MACROECONOMIC FLUCTUATIONS AND BANKERS' DILEMMA

W.A. Wijewardena

Former Deputy Governor
Central Bank of Sri Lanka

The boom-bust cycles

Economies are subject to wide economic fluctuations moving from booms to busts from time to time. Riding along those fluctuations, economic agents – both firms and households – too would experience better or worse times with respect to their performance and, accordingly, to their wellbeing. Bankers who facilitate firms and households to attain economic well-being through enhanced performance will also undergo a similar 'boom-bust cycle' meaning that when an economy is in a boom, bankers do well and when it is in a bust, they too would experience bad times. Enjoying economic fruits in good times and mitigating risks in bad times is, therefore, the bankers' greatest dilemma.

The boom-bust cycles have been identified by economists as 'trade cycles' or 'business cycles' because they occur due to aberrations in trading activities or business behaviour of firms. The observation that firms as a whole do well in certain times and suffer in other times has prompted them to name these fluctuations as business cycles. However, businesses are only one part of the cause of the boom-bust cycles; the other part consists of the behaviour of households who also form an equally important segment of an economy. When both the business and household behaviour is considered as contributory to boom-bust cycles, it could be seen that the causes are inherent in nature and the mankind, however much it is equipped with necessary apparatuses, cannot do much to eliminate them altogether.

The cause of boom-bust cycles: Laws of Nature

The boom-bust cycles occur due to the complexity of the natural phenomena which follows the Laws of Nature instead of the laws of men. Hence, however much men try to regulate and direct the natural phenomena according to their designs, they invariably take a course quite different from what the designers are trying to introduce from outside. These natural laws, consisting of four types, work in conjunction with each other generating eventually a completely different outcome to the dismay of designers whose sole objective has been to promote the wellbeing of people while protecting them from the adverse effects of economic fluctuations. This is a laudable objective, but it requires the authorities to adopt a strategy that would be friendly to the unfolding natural events in an economy. Accordingly, if the authorities, when making their designs, choose to follow the events that are unfolding in an economy as they happen and take measures to minimise the adverse outcomes, then, they would be able to provide protection to a large segment of those who would be affected by such adverse outcomes. But, it would mean the acceptance of a certain amount of fatalities in the economy meaning that it is necessary to enter into a 'give and take contract' with nature. Hence, if they make a wrong move to turn the tides against natural developments, then, the final outcome would be quite disastrous. As a result, to attain the maximum results, the authorities should be conversant with the Laws of Nature that govern the natural phenomena consisting of individuals, firms, industries or at the macro level, the economies.

What are those Laws of Nature that play an important role in causing booms and busts in economic activities from time to time? They are of four types as explained below.

The Law of Impermanence

In the first place, there is the Law of Impermanence meaning that everything in nature has three stages, an arising, an existence and an eventual death. These three sequences occur in every natural phenomenon one after the other. In some cases, the duration of the sequences is infinitesimally short like the life cycle of a cell; in other cases such as an economy or an industry or even that of a human being, it is fairly elongated. There-again, depending on the technology available, the life cycle of a natural phenomenon can be marginally elongated by human action. For instance, about a century ago, the life cycle of a human being was about 50 years. Today, it has been elongated to about 75 years through better medication and healthcare services. Yet, mankind has not been successful in eliminating the three sequences that are natural to every phenomenon altogether and providing a permanent state of living to its fellow beings. Hence, there is nothing in nature that is free from these three stages and, therefore, seeking to establish a permanent state in nature is an illusion. Thus, firms, households and the economies in which they operate do not have a permanent existence: They have an arising, an existence and an eventual death.

The Law of Cause and Effect

Second, there is the Law of Cause and Effect meaning that every cause, whether arising naturally or coming into being by the designs of men, leads to an effect. That effect generates a completely different state that becomes the cause for a subsequent effect and that subsequent effect is different from the earlier state which led to it. This gives rise to a series of causes and effects changing the previous state into a subsequent effect. Accordingly, when a policy authority introduces a new policy or effects changes to an existing policy, it becomes a cause that would generate an effect and that effect will again be a cause for a subsequent effect. The authorities may have a certain objective in introducing the new policy. But its consequences may be completely different from what they had envisaged previously leading to an unintended consequence or a series of such consequences.

The Law of Evolution

Third, there is the Law of Evolution meaning that natural phenomena are all subject to a constant change, evolving from one state to another thereby generating a new state at every point of change which is neither the earlier state from which it had evolved nor a state which is completely different from that previous state. In the case of an economy, the evolution takes place by changing the thinking patterns, ideals, ideologies and the behaviour of its members – again both firms and households. In certain cases such as the evolution of an economy from a feudal economy to a capitalist economy, it took a fairly long time – as long as five to six millennia – for the evolutionary cycle to run its course. However, the evolution of the paper based economy which the world had sometime back into a cyberspace based economy which the world has today took place within a matter of a few decades.

