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The Great Financial Crisis and Challenges for Asia

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Foreword

Dr Michael Lim Mah-Hui and Dr Lim Chin sent me their latest book on the great financial crisis for comments. I was curious to know what this manuscript would add to the mass of literature and debate that is circulating at this juncture. After reading the manuscript, I am fully convinced that it is a valuable addition to the literature on the subject for several reasons.

First, the book is very lucid, easy to read and simple to understand. Second, it captures history, current context and the way forward. Third, it succinctly presents theory and focuses on policies and institutions rather than abstract thinking or anecdotes. Fourth, it gives an emerging market perspective while presenting in detail the debates on the subject in the western world, in particular the Anglo-Saxon world. Fifth, the book emphasizes the Asian point of view and it is presented in a way that captures the dynamic and evolving interrelationship between Asia and global economy. Finally, the analysis has several original elements in explaining theory and practice in public policies as well as the behaviour of financial markets.

The book analyses the causes or the origins of this crisis at three inter-related levels broadly covering economic and financial theory, financial sector practices, and macroeconomic imbalances and the international monetary system. The authors refer to the belief in Efficient Market

Hypothesis that governed public policies in general and central bankers and regulators in particular as the primary cause of the crisis. I can fully endorse the prevalence of this view even in the year 2006 and early 2007. By then the underpricing of the risks in the financial markets and the dangerous level of macroeconomic imbalances had come to the fore. However, in the interactions between central bankers and market participants exploring methods by which soft landing could be engineered, market participants asserted the view that, interfering with market-determined pricing of risks would be a serious policy mistake.

It is "these same people", as the authors describe, that pleaded and perhaps even demanded massive intervention of public policies within few months of their assertion to the contrary, once the crisis struck. The asymmetrical response of financial markets to the desirable level of public policy intervention seemed to be governed by the benefits that accrue to participants in the financial sector. It is instructive to note that financial markets that were keen on transparency for actions by monetary authorities and regulators have joined hands with authorities to not disclose the terms and conditions of many bailout operations. There is yet another asymmetry in the analysis of market behaviour as well as on the causes and cures for the crisis in advanced economies versus that in emerging market economies. The Asian financial crisis was blamed on crony capitalism and improper corporate governance. But these same practices that are also present in the present crisis are conspicuously absent in Western commentators' analysis.

The Efficient Market Hypothesis has its companion in the modern theory of risks management. However this model did not go far back enough to take into account historical facts and data that impact the present situation. It also does not recognize that financial markets may be dominated more by speculative sentiments and expectation of future changes in price than price based on the need to satisfy wants. Such sentiments often result in herd-mentality. The rapid growth of the financial sector was governed by the belief in Efficient Market Hypothesis, reinforced by technological developments and globalization of finance. Consequently, the financial sector has grown much more rapidly than the real sector leading to dominance by the former. This disproportionate growth between the real sector and the financial sector is an additional set of asymmetry that was analysed by the authors.

At a more general level, it can be argued that excessive state intervention and frustration with stagflation prior to Reagan-Thatcher era, together with intellectual inspiration from the Chicago School, led to a belief that if one gets prices right, all other matters will fall in place. The current crisis has shown that prices may not necessarily be right if public policies are not right. The debates in the post-crisis period indicate that there is still inadequate attention paid to find the right balance between market forces and state intervention. There is still an inclination to treat state intervention as exceptions but painful necessities, and that markets are right except in times of crises. It is also likely that the shape of financial reforms under consideration in the present crisis is influenced by the continued power of the financial industry over policy-makers and politicians.

On par with the faith in Efficient Market Hypothesis is the belief that financial innovations have positive contributions to the economy and society. Even after the crisis, the putative benefits of financial innovations are often reiterated without much evidence. In fact, Paul Volcker, a former governor of the Fed recently stated, "I wish someone would give me one shred of neutral evidence that financial innovation has led to economic growth — one shred of evidence."

