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Excerpt
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Introduction

The story of the boom and crash of 1929 is worth telling for its own sake. Great drama joined in those months with a luminous insanity. But there is the more sombre purpose. As protection against financial illusion or insanity, memory is far better than law. When memory of the 1929 disaster failed, law and regulation no longer sufficed. For protecting people from the cupidity of others and their own, history is highly utilitarian.

~ *John Kenneth Galbraith,* The Great Crash 1929, *Preface to the 1975 Edition*

In December 2008 I received a text message on my phone which must have been passed through a million hands:

> 1 year ago RBS paid $100 bn for ABN AMRO. Today that same amount would buy: Citibank $22.5 bn, Morgan Stanley $10.5 bn, Goldman Sachs $21 bn, Merrill Lynch $12.3 bn, Deutsche Bank $13 bn, Barclays $12.7 bn, and still have $8 bn change … with which you would be able to pick up GM, Ford, Chrysler and the Honda F1 Team.

If I had told anyone even six months ago that the current crisis would have resulted in governments owning one quarter of the capital of the Western banking system, most people would have thought me mad.

When friends asked me Why another book on the Asian and global financial crises? I gave four reasons. First, I was a ringside audience to the Asian crisis, as Deputy Chief Executive of the Hong Kong Monetary Authority (HKMA) in charge of external affairs and reserves management from 1993 to 1998. I was present during some of the key discussions over policy and the international architecture. Most of the key actors were personal friends or colleagues, central bankers and policymakers whom I had grown up with through my early days as Chief Economist and Assistant Governor (Bank and Insurance Regulation) of Bank Negara Malaysia. Principal actors, such as Larry Summers, Stan Fischer and Joe Stiglitz, I had worked with when

I was seconded to the World Bank between 1989 and 1993. Others, such as Tim Geithner, former President of the New York Federal Reserve and Treasury Secretary under the Obama Administration, Eisuke Sakakibara (Mr Yen) and Masahiro Kawai, I got to know during the crisis, as we shared both the agony and the drama that deserve to be told, even though the story had been told many times.

It is useful to remember that after the Asian crisis and the dot-com bubble of 2000 the world underwent the most thorough overhaul of accounting, corporate governance, regulation and national financial architecture since the 1930s. As former Chairman of the Hong Kong Securities and Futures Commission, I participated actively in the design of that architecture, being one of the few Asian representatives with an emerging market background. I co-chaired with Bank of England Governor (then Deputy Governor) Mervyn King the Working Group on Transparency and Accountability, which was established by the Group of Twenty-Two in 1998. I also chaired the Financial Stability Forum's Task Force on Implementation of Standards in 1999. As Chairman of the Technical Committee of the International Organization of Securities Commission (IOSCO), the international standard setter on securities regulation, from 2003 to 2005, I worked with luminaries such as former SEC Chairman Arthur Levitt, Arthur Docters Van Leeuwen, former Chairman of the Netherlands Authority for Financial Markets and the Committee of European Securities Regulators, Sir Andrew Crockett, former General Manager of the Bank for International Settlements and Chair of the Financial Stability Forum, Sir Howard Davies, former Chairman of the U.K. Financial Services Authority, Michel Prada, former Chair of the French securities regulator and both the Technical Committee and Executive Committee of IOSCO, and many others to push forward reforms in accounting and securities regulatory standards. None of these was enough to stem the present crisis. Some of them may have contributed to the crisis. *Mea culpa*.

A PERSONAL ASIAN VIEW

Second, there are very few books on the Asian crisis by senior Asian officials who were in place during the crisis. Perhaps we had neither the time nor the inclination to write about our perspectives and experiences. Since we had no good theories to explain the Asian Miracle, we had even less incentive to explain the Asian bust. But for posterity's sake, the Asian side of the story deserves to be told.

At the outset I need to stress that even though this is one Asian's view of financial crises, I am not a proponent of Asian values, because I sincerely believe that the accepted values of hard work, thrift, loyalty and social conscience are universal and not unique to Asia. During the crisis, a number of Western analysts, including Francis Fukuyama explored whether Asian values were associated with authoritarian, corrupt, crony capitalism.[1] Alas, not only have we not reached the end of history, but also financial crises are common to both authoritarian and democratic societies, and both suffer from crony capitalism of different forms.

