The Influence of Poor Government Control on the Financial Crisis

Junjie Ran

Bachuan Quantum Middle School, ChongQing, 400000, China
ranjunjie2022@126.com

ABSTRACT

The financial crisis always makes detrimental impacts on a national economy or even global economy, and the causes of the financial crises are various. Moreover, most of the time there is not only one factor that will contribute to the occurrence of financial crises, usually there are combined factors. This paper aims to certify the poor government control will increase the risk of financial crises. By retrieving papers and data, the paper will deeply investigate why a poor government intervention will cause a financial crisis like the Great Depression, and the poor control will cause a combined factors they are income inequality, excessive financial innovations and low quality of financial reports. The paper finds that the poor government regulation will cause financial crisis. Under poor control, monopoly began to appear and create the income inequality, lead to a decreasing demand but an increasing supply which is the overproduction. Moreover, an insufficient control facilitates the mistreatment of financial innovations, with an accelerating usage, the risk of systemic crisis is also soaring because of the share of the risk.

Keywords*: financial crisis, government control, income inequality, financial innovations*

1. INTRODUCTION

A financial crisis is defined as a sharp, brief, ultra-cyclical deterioration of all or most of a group of financial indicators – short-term interest rates, asset (stock, real estate, land) prices, commercial insolvencies and failures of financial institutions [1].Government control refers to a certain restriction and constraint imposed by the government on the economic activities of social and economic entities by its statutory rights to achieve certain goals. Government control is essential in resolving and preventing a financial crisis. For instance, before the great depression, the US government was a big fan of laissez-faire. The laissez-faire was originated from a French term which means leave alone in English, it indicates that the less the government involved in the market, the better the businesses will be. Thus, the US government at that time had a poor government control in the market. At the beginning, the economy seems to be prosperous, it was even said that every five American people possessed one car.But, it is just seemed, that is actually a false appearance and a bubble. After the bubble burst the whole country suffered. Millions of people lost their jobs and got bankrupt. However, the government realized this inappropriate management, and president Franklin Delano Roosevelt proposed several measures to address the crisis which is very useful and effective. By retrieving papers and data, the paper will deeply investigate why a poor government intervention will cause a financial crisis like the Great Depression, and the poor control will cause a combined factors they are income inequality, excessive financial innovations and low quality of financial reports. In addition, this paper intends to prevent an another disastrous financial crisis in the future and maintain a stable economy.

2. ARGUMENTS

2.1 Income inequality

With poor government intervention, the market structure tend to be a free market, which means that the government power is extremely low. Under this condition, weaker corporations have to leave the market while only the strongest one can stay, thus the monopoly occurred. Nowadays, many countries and government resist this kind of situation is because monopoly is really bad. But under poor government control, no measures will be took to deter monopoly, so monopoly will exist constantly and widely. The monopoly symbolized that a low proportion of population own a large percentage of wealth, on the other hand, a considerable numbers of

Copyright © 2022 The Authors. Published by Atlantis Press SARL.
This is an open access article distributed under the CC BY-NC 4.0 license -http://creativecommons.org/licenses/by-nc/4.0/.

citizens will suffer poverty because they can merely share a small percentage of money.

This situation is the income inequality, a huge gap between the rich and the poor. Income inequality will contribute to the financial crisis since only a small numbers of people possess purchasing power whereas the rest of the people are under poverty. Most of the people cannot afford the products and therefore lead to the decline in the demand. What is worse, these capitalists, they are always eager to earn the money, thereby they produce significant amount of products, but they are unable to sell these products because almost everyone is unaffordable.