This book provides an excellent overview of recent financial innovations. It is clear from the narration that the downside risks are real while the benefits are mere assertions. There is no empirical evidence to support the view that these innovations have added to efficiency in resource allocation or resource use. There is some evidence that most of the innovations have resulted in the redistribution of wealth and income rather than an increase in output or employment. There is a reference in the book to the financial innovations that Minsky wrote about in the early 1980s, and how they have become safe by today's standards. Financial innovations that he did not anticipate have now come into existence. The interesting issue is whether the recent innovations that are proven to be unsafe, will also turn out to be safer after regulatory reforms are undertaken. In my opinion there is qualitative difference in the earlier financial innovations and the recent ones. The earlier innovations improved the efficiency of financial intermediation and contributed to growth of the real sector. The recent financial innovations were mainly meant to side-step financial regulations, in particular capital requirements. Hence, going forward empirical work on the efficacy of each financial innovation in the context of different countries is warranted.

Chapter 3 is valuable in terms of the wealth of evidence provided. However the evidence is mostly from the United States and it is possible that a similar regulatory capture process is happening in other countries though to a lesser extent. A more fundamental question therefore relates to the reasons for such a comprehensive regulatory capture in the U.S. Financial markets have short-time horizon and political leaders also have similar short-term outlook. They reinforce each other in capturing the regulators. The mainstream academia has also been dominated by those who were willing to contribute to and benefitted from the prevailing ideology and dominance of the financial sector. The revolving door for academics between government, regulatory agencies and financial markets reinforced these linkages and shared interests. The media catered to the demands of consumers and investors and hence the coverage on macroeconomic issues was often underplayed, since it was not of immediate interest to readers.

There is a brief reference in the book to the dominance of "Economic Value Added School of Thought". According to this approach, the objective of the company is to maximize shareholders' value while treating other stakeholders as not very relevant. It is true that this approach resulted in emphasis on short-term and fee-based income with a bias towards excessive multiplication of transactions. It also resulted in mechanisms to circumvent the requirements of regulatory capital. More important the evidence shows that operations in the financial sector resulted in huge remuneration to the management and only a smaller part was available for shareholders. This reinforces the view that linkages formed between senior managers in the financial sector, the government and regulatory agencies enabled regulatory capture.

The treatment of the three macroeconomic imbalances in the book as the fundamental reasons for the global financial crisis is excellent. One observation on the subject of imbalances is of significance: "Just as an organic or biological system becomes dysfunctional where its components are out of balance, the same happens to economic and financial systems when things are not balanced." Considerable attention has rightly been given to explain the issue of global current accounts imbalances in terms of excessive savings in Asia, on the one hand, and excess consumption in America, on the other. Personally and from a technical viewpoint, I take a neutral position as there can never be a world where all countries enjoy current account balance, i.e., are without deficit or surplus. The world economy is a closed economy and surplus and deficit in current accounts have to balance at the global level. The real issue is whether these imbalances are sustainable in an imperfectly globalized world where goods and other factors are freely traded.

Growth and development are ultimately guided by human values such as happiness, well-being, equity and justice. If these values are taken into account to explain the two excesses, then excess consumption by an already rich population is difficult to justify not only from a point of justice but even from a point of survival of the world. Since consumption draws on depletable natural resources, the burden on the global ecological system is aggravated by excess consumption. Using a value-informed approach will be helpful in determining priorities for correcting global imbalances and sustainable development. As Mahatma Gandhi once remarked, there is enough on this earth to satisfy everyone's need but not everyone's greed. Or put in another way, the measure of a civilization is not the amount of desires it can satisfy, but the amount of desires it can control.

Chapter 5 provides interesting insights into the impact of the present crisis on Asia, their policy responses and challenges for the future. It would be useful to supplement the analysis with more discussion on economic integration between Japan, China, Southeast Asia and South Asia, in particular India. India has current account deficit and is likely to generate such deficits in view of the need for growth and eradication of poverty. The country has serious concerns on the volatility of capital flows. There is recognition of the increasing importance of Asia in the evolving global economy. Policy-makers in Asia are assessing the manner in which a new paradigm, in the post-crisis global economy, could work out for Asia. I will offer a few thoughts on this subject.

