

# Cambridge Perspectives on the Financial Crisis

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## Microfinance, the Financial Crisis and the Washington Consensus.

*Dr. Kumar Aniket.*

The genesis of the financial crisis seems to lie in the reckless experimentation with the pro-poor policies in America that started in the late nineties. Our attempt here is to draw lessons from the current financial crisis, which seems to have resulted from the experiment gone awry, for poverty alleviation and microfinance.

Human beings have always lived with some form of poverty in the society. The poverty that really worries the social scientists is the kind that gets entrenched and where generations are not able to afford a particular quality of life that others in the society have taken for granted. Of course, the minimum quality of life is entirely subjective and varies from society to society. To do something about it, it is important to understand whether the root cause of poverty operates at the level of an individual, a household, a community, a region or a country.

Social scientists have made some progress in understanding persistent poverty in communities, regions and social networks. Individual poverty may emanate from a lack of certain pre-requisites, i.e. education, health, skills, wealth or just pure bad luck. Poverty becomes a more entrenched phenomenon when people who lack these attributes are either surrounded by or socially connected to other people who also lack it. We know the characteristics of a region where widespread prosperity thrives. It is a region where there is thriving economic activity, a skilled-matched labour force and where everyone can take advantage of the economic activity to attain a sufficiently high quality of life. Conversely, poverty thrives if there is either limited economic activity or if certain sections of the society are marginalised because they do not have the pre-requisite to benefit from this economic activity.

These aforementioned pre-requisites interact

with each other to create poverty traps, not just for individuals, but also for communities, regions and social networks. This implies that in order to be effective, formulation of anti-poverty policies requires the understanding of how a specific policy affects the aggregate, well beyond the level of an individual.

The American pro-poor policies were such that they allowed the poor to accumulate an important indivisible asset on the back of an aggregate phenomenon, the asset market bubble. The government facilitated lending to the poor, or the so-called sub-prime borrowers, so that they could buy a house on a mortgage. These were people who would otherwise not have been able to borrow for the purposes of buying homes because they were not considered credit-worthy. The lending banks were known to refer to them as NINJA (No INcome, Jobs or Assets) mortgages. These borrowers also offered loans at interest rates that were unusually low for the first two years and would rise sharply after that. With steady sustained price rises in the housing market, these sub-prime borrowers would often sell the house once the interest rates rose and in the process made a pile of cash. Loanable funds were drawn to the sub-prime market through packaging and securitisation of these loans. With a downturn in the housing market, default became widespread. The global financial system's extensive exposure to the packaged sub-prime loans meant that the consequences were catastrophic.

With a push from the institutional organisations like the World Bank, microfinance has become one of the mainstays of development policies since the nineties. The proponents of microfinance argue that if the poor across the world could borrow, they could invest in productive indivisible assets that would lift them out of poverty. The institutional organisations

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like the World Bank argue that this lending should be by market-based organisations and lays a huge stress on the financial viability of the microfinance institutions. Predictably, there is a great deal of discussion on the securitisation and packaging of these loans so that financial institutions across the world could lend to the poor of the world.

The optimist in all of us would like to think that we could eradicate poverty on earth in our lifetimes. The proponents of microfinance have sold us the idea that this can easily be done by using market-based microfinance organisations. There are 2 billion people in the world living with less than 2 dollars a day. Most of the poor are severely credit constrained and borrow from the informal sources at very high rates of interest. We are told that linking them to the global financial markets would be a “win-win” situation that would benefit the poor as well as the financial markets.

There are number of potential problems with this approach to poverty alleviation through these kind of World Bank inspired microfinance institutions. Calculating default risk is easy when it is based on idiosyncratic risk faced by the borrower. The poor often live in the environments where risk is covariate. Stefan Dercon, in his work in the rural Africa finds that approximately two thirds of the risk the poor face is covariate risk within the community and one third is idiosyncratic. Looking at it from the perspective of the global financial markets, the covariation of risk at various levels, like communities, regions, countries etc. is not that well understood. The mistake of not factoring in the covariate risk is what lay at the heart of the sub-prime lending crisis. The packaging and securitisation of microfinance loans may increase the funds available to the microfinance institutions to lend to the poor, but only at the risk of creating further systemic risk for the financial markets.

Further, like the American pro-poor experiment, there is a presumption that poverty can be

attacked at the level of individuals through extending credit to the individuals. The argument is that if poor individuals could borrow and invest, they would be able to pull themselves out of poverty on their own. Unfortunately, poverty is often an entrenched phenomenon. The poor often are surrounded by and socially connected to others who are poor too. The efficacy of a credit intervention critically depends on health, education and other public goods being made available to them. It is thus not surprising that most careful impact evaluation work on microfinance interventions has turned up disappointing results. Loosening the credit constraints for the poor may help, but only when it is in conjunction with other policies that make health, education and other essential public goods available to the poor.

It is intriguing that a disparate phenomenon like the American sub-prime experiment and the microfinance movement draws their inspiration from a common philosophical source - the Washington Consensus. This Consensus emerged as a collection of policies from the Washington DC based development institutions that advocated greater liberalisation and openness for developing countries in the post-Cold War world. The Consensus comprised of opinion based prescription-heavy, intellectually-light policies that were largely deemed to be harmful to the interests of the developing countries. The misleading suggestion that credit is an all-encompassing solution to poverty has all the hallmarks of the Washington Consensus.

It is often tantalising to think that there is a magical solution to the problem of poverty. Unfortunately, poverty is an entrenched and pervasive phenomenon, which blights most societies today. Even the prosperous North has not been able to eradicate poverty and has simply bribed its poor minority. The influential people in the South have learnt to ignore it entirely. Here lies a great intellectual challenge for us as a society. We should be careful about underestimating the task of eradicating poverty from the world. Social scientists are keenly

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aware that they are not yet at a stage where they are able to suggest the smallest set of customised policies that would facilitate the transition of a particular community, region or a country to a more prosperous equilibrium. Consequently, understanding the root causes of poverty and eradicating it would require a sustained intellectual effort in the years to come.