Then, a more terrible phenomenon appeared, the overproduction caused by overmuch production and limited demand which will arouse the market price to fall. Here is an example of the cause of income inequality: In the boom years of the 1920s, the agriculture of the U.S. didn't recover from the depression caused by World War I, many farmers were push into poverty, and the new machines put large numbers of workers into unemployment. During 1923 to 1929, labor productivity in the U.S. manufacturing sector grew by 32%, while wages increased by only 8%, the wages of some low-end industries, such as coal mining, even declined. By 1929, the richest 5% persons have almost 1/3 of all personal income.The polarization of income distribution in the United States eventually caused the demands of consumer durables especially housing inadequate, which resulted in real estate price fell rapidly, and finally it spread to the stock market and causing a sharp decline in capital market prices[2]. Before the Great Depression, a severe income inequality have occurred which caused the the decrease in prices and lead to financial crisis. Moreover, the Rajan hypothesis states that the income inequity made crucial role in the eruption of financial crisis. However, there is Ana another evidence than can demonstrate the point:

The bootstrap p-values of the rolling test statistics are shown in Panels A and B in four figures below. From it, if the null assumption of income inequality does not granger-cause credit expansion would be verified, and vice versa. The bootstrap estimates of the sum of the rolling coefficients are shown in Panels C and D in four figures below. From it, the influence of income inequality on credit expansion is verified, and vice versa.

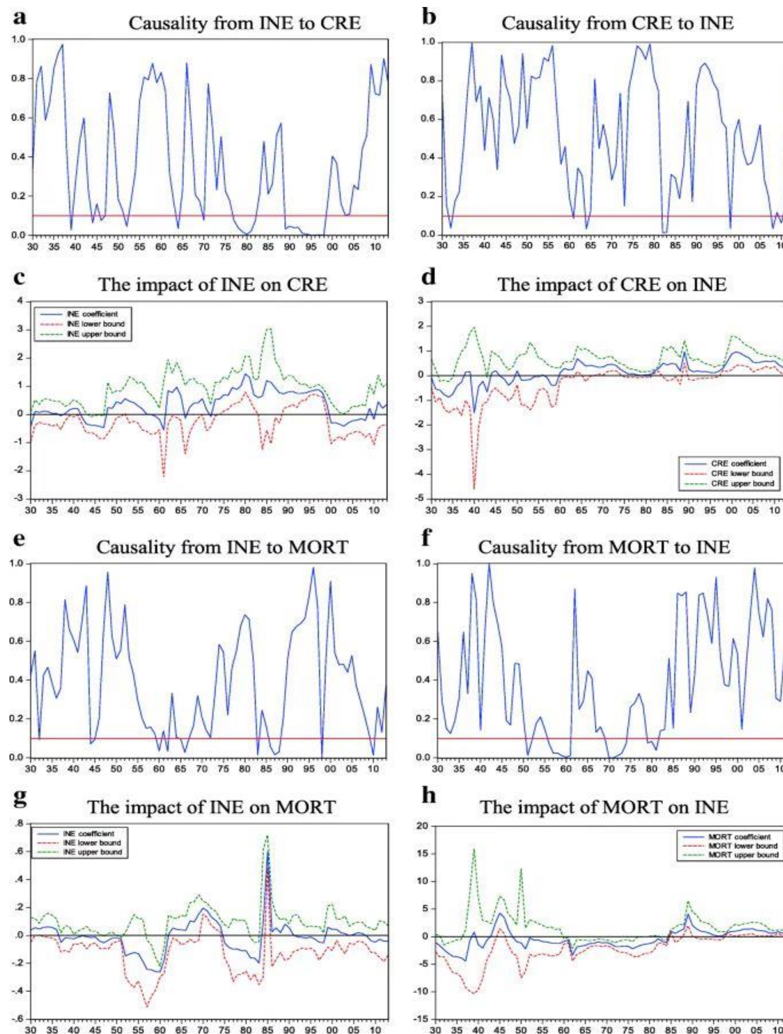

Figure 1 Collection of causality from INE to MORT and impact of INE on MORT

In Figure 1, the results for Australia shown in Panel A display that the null of income inequality does not result in credit expansion. Therefore, it is refused for the 1977–1982 and 1989–1998 sub- periods. Panel C demonstrates that in sub-periods the influence of inequality on credit expansion is positive.

Schularick and Taylor (2012) noted that the systemic banking crisis in Australia appeared in 1989. Thus, the bad outcome resulted from income inequality to credit expansion is valid for the crisis period. Furthermore, a bad outcome from credit to inequality in the crisis period is nowhere as shown in the plot of Panel B in Figure 1. In this way, the Acemoglu hypothesis is baseless.

