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# Financial Markets in The Global Perspective: North & South America

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## Abstract

The paper presents a critique of financial concepts in the global financial markets. The key concepts includes Equity and Debt Financing, Risk of a financial crisis and the economy: Minsky's theory of financial fragility, with reference to hedge, speculative and Ponzi balance sheets. Information Asymmetry: Adverse Selection and Moral Hazard in the Context of the Financial Services Industry, Weakened banking sector (extremely low bank capital), rising interest rates and asymmetric information and the onset of a currency and financial crisis. Elaborate illustrations are also presented to aid the contextualization of the global financial markets.

**Keywords:** *Financial Markets, Equity, Debt, Hedge Funds, Information Asymmetry, Currency Devaluation.*

### 1.1 Equity and Debt Financing

Small and medium business owners are constantly faced with deciding how to finance the operations and growth of their businesses. The decisions involve factors such as how much debt the company already has on its books, the predictability of the company's cash flow and how comfortable the company is in working with partners (Covas & Den Haan, 2012) The distinction between debt finance and equity finance is that debt financing involves the sale of debt of instruments to funders or investors (Valdez & Molyneux, 2013). Where debt instruments include secured or unsecured loans, debentures and bonds. On the other hand, equity finance involves the raising of capital by selling company stock to investors. In return for the investment shareholders received ownership interest in the company. According to Valdez and Molyneux (2013, both equity and debt financing have their advantages and disadvantages as discussed;

## Merits of Equity Financing

**Equity Financing is less risky:** There is less risk with equity financing because the company does not have any fixed monthly loan payments to make. This can be particularly helpful with startup businesses that may not have positive cash flows during the early months.

**Equity Financing solves credit problems:** If the company has credit problems, equity financing may be the only choice for funds to finance growth. Even if debt financing is offered, the interest rate may be too high and the payments too steep to be acceptable.

**Equity financing maintains cash flow:** Equity financing does not take funds out of the business. Debt loan repayments take funds out of the company's cash flow, reducing the money needed to finance growth.

**Relieves Financial Burden:** Equity financing places no additional financial burden on the company. Since there are no required monthly payments associated with equity financing, the company has more capital available to invest in growing the business.

**Equity financing facilitates long-term planning:** Equity investors do not expect to receive an immediate return on their investment and thus keeps the company to focus on a long-term view.

## Demerits of Equity Financing

**Cost:** Equity investors expect to receive a return on their money. The business owner must be willing to share some of the company's profit with his equity partners. The amount of money paid to the partners could be higher than the interest rates on debt financing.

**Loss of Control:** The owner has to give up some control of his company when he takes on additional investors. Equity partners want to have a voice in making the decisions of the business, especially the big decisions.

**Potential for Conflict:** All the partners will not always agree when making decisions. These conflicts can erupt from different visions for the company and disagreements on management styles. An owner must be willing to deal with these differences of opinions.

## Merits of Debt Financing

**Retain Control:** Taking out a loan is temporary. The relationship ends when the debt is repaid. The lender does not have any say in how the owner runs his business. When you agree to debt financing from a lending institution, the lender has no say in how you manage your company. You make all the decisions. The business relationship ends once you have repaid the loan in full.

**Taxes:** Loan interest is tax deductible, whereas dividends paid to shareholders are not. The amount you pay in interest is tax deductible, effectively reducing your net obligation.

**Predictability and planning:** Principal and interest payments are stated in advance, and it is easier to work these into the company's cash flow. Loans can be short, medium or long term. Thus the company know well in advance exactly how much principal and interest you will pay back each month. This makes it easier to budget and make financial plans.

### **Demerits of Debt Financing**

**Qualification requirements:** The Company and the owner must have acceptable credit ratings to qualify. The company needs to have a good credit rating to receive financing.

**Fixed payments and Discipline:** Principal and interest payments must be made on specified dates without fail. Businesses that have unpredictable cash flows might have difficulties making loan payments. Declines in sales can create serious problems in meeting loan payment dates. Financial discipline is required to make repayments on time. The company manager have to exercise restraint and use good financial judgment when using debt financing. A business that is overly dependent on debt financing could be seen as 'high risk' by potential investors, and that could limit access to equity financing.