First, there will be massive economic activity in Asia. Millions will be added to the workforce each year, and living standards will keep improving. A growing new middle class will generate huge demand. Urbanization will lead to infrastructure demand spurring vibrant economic activity. Asian multinationals could take center stage in the world in the next few decades.

Second, with an annual addition of about forty million to the workforce, education and upgrading of skills will continue to be major challenges. There will be heavy demand for public healthcare. Provision of adequate water will be challenging and the effects of climate change will be daunting. The social consequences of all these will be serious. Most of these challenges fall in the domain of public policy, but the private sector cannot prosper if these issues are not satisfactorily resolved.

Third, Asia can become a global financial hub because of the large pool of capital supplied and demanded and the human skills in managing this capital. Until now, domestic or Asian regional financial markets have followed rather than led global finance. The dominant global financial institutions are still based in the United States and Europe. But their ownership could, over the years, change hands in favour of Asia.

Fourth, history shows that leadership in the global economy is firmly linked to leadership in thought and innovation. Although Japan has made significant technological advances, Asia as a whole has yet to demonstrate strength in thought and innovation. Public policy and initiative is critical for this.

Fifth, while the size of economic and financial activity of a region or country is important in determining its position in the global economy, good governance is more important to command credibility and the confidence of global markets.

Sixth, intra-regional cooperation is already taking place on several fronts and in various forms. Notable initiatives in the recent past are a multilateral fund under the Chiang Mai Initiative, and an agreement for surveillance at the regional level (this initiative does not yet fully include India). To be effective in the global context, Asian regional cooperation may ultimately rest on four pillars: Japan, China, India and ASEAN.

Finally, history shows that major shifts in economic power in the world take place over a long period and may not be smooth. But technological development and globalization help expedite the process. Currently, a significant shift in global economic balance in favour of Asia is taking place.

Chapter 6 addresses some of the issues mentioned by placing them in a historical context, and poses some fundamental questions relating to the prospects for meaningful reforms, beyond what the authors describe as "tinkering with the financial system".

This book is indeed a valuable contribution to the literature on the subject and should enhance the quality of ongoing debates on the subject, among academicians, policy-makers and market participants.

Dr Yaga Venugopal Reddy
Former Governor of the Reserve Bank of India
December 2009

Preface

This book grew out of a series of articles I (the principal author) wrote and public lectures I gave in various parts of Asia in 2007 and 2008. As a matter of fact, when I gave one of my first lectures on the financial crisis in October 2007 at the Asian Development Bank (ADB), it did not attract much attention. As the Director General of the Private Sector Operations Department of the ADB was reported to have said, it (the crisis) was just a tempest in a teacup. In a later lecture I gave to the Bankers Association in Singapore in January 2008, I ended the talk by saying it was a perfect financial storm, and I was questioned about the validity of such a conclusion at that time. At the end of 2008, when the crisis was still raging, I was invited to speak at the Institute of Southeast Asian Studies, Singapore. After one of the talks, I was encouraged by the Director and the staff of the Institute to write a book on this subject. One of my good friends and tennis partner, Professor Lim Chin of the National University of Singapore, attended one of my lectures. During the height of the financial panic, he had separately written several articles and edited a book on the crisis. His offer to work with me on this book led to a fruitful partnership in this intellectual journey that has benefitted both of us.

In August 2007, a few weeks after the collapse of two hedge funds managed by Bear Stearns, reportedly the start of the great financial crisis, I started my research fellowship with the Asian Public Intellectuals (API) Programme of the Nippon Foundation. The topic of my research was the Asian financial crisis. I had spent twenty years as a banker in various international banks (Chemical Bank (now JP Morgan Chase), Credit Suisse First Boston, Deutsche Bank, Standard Chartered Bank and the Asian Development Bank). And prior to that I had done research on and taught political economy and sociology in various universities in the United States and Malaysia. When I left the field of banking and finance in 2007, I wanted to spend time to reflect and write on my experience in this area. The API programme offered me the opportunity to do just that, and the outbreak of the financial crisis just as I embarked on my research motivated to write not just about the Asian financial crisis but more importantly on the present crisis.