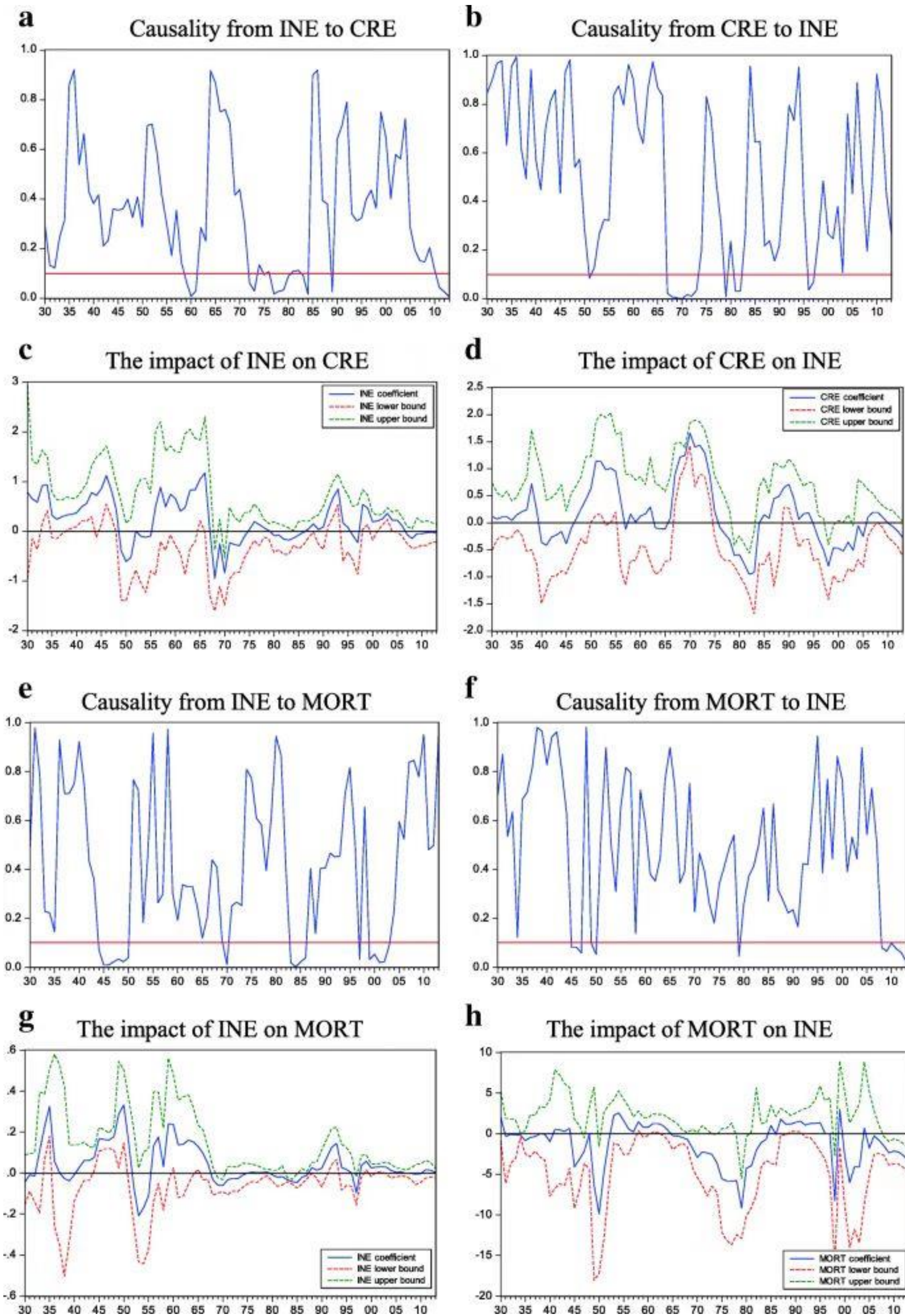

Figure 2 Collection of causality from INE to MORT and impact of INE on MORT

When it comes to Finland, in Figure 2, the null of inequality does not result in credit expansion as shown in Panel A, which is also rejected for the 1959–1961, 1977–1980, and 2011–2013 sub-periods. Besides, in Figure 2, inequality actively affects credit in sub-periods shown in Panel C, without sub-periods of 2011–2013. In Figure 2, credit solely resuts in income inequality for the 1989–1994 sub-period shown in Panel B; besides, credit expansion of this period boosts income inequality shown in Panel D. When comparing these findings with the 1931-1991 banking crises in Finland, the deficiency of these unidirectional causality from inequality to credit and a causal feedback relationship resulted in the rejection of these hypotheses. Because of financial crises boosting inequality, the bad outcome from credit to inequality and credit's positive influence on inequality may come into being.

