucially – on correlations, the relationships between the behaviour of different assets. Some risks are inversely related – an umbrella shop makes money if it rains and an ice cream stand makes money if it shines. In these situations, individually risky assets can be combined to create a portfolio with low overall risk. This textbook example is too good to be true, but

as long as different risks are less than perfectly correlated, the process of aggregation will reduce the overall risk.

The standard assumption of both valuation and risk models is that the dispersion of returns follows the normal distribution, the bell curve that characterizes so many natural and social phenomena. If so, the whole problem can be encapsulated in what is called the variance-co-variance matrix. Fed with such data, a computer can assess any asset distribution and calculate, day by day, the distribution of expected overall gains and losses.

"Financial risk models are only as good as the correspondence between the model and the world"

But models are only as good as the correspondence between the model and the world. The assumption of normal distribution of returns seems to work well in times that are - well, normal. The question however remains as to what of abnormal times? More sophisticated institutions test their own risk models against their own historic experience. That experience is however necessarily drawn from a time when the institution was not experiencing the problems that the models are meant to anticipate.

Keynes and Knight emphasized the uncertainty that arose from the necessarily imperfect nature of human knowledge. The future was not just unknown, but unknowable (unpredictable). Donald Rumsfeld expressed the difference between risk and uncertainty with uncharacteristic clarity. He famously distinguished "known unknowns" (the things we do not know) from "unknown unknowns" (the things we do not know that we do not know). Risk describes the things we do not know; uncertainty describes things we do not know we do not

know. The imperfect state of human knowledge means that widespread uncertainty is inescapable.

"The business and financial environment is vulnerable to fundamental uncertainty"

The common mistake is to believe that the uncertainty described by Keynes and Knight can, through diligent research or analytic sophistication, be transformed into the well-defined quantifiable risk that responds to the techniques developed by the successors of Ramsey and Savage. Keynes correctly observed that the only justified answer to many questions about the future is 'We simply do not know'; but no one is rewarded for saying that. Many people in the financial services sector profess knowledge of the future they do not have, and cannot have.

We need probabilities to help us assess risks and narratives to guide us through uncertainties - and the general knowledge and judgment to know how to approach each particular situation. It is that general knowledge and judgment that has been so lacking in the financial follies of the past decade.

(v) THE SOCIAL AND ECONOMIC CONSEQUENCES OF THE GLOBAL FINANCIAL CRISIS ON THE DEVELOPING COUNTRIES AND EMERGING ECONOMIES: A FOCUS ON AFRICA

What began as an American national prime-mortgage lending crisis has quickly spread to Europe and the emerging markets of Asia, South Asia and Latin America. It became transformed into one of the worst global financial crises since the Great depression. The spectre of global recession and the potential contagion impact on the real economy, not only of the industrialized and

emerging economies, but also of the developed world, raises questions about the decoupling thesis that was popularized in the aftermath of the financial crisis that hit emerging markets in the 1990s (see Dieter 2003). Although there are a number of credible pointers to the decline of America's global economic hegemony, the now nearly global reach of what was essentially an American financial crisis suggests that America still remains the most powerful economy in the world, and that the performance of the American economy is still the single most-important barometer of the health of the global economy. Against the background of intimate and complex interdependences in our contemporary era, it would seem that the post-Second World War popular adage that says "when America sniffs, the rest of the world catches a cold" is still very valid.

The developing world in general and Africa in particular, has always been most hard hit by almost every other global economic crisis that has occurred in recent history, including the global energy and debt crunch of the 1970s. Fears are therefore rife that "when America's sniffing causes a cold in the rest of the world, the developing world generally, and Africa in particular, risks finding itself in an intensive care unit".

*When America Sniffs, the rest of
the World catches a cold*

However, the current global financial crisis has so far, not had such an immediate impact on the developing countries, including those in West Africa and Africa as a whole. This time around, the industrialized economies of the North, particularly America and Europe appear to have borne the greater brunt of the crisis, followed by the emerging economies like China. This notwithstanding, there is consensus that the global South, and Africa more specifically, will not escape the wrath of

the current global financial squeeze, particularly in the light of the rather fragile economic, social and political realities that prevail in these countries and their continued dependence on the developed economies of the North for development assistance, technology import, and as the main destination for their exports.