**Cash flow:** Taking on too much debt makes the business more likely to have problems meeting loan payments if cash flow declines. Investors will also see the company as a higher risk and be reluctant to make additional equity investments.

**Collateral:** Lenders will demand that certain assets of the company be held as collateral and the owner is often required to guarantee the loan personally. By agreeing to provide collateral to the lender, the company could put some business assets at potential risk. The company might also be required to personally guarantee the loan, potentially putting your own assets at risk.

### **2.1 Risk of a financial crisis and the economy: Minsky's theory of financial fragility, with reference to hedge, speculative and Ponzi balance sheets.**

A financial crisis is a nonlinear disruption to financial markets in which adverse selection and moral hazard problems become much worse, so that financial markets are unable to efficiently channel funds to those who have the most productive investment opportunities (Rudd, 2010). A financial crisis thus results in the inability of financial markets to function efficiently, which leads to a sharp contraction in economic activity. A variety of factors can cause a financial crisis. Some of the most common reasons include irrational investor behavior, sudden bank withdrawals, speculation that results in overpricing of certain assets, and bank debt default (Claessens & Van Horen, 2015).

Minsky's theory of financial fragility argues that a key mechanism that pushes an economy towards a crisis is the accumulation of debt by the non-government sector (Minsky, 1975). Minsky identified three types of borrowers that contribute to the accumulation of insolvent debt: hedge borrowers, speculative borrowers, and Ponzi borrowers. The hedge borrower can make debt payments (covering interest and principal) from current cash flows from investments. For the speculative borrower, the cash flow from investments can service the debt. The Ponzi borrower borrows based on the belief that the appreciation of the value of the asset will be sufficient to refinance the debt but could not make sufficient payments on interest or principal with the cash

flow from investments; only the appreciating asset value can keep the Ponzi borrower afloat (Minsky, 1975).

At each moment, economic units manage a cash flow composed of revenues and expenditures to be made in the future. Based on the degree of risk associated with their capacity to discharge financial obligations, Minsky proposed dividing these units into three different categories: hedge, speculative and Ponzi (Minsky, 1975). Hedge financing units are those that can fulfill by the due date all of their contractual payment obligations (interest and principal) only by their current expected revenues (cash flows). In this case, both the entrepreneur and the banker do not need to worry about changes in financial markets conditions, such as the level of interest rates, loan terms, collateral requirements, etc. All risks associated with the discharge of financial obligations depend on a possible frustration of expected revenues. The lesser the degree of indebtedness of a unit the greater the likelihood that it is a hedge financing unit (Minsky, 1975).

Different from hedge units, speculative financing units know beforehand that they will not be able to generate revenues enough to fulfil all of their contractual payment obligations by their due date. Interest payments can be covered, but at least part of the principal of the debt will not be repaid out of current cash flows. Therefore, this unit will need to roll over their liabilities, issuing new debt to meet commitments on maturing debt before its due date (Minsky, 1975).

Ponzi financial units are similar to speculative units by the fact that they will not be able to fulfill all of their contractual obligations by their due date. Nevertheless, for Ponzi units the magnitude of the disequilibrium between revenues and obligations is even greater. Expected cash flows are not sufficient to fulfill both the repayment of the principal and the interest due on outstanding debts. In this situation, a firm's indebtedness will increase in the near future unless it renegotiates its liabilities, sells assets, or issues stocks in financial markets. Financial risks of a Ponzi unit are, therefore, very high (Minsky, 1975).

Financial instability is directly related to the financial risks incurred by firms on their balance sheets and, subsequently, by financial institutions. The greater the relevance of financial risks in speculative and, principally, Ponzi units, the more prone to crisis that economy is. As Minsky (1986) states that, the mixture of hedge, speculative, and Ponzi finance in an economy is a major determinant of its stability. The existence of a large component of positions financed in a speculative or a Ponzi manner is necessary for financial stability.