The Law of Unity

Fourth, there is the Law of Unity meaning that all phenomena in nature have a uniqueness built into it so that a state that evolves into a new state is neither better nor worse but uniquely linked to each other. Hence, it does not enable one to pass judgments on the evolving states on whether they were better than or worse than the previous ones. For instance, one cannot say whether the capitalist economy system which the world has for the last two to three centuries is better than the feudal economy which the world had for many thousands of years prior to that. It has some features which are better and some features which are worse than the feudal type economies. The same observation can be made with respect to the economy to which the modern capitalist economy will evolve in the future. That economy too is neither better nor worse than the modern capitalist economies.

An economy which is one big natural phenomenon, made up of millions of economic agents – both firms and households – is also subject to the operation of these Laws of Nature. Accordingly, every economic boom has its own cycle and following that, every economic bust too has its own cycle. When people work hard utilising their mental and physical energy to the maximum, they are able to produce more goods and services year after year generating an economic boom. But, this boom cannot be continued unless several essential factors are present in the system.

Essential factors for the sustainability of a boom

First, when people utilise their mental and physical energy, they eventually get exhausted needing a recharge of the exhausted energy. If they cannot be recharged any more, they should be replenished by a new batch of energetic people. This process has to be continued without a break for an economy to experience continuous expansion once it has set on a boom cycle path. If the process is broken midway due to natural catastrophes or designs made by men, then, the boom cycle cannot be supported by the existing population thereby paving the way for the onset of the next cycle, namely, the bust cycle.

Second, a boom always starts with innovations leading to the adoption of new technology, introduction of new management practices, improvement in human capital and, coupled with the first three which is commonly known as the ‘knowledge base’ of a society, investment in physical capital such as infrastructure facilities, factories, machinery and equipment etc. All these essential factors have their own life cycles in which they contribute to a higher output during a given period before they start producing diminishing returns. Hence, a boom is time-limited and to avoid the onset of its next natural stage, namely the bust cycle, there should be continuous investment in both the physical capital stock and the knowledge base of a society.

Third, as identified by Niall Ferguson, Professor of History at Harvard University, there are six essential factors that should be put in place for a society to continue to create wealth and prosperity for its people[1]. They are competition, development of science, the observance of the Rule of Law and the protection of property rights, improvement in medical facilities, a consumption oriented population and favourable work ethics by workers. The presence of these factors has helped the Western world to create wealth on a continuous basis during the last five centuries. Similarly, for an economy to support its economic boom, these factors should be present in the economy simultaneously.

The bankers’ requirements

But to make the appropriate choices, bankers should know in advance a few matters relating to boom-bust cycles.

First, they should know the length of each cycle. When a boom cycle starts, how long it will take for the cycle to reach its peak before it starts making a downward journey and in the same way, how long it will take the bust cycle to reach the bottom and restart its upward journey is an important piece of information which bankers should have in order to prepare their medium to long term business plans. Though precise time periods cannot be given for the ending of each cycle due to the complexity of boom-bust cycles, an indicative timeline as to when the peak is reached or the bottom is hit is useful for a banker to plan out his future strategies to minimise the adverse effects of a bust cycle while enjoying the fruits of a boom cycle.

Second, bankers should know the response of the authorities to boom-bust cycles. It is quite normal for authorities to welcome a boom cycle ignoring the fact that it will have an eventual end after going through the three stages, namely, arising, existence and death. All the energy sources of authorities are used to ride on the boom cycle and enjoy the fruits which that boom cycle brings to society. Along with authorities, firms and households too seek to enjoy the fruits of the boom thinking that it is a permanent state. This short-sighted behaviour has been prompted by the assumption that the natural world is governed by straight or linear growth models. According

[1] Ferguson, Niall, (2011), *Civilization: The Six Killer Applications of Western Power,* Penguin Books

to the linear models, if an economy is growing and it is at a certain level at present, after a given number of years, it is expected to grow along a linear path to a pre-determined level. For instance, if the per capita income has grown say, from $ 1400 to $ 2800 during the last six year period, authorities will presume that it will double again to $ 5600 level in the next six years. This presumption makes the authorities ride the boom cycle enjoying its fruits unabated and unrestrained. But the natural world is non-linear and as a result, quite contrary to the expectations of the authorities, the boom cycle can come to an end generating its next stage, namely, the bust cycle. The authorities try to address the issue of a falling economy only after the onset of the bust cycle and not when its symptoms are present in the economy. But, by that time, it is hard to convince the economic agents who are imbibed in the new prosperity which the temporary boom cycle has brought to them that they should now work hard to come out of the bust cycle as quickly as possible. The banker should observe the behaviour and the response of the authorities as an outside spectator, whom Adam Smith called 'impartial spectator' in his 'The Theory of Moral Sentiments' as quoted by Amartya Sen in his 'The idea of Justice'[2]. The banker should never be a rider with authorities on the boom cycle and should remain an impartial spectator who could make independent judgments.