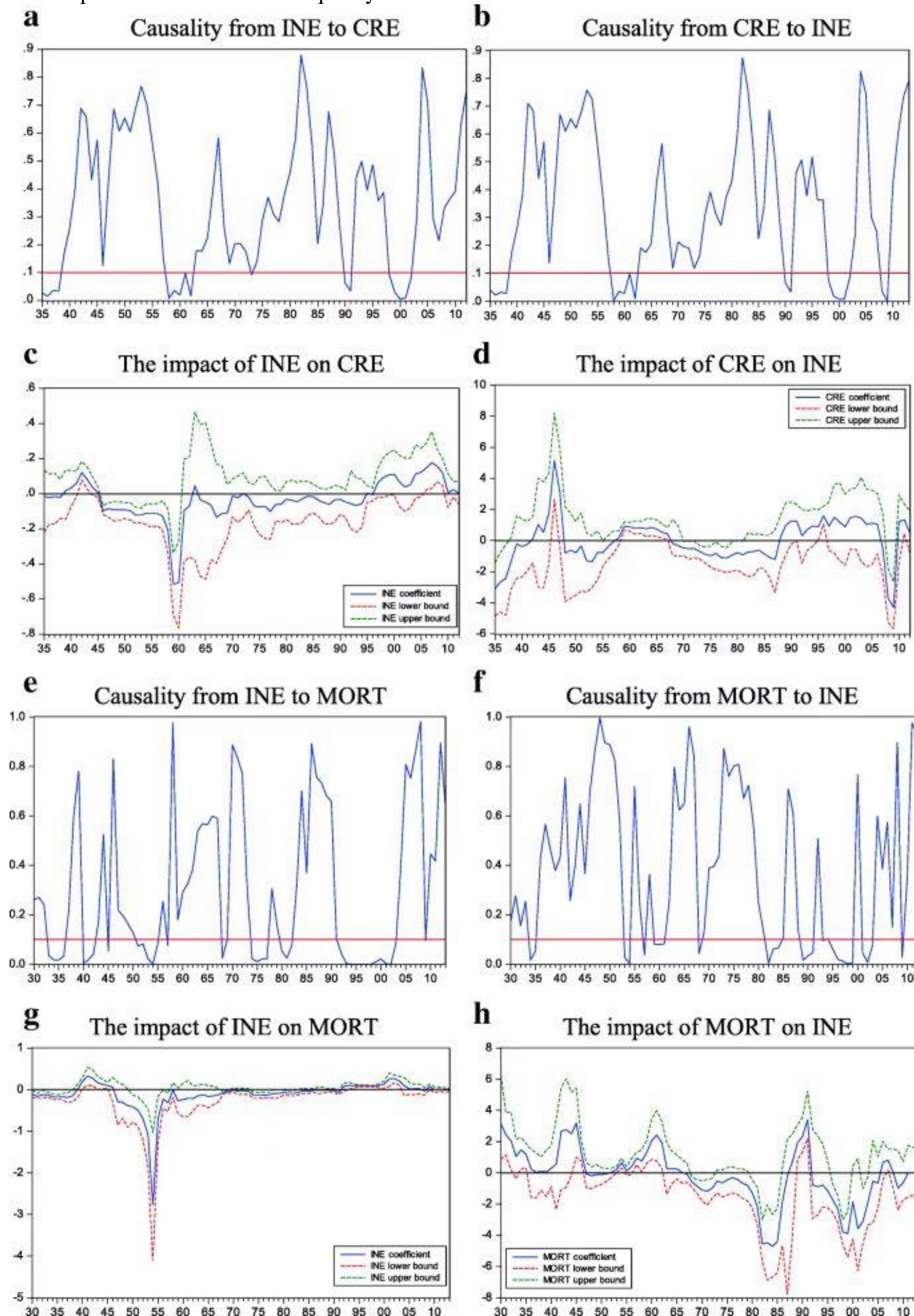

Figure 3 Collection of causality from INE to MORT and impact of INE on MORT

When considering the results for France, in Figure 3, income inequality rsulted in credit expansions in the 1935–1938, 1958–1962, and 1998–2002 sub- periods as shown in panal A. Schularick and Taylor (2012) noted that banking crises in France started in 1930 and 2008; Thus, there are no causality between inequality and credit in these periods. Besides, the influence of inequality on credit expansion was negative in the 1935–1938 and 1958–1962 sub-periods shown in Panel C in Figure 3. Besides, the effect of credit on inequality is negative in these crisis periods. Therefore, the Acemoglu hypothesis is baseless.