### **3.1 Information Asymmetry: Adverse Selection and Moral Hazard in the Context of the Financial Services Industry**

#### **Information asymmetry**

Information asymmetry is an imbalance between two negotiating parties in their knowledge of relevant factors and details. Typically, that imbalance means that the side with more information enjoys a competitive advantage over the other party (Omar, Sell & Rover, 2017). It is a situation where there is imperfect knowledge. In particular, it occurs when one party to an economic transaction possesses greater material knowledge than the other party.

George Akerlof introduced the term information asymmetry in his 1970 article, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism." Akerlof argued that because people buying cars have less complete information about them than car salesmen do, the salesmen are motivated to sell to people cars of less-than-average quality. At the same time, because most buyers cannot differentiate good cars from bad cars (lemons), sellers of good cars cannot sell them for what they are worth, comparatively (Akerlof, 1970). Akerlof referred to this situation as the "lemon problem." Information asymmetry is relevant to most types of negotiations and is particularly significant to game theory, and the related contract theory, which is the study of how two parties come to terms of agreement despite unknown factors and unequal knowledge (Akerlof, 1970).

Asymmetric information is a problem in financial markets such as borrowing and lending. In these markets, the borrower has much better information about his financial state than the lender (Crawford, Pavanini & Schivardi, 2018). The lender has difficulty knowing whether it is likely, the borrower will default. To some extent, the lender will try to overcome this by looking at past credit history and evidence of a reliable salary. However, this only gives limited information. The consequence is that lenders will charge higher rates to compensate for the risk. If there were perfect information, banks would not need to charge this risk premium (Balafoutas, Kerschbamer & Sutter, 2017).

### **Adverse selection and moral hazard in financial services industry**

Asymmetric information can lead to either moral hazard or adverse selection and both moral hazard and adverse selection result in market failures (Akerlof, 1970). Adverse selection is an asymmetric information problem that occurs before the transaction occurs when potential bad credit risks are the ones who most actively seek out loans. Thus, the parties who are the most likely to produce an undesirable (adverse) outcome are most likely to be selected. For example, those who want to take on big risks are likely to be the most eager to take out a loan because they know that they are unlikely to pay it back. Since adverse selection makes it more likely that loans might be made to bad credit risks, lenders may decide not to make any loans even though there are good credit risks in the marketplace (Klein, Lambertz & Stahl, 2016).

Moral hazard occurs after the transaction occurs because the lender is subjected to the hazard that the borrower has incentives to engage in activities that are undesirable (immoral) from the lender's point of view: i.e., activities that make it less likely that the loan will be paid back. Moral hazard occurs because the borrower has incentives to invest in projects with high risk in which the borrower does well if the project succeeds but the lender bears most of the loss if the project fails (Hébert, 2018). In addition, the borrower has incentives to misallocate funds for his own personal use, to shirk and just not work very hard, or to undertake investment in unprofitable projects that increase his power or stature. The conflict of interest between the borrower and lender stemming from moral hazard (the agency problem) implies that many lenders will decide that they would rather not take loans, so that lending and investment will be at suboptimal levels (Itoh, 2016).

Moral hazard is the post transaction problem of information asymmetry in financial markets. In equity contracts it manifests as the principal-agent problem where the separation of ownership and control incentivizes managers (the agents) to act against the interest of the owners (the principals) (Fu Yang & An, 2019). The principal-agent problem would not arise if the shareholders had complete oversight (information symmetry) of the manager's actions and could prevent

unproductive expenditures and possible fraud, or if there was no separation between ownership and control. Therefore, effective auditing may alleviate the moral hazard problem. Nonetheless, the monitoring process can be expensive giving rise to costly state verification that makes equities less attractive and explains the prevalence of debt as a means of financing.

