Leverhulme Centre
for Research on Globalisation and Economic Policy

The University of Nottingham
Ningbo Campus

GEP in China:
The Global Financial Crisis

Crisis demands new economic theories, says leading academic

Conference briefing

The global financial crisis has exposed the shortcomings of basing economic models on assumptions of rational behaviour, one of the world's leading Chinese academics has claimed.

The very opposite – people's irrationality – was crucial to the meltdown and will also determine the nature of recovery, Professor Shujie Yao told a prestigious international conference.

He was speaking at a gathering of some of the world's foremost economists at the Globalisation and Economic Policy Centre's China branch at the University of Nottingham, Ningbo.

Delegates from around the globe attended the event, the centre's second annual conference, entitled The Global Financial Crisis.

Topics discussed included how nations can respond to a collapse in exports, how they might recover from the slump and how China specifically might avoid a second 'credit crunch'.

China's own likely future role in the wake of the seismic economic shocks that began in the middle of 2007 also came under the spotlight at the event.

Professor Yao said: "It is no easy task to come up with a new economic theory that can predict – let alone prevent – the occurrence or re-occurrence of a world financial crisis.

"But economists should not try to avoid responsibility and should instead think harder about why existing economic theories have failed to serve their purpose."

Professor Yao is the co-ordinator of GEP's China and the World Economy programme and Head of the University of Nottingham's School of Contemporary Chinese Studies.

In an article published in the Journal of Asian Economic Literature he was ranked in the top 10 Chinese scholars specialising in the country's economy.

Speaking at the conference, he suggested a new theory, defined as "the asymmetric psychological reaction of market players to gains and losses", to explain the financial crisis.

He said: "Traditional economic models are mostly based on the assumptions of rational behaviour of individuals and efficient markets.

"But many individuals – whether they are consumers, investors or firms – are irrational in the real world, and many markets are not efficient in adjusting to new equilibriums.

"Market players tend to take excessive risks when the economy is booming and be overcautious when the market is low."

Professor Yao's theory is founded on the basis that people care less about a gain in a booming market than they care about a loss of the same amount in a collapsing market.

He explained: "When markets are high most people tend to make financial gains. They derive happiness through these gains, but the marginal happiness diminishes as more gains are made.

"To derive more happiness – and in part driven by greed and speculation – they have to take more risk by investing more. This is what makes the market inflated and forms the 'bubble'.

"In a crisis situation – that is, once the bubble has burst – consumers, investors, firms and even governments have lost confidence in the economy.

"And confidence cannot be easily recovered, because most people behave 'irrationally' in the sense that they tend to overestimate potential losses.

"This is due to the inevitable law that marginal unhappiness

caused by consecutive units of losses increases rather than diminishes.

"After a certain level of losses people are hesitant to make any investments at all, even if in the long term investments in a depressed market can potentially earn high returns."

Professor Yao said his theory had important policy implications, adding: "The role of state and government is to improve people's confidence through various interventions in the economic system.

"For instance, the current rescue packages of the G20 governments are an important instrument to prevent the whole world economy from collapsing.

"But they are short-term policies to reduce the impact of the crisis. In the longer term, when the crisis is over, central banks and governments have to think hard about why things went so wrong.

"More attention should be paid to spot and predict the development of potential market bubbles and make sure effective policies stop them developing by cooling people's expectations.

"State policies should aim to reduce 'collective irrationality' by discouraging excessive risk and structural imbalances. For example, the adjustment of interest rate should be as counter-cyclical as possible.

"Stricter regulations and financial control should be implemented before the market starts to boom, while more state support and more relaxed regulations should be implemented before it is about to bust."

About GEP

GEP is based at the University of Nottingham and is substantially funded by grants from the Leverhulme Trust.

In January 2008 it opened GEP in Malaysia at the University of Nottingham's purpose-built Semenyih campus, 30km from Kuala Lumpur.

In November 2008 it launched GEP in China at the University of Nottingham, Ningbo, China.

GEP is keen to promote its research work and is committed to communicating its expertise through the media and to assisting journalists whenever able.

Website: www.gep.org.uk

GEP in China: The Global Financial Crisis

Conference delegates included:

Professor David Greenaway, University of Nottingham

Professor Shujie Yao, University of Nottingham

Professor Tony Venables, University of Oxford

Professor Wing Thye Woo, University of California, Davis

Professor Bob Anderton, European Central Bank

Professor Jiadong Tong, Nankai University

Professor Lina Song, University of Nottingham

Professor Xianguo Yao, Zhejiang University

Dr Spiros Bougheas, University of Nottingham

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