Hubris always ends up as humbug. Nothing proves the universality of this truth better than the fact that everything that is being done to deal with the current crisis is exactly what the Washington Consensus told us that we should not do during the Asian crisis. The list includes intervention in markets, blanket deposit guarantees, lower interest rates, loosened fiscal discipline, letting banks fail to stop moral hazard, stopping short selling and blaming market manipulation.

Saying 'I told you so' gets us nowhere because I would be the first one to say that if Asia does not get its act together in certain areas, it may suffer the next crisis in the next decade or so. What we need to realize is that we are all fallible, vulnerable and in the same boat.

The global nature of the present U.S. crisis can be seen in the following context. At the end of 2007, the United States had gross domestic product (GDP) of US$13.8 trillion, compared with Japan (US$4.4 trillion) and China (US$3.2 trillion). The United States had gross and net international liabilities of US$16.3 trillion and US$2.5 trillion,[2] respectively (data at end of 2006). On the other hand, Japan and China together held half of the total U.S. government treasury securities at the end of July 2007.[3] At the end of June 2007, foreigners owned 56.9 percent of marketable U.S. Treasury securities, 24 percent of corporate and other debt, 21.4 percent of U.S. government agency paper and 11.3 percent of total U.S. stock market capitalization.[4]

In other words, whatever pain the United States feels, the rest of the world will also share. No one is gloating.

Personally, this book is my attempt at unravelling the *Rashomon* of financial crises. When I first saw Japanese director Akira Kurosawa's film as a

1 See Fukuyama (1998).
2 Data from www.bea.gov.
3 Data from www.ustreas.gov/tic/mfh.txt.
4 Data from www.ustreas.gov/tic/shl2007r.pdf.

student in the 1960s, I realized that there are many sides to truth. The story is about a nobleman and his wife who are attacked by a brigand in an isolated wood. Each version of the story as it unfolds during the trial (including the victim's story as told by a medium) demonstrates that truth is in the eyes of the beholder. I shall try to tell in each chapter the drama from both the perspectives of the crisis economies and the major players, quoting where possible from different personal, official and public sources.

THE SECOND COMING

The third reason is simply the eruption of the current financial crisis. In the summer of 2007, even as I was putting finishing touches to the book, I was reminded eerily of the summer of 1996. Things looked too good to be true. Stock markets and property prices were at record levels. The world was flush with liquidity and risk premiums had declined to record lows. There was just too much hubris in the air. I was reminded of W. B. Yeats' poem 'The Second Coming':

> Things fall apart; the centre cannot hold;
> Mere anarchy is loosed upon the world,
> The blood-dimmed tide is loosed, and everywhere
> The ceremony of innocence is drowned;
> The best lack all convictions, while the worst
> Are full of passionate intensity.

In 1996 the Asian crisis crept up on East Asia, flush with more than a decade of prosperous high growth and low inflation. Almost everyone saw large capital inflows and low-risk premiums as votes of confidence, rather than harbingers of disaster. In July 1997 the Thais floated the baht, and by October Malaysia, Indonesia and Hong Kong were already in crises. In December South Korea, a member of the Organisation for Economic Co-operation and Development (OECD), had to call in the International Monetary Fund (IMF). The miracle economies of East Asia were pummelled with escalating bad news one after another, until in August 1998 Hong Kong intervened in the stock market, Malaysia introduced exchange controls and Russia defaulted on its debt obligations. The failure of long-term capital management (LTCM) and the subsequent lowering of interest rates by the U.S. Federal Reserve (the Fed) in September was the signal that the centre now took the crisis seriously as one of global proportions.