Similarly, to the adverse selection situation, government regulation provides only a partially effective deterrent. Financial intermediaries such as the venture capital firm curtail the negative effects of moral hazard and the free rider problems arising from information asymmetry. These firms provide equity capital in exchange for supervisory oversight in the form of appointed board members and exclusive equity shares (Hébert, 2018). As a result, the venture capital firm has an increased oversight and is safe from the free rider problem. Debt contracts have lower moral hazard risks, by virtue of fixed interest and principal repayments at periodic intervals, regardless of a firm's accounting (book) profitability, making them a more frequent source of financing than equity contracts (Fu, Yang & An, 2019). High net worth, again, makes the debt contract incentive-compatible, by aligning the incentives of the borrower with those of the lender because the former will have at least as much at stake as the latter, thus reducing the moral hazard risk.

### **Information asymmetry manifestation to inefficiencies**

Asymmetric information can lead to both moral hazard and adverse selection result in market failures. Financial markets exhibit asymmetric information in that in a financial transaction, one of the two parties involved will have more information than the other and will have the ability to make a more informed decision (Styrin, 2015).

When it comes to the purchase or sale of a financial security, asymmetric information occurs when either the buyer or seller has more information on the past, present or future performance of that financial security. If the buyer has more information, he knows the security is underpriced relative to its aggregate performance. If the seller has more information, he knows the security is overpriced. Asymmetric information gives either the buyer or seller a better opportunity to make a profit from the purchase or sale (Apergis, Fafaliou, & Stefanitsis, 2016).

When it comes to borrowing or lending money, asymmetric information occurs when the borrower has more information about his financial state than the lender does. The lender is more unsure whether the borrower will default on the loan. The lender can look at a borrower's credit history and salary level, but this provides limited information compared to what the borrower knows about his own financial situation. To account for this asymmetric information, a lender will charge a risk premium to compensate for the disparity in information (Klein, Lambertz & Stahl, 2016). Allowing banks to set their own policies, including setting interest rates, does not always produce desirable results. If the market is left to itself, many people do not get access to the financial services that they could benefit from; most often it is the poor, particularly the rural poor, who have the least access of all. One of the reasons for this is that the connection between interest rates and savings is not as clear as it might seem. Increased interest rates do not always lead to higher savings rates (Styrin, 2015). Savings are not determined simply by the profit that can be earned; they also depend on how much income someone has. Higher interest rates may, in some cases, lead to lower savings rates as people can reach their target savings goal more quickly. In addition, with the development of other types of financial intermediaries, particularly insurance companies, people may choose to save less if they know they are protected against future risks (Hébert, 2018).

## **Mechanisms Applied to mitigate the effects of information asymmetry**

To overcome asymmetric information problems, financial intermediaries screen potential borrowers before making loans. The financial intermediaries industry check any credit ratings issued by the credit rating agencies for businesses, such as Credit Reference Bureau (CRB), as well as credit reporting agencies for businesses (Nasieku & Ngugi, 2016). More information is available on businesses that seek direct financing through the issuance of stocks and bonds, because they are required by law to report significant financial information before offering their securities for sale, and to update that information periodically (Boateng, Asongu, Akamavi & Tchamyou, 2018).

The financial intermediaries also use collateral as it reduces adverse selection by requiring a specific value of collateral, such as 20% down payment on a house, for instance. Collateral also lowers moral hazard risk because the borrowers stand to lose their collateral if they do not make the required payments. The financial intermediaries monitor borrowers' financial conditions and how they are using borrowed funds after making loans (Mugwe & Oliweny, 2015). They also insert restrictive clauses into debt contracts to limit borrowers' behavior. They require a minimum net worth to reduce adverse selection because only those individuals or businesses with sufficient assets over liabilities will be considered for a loan. Moral hazard is reduced because the borrower can be sued if they fail to make timely payments on their loans (Kodongo, 2018). Other methods include equity finance, which is financing through the issuance of stock, this require the managers to own a certain percentage of the company, which is often achieved through the granting of stock options as part of the compensation package. For individuals applying for insurance, insurers can consult credit reports and other databases. Medical records can be checked for health and life insurance applicants.

