

On Economic Theory and Recovery of the Financial Crisis

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First published: 26 May 2011

<https://doi.org/10.1111/j.1467-9701.2011.01347.x>

Financial support by the Leverhulme Trust is gratefully acknowledged (F00114AQ).

Abstract

This paper presents a new economic theory to explain the evolution of a financial crisis and why a major crisis may take a long time to recover. It suggests that asymmetric psychological reactions of market players to gains and losses are the principal cause of a crisis and responsible for prolonging recovery. Three different shapes of recovery, V, U and L, are defined and explained. During the current financial crisis, some countries such as China and India may have a V-shaped recovery; others such as the UK and the US may have a U-shaped recovery. An important policy implication is that effective macroeconomic policies should be designed to smooth market movements and implementation of such policies has to be countercyclical rather than pro-cyclical.

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