Third, the bankers should also know the underlying reasons for the boom cycle and the bust cycle, respectively. A boom cycle will run a longer course if the underlying reasons for the boom are sustainable and self-enriching such as the introduction of an innovation that pushes an economy to a higher level where it could not be copied by competitors easily. In this case, without the threat of competition, the initial boom can benefit an economy for a significantly longer period of time until the particular innovation becomes eventually obsolete. If on the other hand, the boom is caused by the government's high expenditure programmes aiming at providing infrastructure facilities, the boom becomes short lived if the economic reforms are not continued by the government and the incentive structure for the private sector to engage in economic activities has not been improved. Similarly, if a bust cycle has started due to a natural disaster, then, the bankers can safely gauge that it would be corrected within a short period of time. However, if the bust cycle has started due to the wrong economic policies, then, it would take a long time for the economy to respond to corrective measures.

Bankers' response to boom-bust cycles

How should the bankers respond to boom-bust cycles? When an economy has entered a boom cycle, the bankers will immediately feel it because their profit levels will start to swell beyond their historical levels. Even the banks which had made losses or small amounts of profits in the past will start to experience super high profits. They should then identify the probable length of the boom cycle and whether its underlying causes are sustainable or not. With that knowledge, they have to make themselves ready for the imminent next stage of the cycle,

---

[2] Sen, Amartya, (2009), *The Idea of Justice,* Allen Lane, p 44-6

namely the onset of the bust cycle. There are several precautionary measures which banks can adopt in such a situation.

First, if the bankers perceive that the boom cycle will be short-lived, they should make use of the high profits they earn at the initial stage of the cycle for building their capital base instead of using the same to remunerate the shareholders and the employees. This is because when the bust cycle starts, bankers are likely to incur heavy losses due to the possibility of the mass-scale default of loans by their customers. To finance such losses without undergoing severe financial difficulties, they should have adequate capital within banks. Also, when the going is good, they are in a position to attract new capital from the market at lower rates because of the favourable perceptions which the prospective shareholders would form about banks.

Second, the bankers should resist the temptation to over-expand their credit portfolio when they feel the onset of the boom cycle. Strict credit appraisal criteria should be applied in order to improve the quality of the credit portfolio so that even when the bust cycle starts, they would not face a severe credit default problem by their customers. The building up of a solid credit portfolio is essential to face the possibility of loan defaults by customers during a bust cycle. If the customer base is solid, faithful and resilient, the bankers could easily wade through the difficult periods that lie ahead of them.

Third, the bankers should not overly engage in derivative products which bring in good returns in a boom cycle but high risks in a bust cycle. The history of financial crises has revealed that the over-expansion of derivative products by banks has led to financial bubbles which cannot sustain themselves in a bust cycle. The world-wide financial crisis of 2008-9 is a good example of the bursting of the sub-prime housing bubble bringing innumerable problems to the global community[3].

Fourth, it is quite normal for banks to relax their strict control measures and good governance codes at a time when they make good profits. But, such relaxations lead to undetected frauds that become fatal and costly for banks once they are detected. The banks are liable to experience a severe dent in their reputation once the frauds are detected due to investigations carried out by financial regulators, litigations made by affected customers and the adverse publicity they receive in the media. Apart from the loss of reputation, if the frauds are sufficiently large to make the bank in question insolvent, they have to go through a painful restructuring plans which invariably impose strict conditionalities on them. The case in point is the sale of the Bearing Bank in the UK for £ 1 to Ing Bank of the Netherlands after the Bearing Bank suffered heavy losses due to the uncontrolled speculative trading by one its traders in Singapore in 1995[4]. Hence, even in a boom cycle, the bankers should exercise the strictest control measures and observe the governance codes to the letter.

---

[3] Mills, Daniel Quinn, (2009), *The World Financial Crisis of 2008-2009,* Published by the author.

[4] Available at http://en.wikipedia.org/wiki/Barings_Bank

Summary and conclusions

The above discussion reveals that the boom-bust cycles are the rule of the world economies rather than the exception. They occur due to the non-linear behaviour of the natural phenomena which are governed by the Laws of Nature rather than the laws of men. Hence, if wrong policies are introduced by authorities oblivious to the natural changes that take place in a system, the result will be catastrophic. In a boom cycle, all economic agents are made better off while in a bust cycle, they are made worse off. Along with the economic agents who are facilitated by banks, the banks too experience good times or bad times in a boom-bust cycle. The dilemma of a banker is to avoid the heavy costs they would be forced to bear in a bust cycle while enjoying the fruits that would be delivered to them in a boom cycle.

To do so, the bankers should identify the length of the cycle which the economy is going through, whether the underlying causes are short-lived or long lived and whether the response of the authorities to the boom-bust cycle is prudent or imprudent. Once they identify these factors, they should prepare themselves to live through the bust cycle without undergoing severe hardships. That requires them to follow a policy of handling the boom cycle prudently by raising their capital base, maintaining the quality of the credit portfolio, resisting the temptation to overly engage in derivative products and strict adherence to management controls and good governance practices. Thus, living wisely and soberly in good times is the best way to live through difficult periods.

References

Ferguson, Niall, (2011), *Civilization: The Six Killer Applications of Western Power,* Penguin Books

Mills, Daniel Quinn, (2009), *The World Financial Crisis of 2008-2009,* Published by the author.

Sen, Amartya, (2009), *The Idea of Justice,* Allen Lane, p 44-6

http://en.wikipedia.org/wiki/Barings_Bank