### **4.1 Weakened banking sector (extremely low bank capital), rising interest rates and asymmetric information and the onset of a currency and financial crisis.**

Banks in developing countries face additional potential shocks that can make a banking crisis more likely. First, developing countries which are often primary goods producers are often subject to large terms of trade shocks that can devastate banks' balance sheets whose assets are composed primarily of loans to domestic firms. The lack of diversification outside their country can thus be a severe problem for banks in developing countries that is not present for many banking institutions in developed countries which do have the ability to diversify across countries (Valdez & Molyneux, 2013). In addition, banks in many developing countries raise funds with liabilities that are denominated in foreign currencies (Riles, 2011). A depreciation or devaluation of the domestic currency can thus lead to increased indebtedness, while the value of the banks' assets do not rise. The resulting deterioration in banks' equity capital then increase the possibility of bank failures and bank panics. Even if the exchange rate depreciation does not lead to bank failures directly, it can lead to substantial declines in bank lending because the resulting drop in bank capital results in a failure of banks to meet capital standards, such as the Basle requirements.

Asymmetric information and the resulting adverse selection problem can lead to credit rationing in which some borrowers are denied loans even when they are willing to pay a higher interest rate (Iqbal, 2010). This occurs because individuals and firms with the riskiest investment projects are



exactly those who are willing to pay the highest interest rates since if the high-risk investment succeeds, they will be the main beneficiaries. Thus, a higher interest rate leads to even greater adverse selection, that is, it increases the likelihood that the lender is lending to a bad credit risk. If the lender cannot discriminate among the borrowers with the riskier investment projects, it may want to cut down the number of loans it makes, which causes the supply of loans to decrease with the higher interest rate rather than increase (Valdez & Molyneux, 2013). Thus, even if there is an excess demand for loans, a higher interest rate will not be able to equilibrate the market because additional increases in the interest rate will only decrease the supply of loans and make the excess demand for loans increase even further.

Among the many institutional characteristics common to developing economies in general are some of special relevance in influencing the potential role, scope, and effectiveness of central banking (Valdez & Molyneux, 2013). Monetary policy operates within a relatively smaller area of the economy than it does in the more developed countries. Even in the monetary sector of the economy, the banking habit is not yet widespread. Some 50 per cent or more of the money supply tends to take the form of currency in circulation. Money markets and capital markets are limited in scope or virtually nonexistent, thereby restricting the possibilities of central bank open-market operations and to some extent discount operations as well. There are few organized markets in bills or commercial paper and there is often a lack of discountable paper (Riles, 2011). Markets in short- and long-term government securities are very narrow, as are markets in corporate stock. Institutional investors, such as savings banks and insurance companies, play only a relatively small role in mobilizing and channeling the limited volume of private saving that takes place. Such saving tends in large part to be invested in forms that remain directly under the control of the saver.

The interest rate structure in underdeveloped countries is an unintegrated one and over a large part of the economy interest rates are relatively insensitive to the actions of the monetary authorities (Valdez & Molyneux, 2013). Even within given sectors or localities of the market there is often a wide diversity of rates. There is an especially wide gap between interest rates in the so-called organized and unorganized sectors of the money market. Interest rates play a lesser role than they do in the more developed countries in influencing the volume and direction of investment. In the modus operandi of monetary policy, the availability of credit factor is likely to be more important, relative to the cost factor, than it is in the more developed countries.

In most developing economies, there is a marked lack of balance in the allocation of commercial bank credit. Commercial banks, in large part because of their concern for a very high degree of liquidity, tend to concentrate heavily on short-term loans to finance foreign trade and domestic commerce (Valdez & Molyneux, 2013). Production loans to agriculture and industry, and especially medium- and long-term loans, usually constitute only a relatively minor part of their portfolios. Commercial banking facilities likewise tend to be concentrated mainly in the urban centers. The role and scope of central banking in developing economies are greatly influenced by the strong development drives to which most of them are subject (Jacoby & Skoufias, 2017). These drives, superimposed upon economies of low savings propensities, low taxable capacities, and relatively inelastic outputs, make these countries especially sensitive to inflationary pressures and call for constant vigilance by the monetary authorities. They contribute to strong political pressures upon the central bank to extend credit unduly. They often make it necessary for the central bank to be more concerned with the development process, and to engage in a wider range of activities and operations, than is traditional with central banks in the more developed countries (Iqbal, 2010).