This book takes a multi-disciplinary approach to the great financial crisis of 2007–09. It combines the disciplines of economics, finance, sociology and politics to analyse the causes, consequences and challenges of the crisis. Above all it is historical and holistic in perspective. Too much of social science, in particular, the discipline of economics, has been dominated by an a-historical and fragmented way of thinking with disastrous consequences such that Paul Krugman, a recent Nobel laureate in Economics in his Lionel Robbins lecture in June 2009, stated that much of macroeconomics over the last few decades was useless at best and destructive at worst (Krugman 2009*b*).[1]

History is the basis of all social science because all social (economic included) phenomena have historical roots. Nothing emerges from nowhere. To comprehend the present forces and institutions, one has to understand the past, to discover how a particular phenomenon or problem originated and developed. To ignore history is to court ignorance and disaster. As George Santayana, the philosopher, puts it, "Those who cannot remember the past are condemned to repeat it." Or to rephrase it in a more positive way, the further one looks to the past, the more one can see forward.

The other approach that has been neglected in social science is a holistic and integrated understanding of social reality and the world. Science, like so much else, has become so specialized that every discipline has carved a niche for itself, with its own language, symbols and territorial turf. Most people have lost the ability to think holistically across disciplines; instead they are trapped in their silos-mentality. Capra (1983, p. 44), a physicist, wrote, "… overemphasis on the Cartesian method has led to the fragmentation that is characteristic of both our general thinking and academic disciplines, and to the widespread attitude of reductionism in science — the belief that all aspects of complex phenomena can be understood by reducing them to their constituent parts". As we shall show later, this fallacy of composition — reducing the whole to the sum of its parts — stands at the heart of the theoretical failure.

The great financial crisis is not the result of greedy financiers who took the world to the cleaners (that is a constant in the world of finance); or even simply the mistakes of central bankers and regulators who were caught asleep in their jobs, though they certainly share responsibility for the crisis. It is easier to look for convenient or accidental causes such as the lack of integrity of bankers,[2] or policy mistakes and poor implementation of policies, but more demanding intellectually and politically is to understand the underlying structural causes of the crisis. We propose that the causes of the crisis should be understood at three inter-related levels — the level of theory and ideology; the level of financial industry practices and malpractices that are a result of the failure of the theories; and finally the level structural imbalances in the international economy.

Chapter 1 begins with an analysis of the failure of the efficient market hypothesis and the rational expectations theory that underlie the disciplines of finance and macroeconomic theory. Rational expectations theorists believe market is always right in pricing assets, and government policies only reduce optimal allocation of resources. Blind faith in this assumption (it is no more than an assumption), has influenced not only academicians but more importantly policy-makers to adopt policies that accentuates financial instability. Chapter 2 traces the U.S. housing bubble that burst and triggered the financial crisis in relation to recent financial innovations that multiplied, rather than reduced, risks in the financial system. These included mortgage backed securities, collateralized debt obligation, credit default swaps, structured investment vehicles, private equity and leveraged buyouts.[3] Chapter 3 analyses how the financial industry in the United States became dominant again after almost fifty years of regulation, from the end of the Great Depression to the late 1970s. The re-emergence of finance over the real economy is associated with the rise in the ideology of deregulation and liberalization that escalated under President Reagan and Prime Minister Margaret

Thatcher. In the United States, the financial industry re-emerged with greater economic and political power after the bailout of the savings and loans crisis, and managed to capture the regulatory process over the years.

Chapter 4 moves beyond the financial industry to analyse structural changes in the U.S. economy that laid the foundation for the crisis. In particular, the secular decline in the U.S. growth rate was counteracted by an increasingly debt-driven economy. Between 1960 and 2007, total debt in the U.S. economy rose 64 times compared to 27 times for its GDP. Financial debt exploded 490 times and household debt increased 64 times. The imbalance between the financial sector and the real economy is the first structural imbalance. Two other structural imbalances explain the crisis — the wealth and income imbalance and the imbalance in current accounts between the United States and the rest of the world. The relationship between wealth and income inequality and the financial crisis is crucial, yet systematically absent in most discussions on the crisis. We argued that inequality led to overconsumption and the debt bubble for the majority, and over-savings and asset bubble for the minority in the United States. We also contend that wealth and income inequality plays a role in affecting current account imbalances by showing how it caused savings glut in China, while it, together with the growth of financial instruments and debt, caused a consumption glut in the U.S.