The Asian economies recovered because the centre and main engine of global growth, the U.S. economy, was fundamentally strong in 1998. Ten years later the tables have been turned. Asia, including the Middle East oil producers, as a whole has become a major creditor to the U.S. economy. In contrast, the U.S. economy is running large twin deficits as current account deficits surpassed 5 percent of GDP since 2004, whilst the fiscal deficit had grown in the face of the costs of the Iraq war and growing demands for tax cuts and social services. From 2005 onwards the U.S. dollar began its depreciation of more than 20 percent in real effective exchange rate terms. Initially there was no apparent impact on the rest of the world, but as gold, commodity, food and energy prices began to rise for a variety of reasons, the world moved from the decade of Great Moderation to a period of grave uncertainty.

Like its Asian predecessor, the subprime crisis crept into global awareness almost by stealth. Even though two Bear Stearns hedge funds investing in subprime mortgages had failed in February 2007, there was no awareness of the ferocity and speed of the deterioration. By summer 2007 the subprime crisis that began with the decline in housing prices in the United States had started to unwind. In August the European Central Bank and the Fed injected over US$300 billion into their interbank markets to ease liquidity. The Bank of England, concerned with the risks of moral hazard, was initially more reluctant to follow suit. But by September it had to intervene in the run against Northern Rock, the first bank run in the United Kingdom for 189 years, stopped by a blanket guarantee of all deposits. The Fed responded to the subprime crisis by lowering interest rates.

Just like the second half of 1997, the summer of 2008 erupted like a volcano, with events every month escalating in size and intensity. In March the fifth largest U.S. investment bank, Bear Stearns, was taken over by JP Morgan with US$29 billion worth of Fed support. By July the U.S. Treasury had to mount a rescue for Fannie Mae and Freddie Mac, the government-sponsored mortgage corporations, which together held or guaranteed more than US$5 trillion worth of mortgages. In the first week of July, the price of oil rocketed to a peak of US$147 per barrel, sparking fears of global inflation in the midst of possible financial collapse. By 7 September the Treasury had to put both Fannie Mae and Freddie Mac into conservatorship, de facto nationalizing them. In the following two weeks, the world as we knew it changed.

As pressure mounted on the four remaining U.S. investment banks, Merrill Lynch found refuge after agreeing to be taken over by Bank of America over the weekend of 14 September. The next day Lehman Brothers failed with over US$613 billion in debt. The same day the largest insurance company in the world, AIG, received a US$85 billion loan support from the Fed in exchange for a 79.9 percent equity stake. It had provided US$446 billion of credit default swaps and had become too big to fail. On 17 September the money market funds were facing large institutional withdrawals, forcing the U.S. Treasury to announce a US$50 billion guarantee for them. If these funds failed, more than US$3.4 trillion of funds were at stake.

It was by now clear that piecemeal solutions would not solve the crisis in confidence. On the weekend of 20 September, U.S. Treasury Secretary Paulson announced a US$700 billion rescue package to buy toxic mortgage assets and unclog the system. On 23 September the Fed allowed Goldman Sachs and Morgan Stanley, the last two remaining investment banks, to become bank holding companies.

On Wednesday, 24 September, President Bush admitted that the United States was in the midst of a crisis, as he tried to get Congress and Senate to pass his rescue proposal. To the shock of the markets, the U.S. Congress voted down the rescue package, reflecting huge anger of Main Street towards Wall Street.

By the end of 2008 it was clear that the meltdown in global financial markets had severely shocked the real economy. The United States was officially declared to have been in recession at the end of December 2007, whilst the rest of the world prepared for the worst. Everyone expected that 2009 and beyond could be the toughest economic conditions since the Great Depression.

What went wrong? Were the lessons of the Asian crisis and the subsequent reforms insufficient? Despite huge advances in theory and understanding of institutions and markets, have we missed something?

A FRAMEWORK FOR ANALYSIS

The fourth justification for this book therefore is a framework for thinking about the role of financial regulation in financial stability and crises.

No financial crisis is exactly alike, but there are common elements that would, I hope, help us identify and mitigate the next one. All crises start with excess liquidity, followed by speculative manias, culminating in a bubble and subsequent crash. History is replete with such bubbles and crashes, but the intellectual debate about their causes and their resolutions continue. If the 1994 Mexican crisis was 'the first financial crisis of the 21st century' as famously dubbed by Michel Camdessus, then Managing Director of the IMF,[5] the 1997–1998 Asian crisis was the harbinger of the present crisis.