Externally generated fluctuations in the balance of payments, associated with fluctuations in world demand for their exports, are usually a major cause of changes in the money supply in developing economies (Rudd, 2010). Such money supply changes are not easily subject to the control of the central bank nor can they easily be offset by central bank action on that part of the money supply which is so subject. Nor can the central bank exercise genuinely effective control over that part of the money supply which is generated by the credit which it and sometimes the commercial banks are called upon to extend to the government and to government enterprises and instrumentalities. Such credit extensions often account for a very large part of the money supply increases in underdeveloped countries because of strong development drives, inadequate tax systems, and narrow markets in government securities.

### **Devaluation of a developing country's currency to solve a currency crisis**

Currency devaluation involves taking measures to strategically lower the purchasing power of a nation's own currency. Countries may pursue such a strategy to gain a competitive edge in global trade and reduce sovereign debt burdens. A devaluation means that the value of the currency falls (Valdez & Molyneux, 2013). Currency devaluations can be used by countries to achieve economic policy. Having a weaker currency relative to the rest of the world can help boost exports, shrink trade deficits and reduce the cost of interest payments on its outstanding government debts. Devaluation of currency is decided by the government issuing the currency and is the result of governmental activities (Saibene & Sicouri, 2012).

One reason a country may devalue its currency is to combat trade imbalances. Devaluation causes a country's exports to become less expensive, making them more competitive on the global market. This in turn means that imports are more expensive, making domestic consumers less likely to purchase them. By making the domestic currency relatively cheaper, local production and exportation of commodities is thereby encouraged. This helps to enhance the level of output growth of the economy (Jacoby & Skoufias, 2017). The idea for devaluation in developing country's currency to solve a currency crisis has various advantages and disadvantages as discussed below:-

### **Merits of devaluation**

The Exports become cheaper and more competitive to foreign buyers. Therefore, this provides a boost for domestic demand and could lead to job creation in the export sector. A higher level of exports should lead to an improvement in the current account deficit. This is important if the country has a large current account deficit due to a lack of competitiveness. Devaluation is a less damaging way to restore competitiveness than internal devaluation. Internal devaluation relies on deflationary policies to reduce prices by reducing aggregate demand. Devaluation can restore competitiveness without reducing aggregate demand. With a decision to devalue the currency, the Central Bank can cut interest rates as it no longer needs to prop up the currency with high interest rates. Higher exports and aggregate demand can lead to higher rates of economic growth (Okaro, 2017; Kohler, 2017).

### **Merits of devaluation**

Devaluation is likely to cause inflation because the Imports will be more expensive and the aggregate demand increases causing demand-pull inflation. Further, firms/exporters have less incentive to cut costs because they can rely on the devaluation to improve competitiveness (Betz & Kerner, 2016). The concern is in the long-term devaluation which may lead to lower productivity because of the decline in incentives. Devaluation reduces the purchasing power of citizens abroad. Devaluation causes reduced real wages. In a period of low wage growth, a devaluation which causes rising import prices will make many consumers feel worse off (Bergin & Corsetti, 2019).

In conclusion, currency devaluations can be used to achieve economic policy. Having a weaker currency relative to the rest of the world can help boost exports, shrink trade deficits and reduce the cost of interest payments on its outstanding government debts. However, in the developing country context, there arise major shortfalls and long-term effects that discourage of devaluations. They create uncertainty in global markets that can cause asset markets to fall or spur recessions. Countries might be tempted to enter a retaliation currency wars, devaluing their own currency back and forth in a race to the bottom. This can be a very dangerous and vicious cycle leading to much more harm than good. Devaluation also undermines the banks and consequently domestic ownership of privatized assets and performance of the rest of the real economy. Devaluation further hurts firms in trading as well as poor farmers and the urban poor. Devaluation has the effect of raising costs of production among farmers producing cash crops and further costs of transporting produce to markets, thus taking away the initial gains. Therefore, devaluation could pose major negative effects to the developing countries in the end.

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