Chapter 5 discusses the impact of the crisis on Asian economies, its relation to the earlier Asian financial crisis, and the three major challenges facing Asia arising out of this crisis. They are the limits of the export-led growth model that has served Asia quite well, the issue of free capital flows and its destabilizing effects on the economies, and what, if any, alternatives Asia has to holding the U.S. dollar as the predominant international currency.

The final chapter closes by locating the crisis in a macro-historical perspective in terms of contestations in three realms. The crisis can be seen as a contest for continued hegemony by the United States in the international economic and financial system; a contest for continued dominance by the financial sector over the real economy; and finally, a contest of ideas between market fundamentalists and neo-liberals on the one hand and those who recognize the role of the state in human development on the other hand.

The crisis is an episode in these contestations. We have not seen the end of history, both in politics and in economics, as was proudly and prematurely asserted by neo-conservatives, such as Fukuyama, who touted the end of history after the fall of the Berlin Wall, and by mainstream economists, such as Bernanke, who spoke of the Great Moderation and the passing of business cycles. On the contrary, the future is uncertain.

To write a book, one has to stand on the shoulders of many. We owe much to friends and colleagues who have contributed in many ways to the formation of this book. In particular, we like to mention Dr Khor Hoe Ee, a long-time friend and former Assistant Managing Director of Economics at the Monetary Authority of Singapore. Dr Khor personally encouraged me to write my first paper on the financial crisis that was presented at the Federation of ASEAN Economists in Bangkok, December 2007. Subsequently we have had many discussions with him as the crisis unfolded and he also commented on parts of the manuscript. Others whose discussions we have benefitted from are Michael Anderson, James Miraflor, and Edsel Baja Jr. Thanks also go to Douglas Porpora, Chan Huan Chiang, Yilmaz Akyuz and Subramaniam Pillay who read and commented on sections of the draft manuscript. I was privileged to be able to tap on the knowledge of my former colleagues in banking and finance, particularly the helpful discussions with Charlie Chan, Victor Wee, Tan Kok Wee, Melissa Lee, Ananth Sankaran, and Siantoro Goeyardi on the complexities of financial products. This work would not be possible without the abled research assistance we received from the following persons — Liew Han Hsien, Chen Qun, Xylee Javier, and most of all, Stephen Santos who selflessly sacrificed much of his free time to assist us gather vital financial data. The authors also thank the external reviewers for their incisive comments, Triena Ong and Sheryl Sin for their editorial support and Fadzli Amir for the cover illustration. Finally, special thanks to Dr Venugopal Reddy, the former Governor of the Reserve Bank of India, who graciously agreed to write the Foreword and to share his insights on the issue. Last but not least, I am grateful to the Institute of Southeast Asian Studies for offering me a visiting fellowship to complete the manuscript.

The authors apologize to those who have contributed but whose names have been inadvertently missed. Needless to say, all shortcomings are the responsibility of the authors.

Michael Lim Mah-Hui
Penang
December 2009

Notes

1. Thirteen years earlier, in October 1998, one year after the Asian financial crisis started, Krugman wrote, "Suppose that you were to buy a copy of the best-selling textbook on international economics. What would it tell you about how to cope with such a sudden loss of confidence by international investors? Well, not much." He then added: "Trust me — I'm the coauthor of that textbook" (cited in Whalen 1999, footnote 13).
2. This is the argument made by Greenspan in his lecture at Georgetown University in October 2008 where he emphasized the lack of integrity of bankers as a major cause of the crisis. He said, those peddling derivatives were not as reliable as "the pharmacist who fills the prescription ordered by our physicians", and that in a market based on trust, he was "distressed how far we have let concerns for reputation slip in recent years" (cited in Goodman 2008).
3. Chapters 2, 3 and 4 are expansion of an earlier version of an article published as a working paper of the Levy Economics Institute. See Lim 2008.