[5] Camdessus (1995).

The problem of describing the Asian and current crises is that they cannot be seen as static country-by-country analyses, but rather as dynamic, complex interactions between a group of Asian countries, Japan included, and their relationship with the United States, their largest customer and trading partner. The Asian crisis was a structural crisis of the Asian global supply chain, which had not one currency standard, but two, the U.S. dollar and the Japanese yen, emerging into a globalized world of growing imbalances, awash with huge capital flows. The volatility erupted into crisis. No one anticipated how quickly contagion could spread.

Ten years later, after a period of great global prosperity with low inflation, the developed world also slipped into crisis. Again, the usual suspects were questioned – large capital flows, misaligned exchange rates, excess liquidity and leverage, greedy bankers, hedge funds and inadequate supervision. Influential *Financial Times* columnist Martin Wolf coined the phrase 'unfettered finance' in a prescient piece in May 2007 on how capitalism has mutated: 'While the new world of unfettered finance has many friends and foes, all are concerned about the possibility of serious instability'.[6]

But for all its tragedy, the Asian crisis was a crisis at the periphery, when the centre was strong. Today we are witnessing a financial crisis at the centre, and its shocks are spreading worldwide like a tsunami, in both financial and real economy terms.

Consequently the signal difference between the Asian crisis and the current crisis is not just one of size, but in essence, complexity. Because of complexity, we must try to reduce the multidimensional origins and causes into simpler understandable components. Using an institutional and evolutionary perspective,[7] we approach both financial crises at three levels: the lens of history, the macro-view and the micro-issues.

Jerry Corrigan, former President of the New York Fed and arguably one of the most perceptive, brilliant and incisive thinkers and practitioners in global financial markets today, taught me that you need to look at a problem from 30,000 feet up, zoom down to ground level and then slowly rise to 300 or 3,000 feet until you get a much clearer perspective of the issues and the problem.

When you are at 30,000 feet up, you have an overview of the context and the relativity of issues. At 3,000 feet, there is a clearer macro-perspective of the scale of the problem, but the devil is in the details that you might be able

[6] Wolf (2007a), 15.
[7] For an overview of Complexity Economics, see Beinhocker (2007).

to examine only at ground level. Hence one must also have a grasp of the complex issues at the micro-institutional level of what led to the crisis.

This book starts from the premise that markets are an essential part of social institutions that have a symbiotic relationship with governments. We will examine the complex institutional interaction between markets and governments to consider how financial crises emerge.

To encompass such complexity, we must be eclectic in approach, but there is an underlying theme woven into the fabric of our approach. Markets are what sociologist Manuel Castells called part of the Network Society.[8] They function to trade and exchange ideas, goods and services. Successful markets all share three key attributes: the protection of property rights, the lowering of transaction costs and the high transparency. Financial markets are interlocking networks that exchange money, equity, bonds and derivatives.

But the more networks evolve, the more complex they become, so that shocks or failure in one hub can easily be transmitted to other parts of the network through contagion. The cascading waves of institutional failure can be seen as network failure, whereby hubs (read: investment banks) have to shut down if only to isolate the damage to the rest of the network. Contagion is like viral transmission of disease. You have to quarantine the infected quickly, so that the rest of the network remains healthy. In that sense crises are only one stage of evolution of markets.

There is, however, another level of history that is more powerful than the history of events – the history of economic thought. Since the fall of the Berlin Wall in 1989, the power of free market fundamentalism has been on the ascendant. Ironically, free market fundamentalists viewed the Asian financial crisis as proof that government fettering financial markets was futile, because Asian governments were impotent before the forces of global markets.

The free market philosophy powerfully encouraged financial innovation, particularly in derivatives that created new profits and reputedly improved risk management. There is no doubt that the flowering of derivative markets in the 21st century was a marvel to wonder at. From 2001 to 2007 global GDP increased by 75.8 percent from US$31 trillion to US$54.5 trillion.[9] Over the same period, global bonds, equities and bank assets grew by 53.1 percent from US$150 trillion to US$229.7 trillion. In contrast, the notional amount of outstanding contracts of global over-the-counter (OTC) derivatives market rose 536.5 percent from US$111.1 trillion to US$596 trillion.