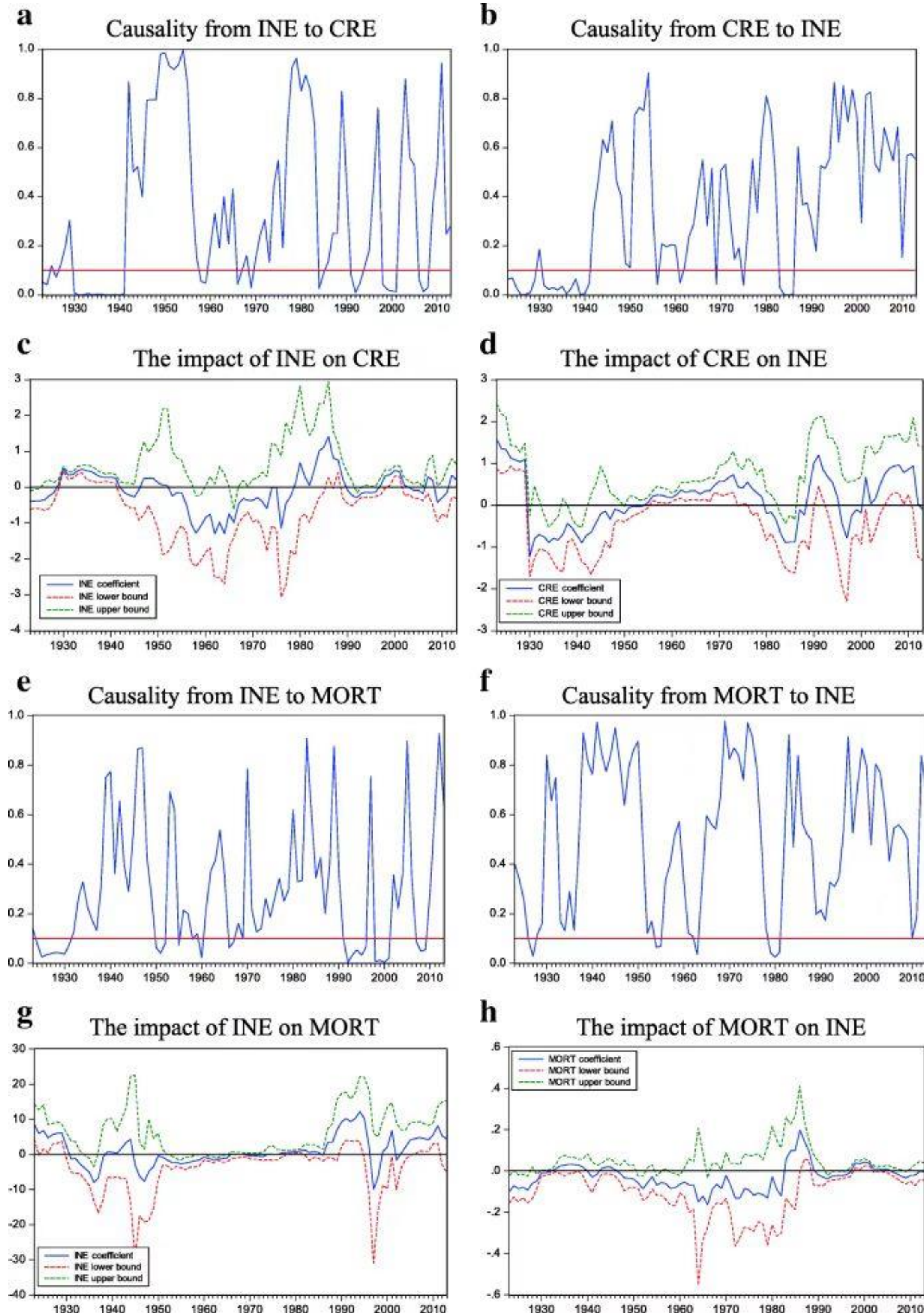

Figure 4 Collection of causality from INE to MORT and impact of INE on MORT

Finally, the results of rolling-window estimation of the United States have been demonstrated in Figure 4. The income inequality resulted in credit booms in the 1929–1942, 1997–2002, and 2005–2009 sub- periods as shown in Panel A. Besides, in Panel C, the income inequality positively affected the credit boom in these sub-periods. Once the feedback relationship between inequality and crisis is valid in Panel B, it means that the inequality in the 1923–1941 and 1983–1986 sub-periods was resulted from credit booms.

However, in Figure 4, the influence of credit expansion on income inequality is negative in the 1929–1954 sub-period shown in Panel D. Given the United States had been going through the banking crises in 1929, 1984, and 2007, it can be found that the Rajan hypothesis was valid for the United States crises in 1929 and 2007, even though the 1984 crisis had not been confirmed.

2.2 Excessive financial innovations

Financial innovation is the process of creating new financial products, services, or processes. For examples, securitization and derivatives. Securitization enable the financial institutions to share the risks and transfer them to various subjects like financial market participants. However, a transportation of risks will not resolve the risks, there are still risks, financial innovations never eliminate those risks, on the contrary, they generate new risk which is increase probability of losing together. This is an evidence: On the one hand, these financial instruments allowed banks to offload certain kinds of risk. Securitization gave banks a tool to transfer credit risk to other financial market participants, reducing