GLOBAL ECONOMIC RECESSION: DANGERS OF A KNOCK-ON EFFECT ON AFRICA?

The impact of the global financial crisis and the ensuing economic recession is not uniform across the continent. Rather it has and will affect various African national economies differently, depending on their respective levels of integration into the global economy and position in the international division of labour. The impact of the recession on various segments of the economy also varies, for example between the financial and banking sectors on the one hand, and the real economy on the other. This gives rise to two major perspectives on the impact of the crisis on the continent: the one is that Africa's marginal or/and peripheral position in the global economy appears to have shielded the continent from the disruptive effects of crisis. The second is that, as has been the case in previous global economic down turns, Africa is most likely to receive the most serious knock-on from the current crisis and that the thesis of Africa's marginality in the global economy is not wholly true.

The contention that Africa stands a reasonable chance of sailing through the global financial crisis, less bruised than the other regions of the world, is premised on the fact that some of the economic weaknesses that have impeded the continent's development in the past, now appear to serve as a useful shield against the full brunt of the crisis. Key among them is what appeared in the past as excessive

regulations and conservatism of a majority of African countries' banking systems including rigid controls on foreign exchange and limited foreign ownership of banks. What appeared as a form of counter-productive financial de-linkage from the western global financial system now, paradoxically, stands out as a useful shield of the continent's banking sector from the ongoing global financial turmoil (see the Economist, 2008: 34). This argument suggests that the thesis of Africa's marginality in the global economy is valid as far as the banking sector is concerned. However, while this could be true of a majority of African economies, it is not true for all of them. South Africa, one of the global South's emerging markets for example, is an exception to this rule.

While the thesis of Africa's marginality in the global economy appears to hold true with regard to the shielding of its banking sector from the global financial system, South Africa appears an exception. It may not be valid when it comes to the real economy. This explains why, in the medium and long-term, African countries would not expect to be spared by the global economic recessions.

The continent's integration into the global economy is most visible in the areas of its export markets; import of inputs; development assistance, and foreign direct investment, which together, are the conduits through which the global crisis would impact on the continent's economic and social life.

In Africa, the corporate crunch has culminated in growing unemployment brought about by lay-offs thus aggravating the already sufficiently high levels of criminality in Africa. This is further

aggravated by the rural-urban migration, particularly of the youth in search of a better life in the cities. Economic contraction and increasing unemployment only adds to the frustration and social dislocation.

'Overall, reduced remittances will exacerbate foreign exchange shortages'

Remittances have fairly recently emerged as an important element in African countries' foreign exchange earnings and as a critical element in its integration into the global economy. For many African countries, such as Senegal, Somaliland, Ethiopia, Liberia, and Sierra Leone, remittances from their citizens in the diaspora are critical in their development efforts and has served as a critical social support mechanism in the backdrop of the failure of the state to meet many of its obligations. The current **credit crunch** and economic recession and the lay-offs it has engendered in the developed countries have implications for this critical source of foreign exchange earnings. Overall, reduced remittances will exacerbate foreign exchange shortages, dampen domestic growth prospects through reduced consumption, and heighten pressures on government revenue (Draper, 2008: 47).

Securing **credit/loans**, particularly **micro-credit**, for small and medium sized enterprises has always been a challenge in most African countries. The global **credit crunch** is most likely to complicate conditions and procedures for securing bank loans in the continent, further complicating matters for small and medium sized enterprises (SMEs).

To be continued in **PART II**

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About the Author

Professor Kwame Boasiako Omane-Antwi is a University Teacher at both the undergraduate and the graduate MBA Programmes in the School of Business, University of Cape Coast.

He is the Vice Rector and Dean of the Faculty of Business Administration, Pentecost University College. Kwame is also Oxford Business Alumnus (Oxonian # 10097277) Templeton College, University of Oxford.

He is a Certified Fraud Examiner and has a Consultancy firm B. Omane-Antwi Consult, Chartered Accountants.

Contact Address
B. Omane-Antwi
P. O. Box CT 1879
Cantonments
Accra, Ghana

Tel: 0244-320448
E-mail: kbomane@yahoo.com
Website: www.bomaneantwi.com