[8] Castells (2000).
[9] IMF, *Global Financial Stability Report* (2003, 2008).

In other words, the derivative book rose 10.1 times faster than traditional financial assets and 7.1 times faster than real economy activity.

Unfortunately, as the current financial crisis showed, unfettered finance also leads to instability and destruction, not all of it creative. U.S. Treasury Secretary Hank Paulson summed it up best in September 2008 in explaining the bailout: 'raw capitalism is a dead end'.[10]

At the other end of the spectrum, state intervention in markets is seen as necessary to deal with distributional justice and the protection of property rights. This was fundamentally the Asian view of development. The tragedy is that, taken to its authoritarian extreme, overregulation and state intervention has also been disastrous.

The complex reality, as Asian philosophy has argued, is a golden mean, somewhere in the fuzzy wuzzy middle, a dynamic and complex interaction and interdependence between creative disorder in the market and the rigid order of bureaucracy, and between individual freedom and social responsibility. A reality is that whilst national governments may have in the past been successful in managing development within national borders, it does not mean that they can be successful in managing shocks emanating from the borderless world of unfettered finance.

Unfettered globalization has also been accused of creating social inequality and wanton destruction of the environment for short-term gains. As Dani Rodrik and other development economists have noted, we should not get into the facile debate between market fundamentalism's 'just let the market work' and institutional fundamentalism's 'just get governance right'.[11] The view of 'letting the market work' is mostly right, but not always. On the other hand, the institutional view of 'getting governance right' is necessary but not sufficient, because many times crises have been the result of bad policies and weak governance. Nobel Laureate Michael Spence,[12] in the recently published Growth Commission Report, rightly emphasized that no generic formula exists for successful economic development or governance.

Herein lies the flaw of globalization. We have today a global financial system with almost unrestricted capital flows, but macroeconomic policies and regulation are conducted within national borders. We often ignore the externalities of our national policies on the rest of world. National crisis is about the failure of domestic markets, policies or institutions, but global

[10] Quoted in Gunther and Easton (2008), 53.
[11] Rodrik (2008).
[12] Spence (2008).

crisis is about the breakdown transmitted through the interdependence of economies in a networked world. National policymakers and regulators have grossly underestimated not only the size and nature of global flows and our interdependency, but also our ability to coordinate and execute appropriate responses.

In other words, we have been blind to emerging crises because we have too many mental, legal and bureaucratic silos operating in social disciplines and policymaking and execution, each with their blind spots. If it is bad at the national level, it is disastrous at the global level.

A POTTED HISTORY OF ASIAN AND GLOBAL FINANCIAL CRISES

London Business School Professor John Kay insightfully observed that markets are social institutions that are self-organized and path dependent. No one designed the market economy, but one of the principal participants is the government, as owner, regulator and protector (in some cases predator) of property rights.[13] This path dependency is why we need to look at history, if only to remind us of our own follies.

History is a river of the timelines of life. There is a cycle of boom and bust, order and disorder, memory and dementia. No crisis is identical to the previous one, but there are general principles that apply, which we forget at our peril.

Crisis is an event, but as Nobel Laureate Douglass North has noted, development is a process.[14] All human activity is an unending process of man's control over his environment and vice versa. Therefore, the ultimate test of economic success is not natural resource endowment or geography, but the quality of governance.

Seen from the longer perspective of macro-history,[15] the Asian crisis was a defining moment in the resurgence of Asia after nearly two centuries of decline. At its height in 1820, Asia accounted for 57 percent of global GDP in purchasing power terms, but its outmoded feudal system could not compete with the march of Western markets and technology. By 1950 Asia's share of global GDP had fallen to 18 percent. Applying this path-dependent analysis of economic change, the Asian story from Miracle to Crisis can be encapsulated into how Japan led the way in mental and institutional

13 Kay (2004).
14 North (2005b).
15 Huang (1998) first used this term.