idiosyncratic risk for these institutions (e.g., the specific risks associated with the bank's area of lending). Derivatives also gave banks a tool to counterbalance (or hedge) undiversified risk exposures, further reducing idiosyncratic risk [3]. Yet both financial instruments also exposed banks to new risks, including systemic risk. When banks used securitization and derivatives to reduce idiosyncratic risk, they also increased the correlation between their own risk exposures and those of other financial institutions [4].

As this correlation increased, so did the probability that banks would suffer losses jointly, making systemic crisis more likely [3]. Under insufficient government control, the popularity of financial crisis soared dramatically and people and institutions will rely on financial innovations. Taking 2008 financial crisis and the Great Depression as instances: Before the 2008 financial crisis, asset securitization and financial derivatives innovation accelerated in America. 1920s, U.S. commercial banks leveraged finance transactions and then enlarge the stock market trade credit. The brokers' loans rose from 2 billion - $ 2.5 billion early in 1926 to $ 6 billion by the end of 1928's. In 1921, there were only a handful of the investment trust in U.S. and then from the beginning of 1927, it added to 140,186 and 265 annually. Before the 2008 financial crisis, asset securitization and financial derivatives innovation accelerated in America. The loans securitized real estate mortgage in the United States grew from $ 740 billion in 1990 to an explosion in the $ 4.9 trillion by the end of 2007.[4]. The shocking data presented a dramatic reliance on excessive financial innovations under poor regulation, which lead to the two most serious financial crisis.

2.3 Poor-quality financial reports

Financial report refers to the documents provided by an enterprise to reflect the financial position of the enterprise on a specific date and the accounting information such as operating results and cash flows of a certain accounting period. A bad financial report will generate information asymmetry which will damage investor confidence, investor confidence was defined as investors' willingness to engage in the investment opportunities and associated intermediation channels available to them based on their perception of risk and return. Therefore, the investor confidence damages symbolize the exit of investors. What if the whole financial system possess a low-quality of financial report, there will appear a missive outflow of investors, then investment that the market then received must be extremely low compare to a condition where the quality of financial report is normal. The finite investment will made negative impact on equity market liquidity, the market liquidity refers to the ability of buyers and sellers of securities to transact efficiently.

The essence of the liquidity in equity market is originally very weak, like the financial crisis in1998 happened in Russia and the one happened in 1987, the sudden vanish of liquidity in the financial market brought critical effect to the whole financial system even the global economy[8]. A low liquidity caused by poor quality of financial report will be very likely to induce a new financial crisis. Extant literature shows that the quality of financial reporting depends on the following country-level factors: the underlying legal system [5]; whether the economy is market-oriented or bank-oriented [7]; the accounting standards adopted [6]; and the level of law enforcement [5]. This research mentioned the quality of financial report will depend on the level of law enforcement, under a poor government control, the level of enforcement must be quite low which will then effect the quality of the financial reports

3. CONCLUSION

In conclusion, this paper finds that the poor government regulation will cause financial crisis. Firstly, under poor control, monopoly began to appear and create the income inequality, lead to a decreasing demand but

an increasing supply which is the overproduction. Because of overproduction, the market price began to fall rapidly, increased the risk of financial crisis. Moreover, an insufficient control facilitates the mistreatment of financial innovations, with an accelerating usage, the risk of systemic crisis is also soaring because of the share of the risk. A poor regulation will result in low level of law enforcement which is responsible for the poor quality of financial report. A bad report decrease the liquidity among the market increasing the risk of suffering financial crisis. This paper lack of the support from graphs, models and equations. Nevertheless, absence of citing proving process is also another drawback, which will be searched exclusively in the future research.

REFERENCES

[1] Kindleberger C.P. Financial Crisis. In: Palgrave Macmillan (eds) The New Palgrave Dictionary of Economics. Palgrave Macmillan, London. 1987. https://doi.org/ 10.1057/978-1-349-95121-5_373-1

[2] Chuanyu Liu. “The Same Causes of the Great Depression and 2008 Financial Crisis and Its Enlightments”. Proceedings of 2014 4th International Conference on Applied Social Science (ICASS 2014)Volume 51.Ed.,2014,342-345

[3] Destek, M.A., Koksel, B. Income inequality and financial crises: evidence from the bootstrap rolling window. Financ Innov 2019, 5, 21. https://doi.org/10.1186/s40854-019-0136-2

[4] Pernell, K. Market governance, financial innovation, and financial instability: lessons from banks’ adoption of shareholder value management. Theor Soc 2020, 49, 277–306. https:// doi.org/10.1007/s11186-020-09389-y

[5] Chuanyu Liu. “The Same Causes of the Great Depression and 2008 Financial Crisis and Its Enlightments”. Proceedings of 2014 4th International Conference on Applied Social Science(ICASS 2014)Volume 51.Ed.,2014,342-345

[6] Lin, Zhiwei; Jiang, Yihong; Tang, Qingliang; and He, Xiangjian, Does High-Quality Financial Reporting Mitigate the Negative Impact of Global Financial Crises on Firm Performance? Evidence from the United Kingdom, Australasian Accounting, Business and Finance Journal, 2014, 8(5), 19-46. doi:10.14453/aabfj.v8i5.3

[7] Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression[J]. Ben S. Bernanke. The American Economic Review. 1983 (3).

[8] Changes in Business Cycles: Evidence and Explanations[J] . Christina D. Romer. The Journal of Economic Perspectives . 1999 (2).