Chapter 1

Introduction

The United States of America has been hit by the collapses or near-collapses of Bear Stearns, Indy Mac, Lehman Brothers, Washington Mutual, Wachovia, Fannie Mae, Freddie Mac, the American Insurance Group and the Citigroup. To quote the US Secretary of Treasury of the Bush Administration, Henry M. Paulson, Jr., "Each of these failures would be tremendously consequential in its own right."[1]

To give us a sense of the magnitude and the gravity of the current bailout, here are some figures associated with the current financial situation. If we add up the sum of the funds committed so far by the US government, the figure is certainly mind-boggling. According to Jim Bianco of Bianco Research, it is bigger than the combined costs of the Marshall Plan, the Louisiana Purchase, the New Deal, the Korean War, the Vietnam War, NASA, the Moon Landing Program, Savings & Loans debacle and the invasion of Iraq. All these big-ticket items total $3.92 trillion, adjusted for inflation. With the Citigroup bailout added in, the current total cost exceeds $4.62 trillion. It is arguably the biggest injection of funds in American history. The only single event in US history of this magnitude is World War II. The original cost of World War II was $288 billion or $3.6 trillion when adjusted for inflation, which is still less than the $4.6 trillion we are talking about.[a,2]

The crisis has engulfed the world as the global economy slipped into recession. The economic data so far suggests that the recession will be deep and painful. There is general consensus that the world is facing the worst economic meltdown since the Great Depression. However, the world can avoid descending into depression if governments adopt the right measures.

No Two Financial Crises are the Same

In a strange way, financial crises bear certain similarities with earthquakes.[3] Long periods of calm are interrupted by short periods of violent tremors. During the calm period, pressure is slowly building up. A point is reached when disaster strikes. The tremors release the stress built up and after a while, calm returns. This cycle then repeats.

To understand how and why the credit system promotes economic growth, with its inevitability of boom and bust, let us begin with the calm period. The volatility is low, the system is stable and the profit outlook is good. Under the pressure to reward investors with more profits, corporations take on more risk. They assume more debts in order to increase their productive capacity. Banks are just too keen to lend. When times are good, they lower their guard. As stock prices climb, investors, having exhausted their funds, start to borrow to buy more stocks. Both corporations and investors take on more leveraging. The profits are so seductive when the going is good. The practice can become a habit for some time. This is a time of irrational exuberance when the bubble is building up.

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[a] Unless otherwise stated, the $ sign in the book refers to US$

A point will come when the bubble bursts. Assets must be liquidated quickly to pay back the loan; money must be found to unwind the leveraging. In panic, investors rush for the door. Before long, we have a fire sale going on. Banks which cannot get their money back just go bankrupt. With the bleak business outlook, banks are very reluctant to lend to even viable businesses. We have a credit crunch, which aggravates the situation. To make the best out of the situation, management retrenches staff, persuades the rest to work harder without overtime pay, squeezes the suppliers and offers discounts to the buyers. If all these fail, the company goes bankrupt. Gloom overtakes euphoria and the economy slips into recession. The financial system reveals its fragility in its "full glory". Millions of innocent bystanders become the victims of greedy speculators. Their suffering provides rich material for social critics to hammer at the ills of capitalism. A global financial crisis suggests the possibility of some fundamental weakness of the international financial system, and sparks calls for redesigning the international financial architecture. But when the hurricane blows over, it carries away with it the honest anxiety. It is business again as usual, until the next turmoil. Are we going to see a replay of the story?

Financial crises share common features, yet their details differ. The Asian financial crisis took the form of currency crisis, degenerated into economic crisis and, in the case of Indonesia, ended up as political crisis. The dot-com bubble affected mainly the technological sector, and did not cause a panic in the banking and financial firms. The current turmoil is often described in the following terms: *credit crunch*, *banking crisis*, and *the worst since the Great Depression*. Expectedly, the financial industry is the worst affected, with bankruptcy, absorption, and the rest suffering sharp drops in stock prices.

What is this book about?

Banking and financial firms (BFFs) have a few crucial roles to play in economic activities, namely, as payment systems, in efficient allocation of financial resources, and in hedging risks associated with uncertainties.

Over the past several decades, the BFFs have undergone crucial changes as a result of the broader business and political environment. The global economy is more integrated and there is deregulation across a range of business activities. The application of advanced IT has enabled BFFs to take advantage of this environment to weave a tightly integrated network of financial systems.

Operating under a competitive free market environment, BFFs are under immense pressure to earn more profits. They resort to more and more financial instruments like derivatives and develop an appetite for risk taking, often with money entrusted to them for safe custody by their clients. Bankers are generously rewarded for the profits they make, while there is lax control of the risks undertaken by them. This encourages the well known behaviour of moral hazard. Under the watch of Alan Greenspan, the bankers had never had it so good. The financial service industry accounted for a large share of American total corporate profits. The share rose from 10% in the early 1980s to 40% at its peak in 2007, the profits in the past decades are in the order of trillions.[4]

The current round of financial crisis is extremely serious as a result of a convergence of a number of factors: huge current account deficits of the US, deregulation, loose monetary policy, and excessive liquidity, shoddy underwriting, abuse of derivatives, negligence of credit-rating agencies and lax government oversight. The subprime problem is but one of the many problems. Other problems are credit-card debt, student-loan debt, auto loans, commercial real estate loans, home-equity loans, corporate debt and loans that financed leveraged buyouts. The magnitude of the crisis inspires the economist Nouriel Roubini to observe: “We have a subprime financial system, not a subprime mortgage market.” The scenario of the financial system falling like dominoes certainly gains currency as the crisis broadens and deepens.

The current crisis provides a valuable occasion for the world to re-examine the nature of the financial market. This book sets out to take a hard look at deregulation, derivatives, leveraging, remuneration systems, and rating agencies.

Our point of departure is that as custodians of depositors’ or clients’ money, BFFs should exercise due prudence in using that money to make more money. It does not mean that BFFs should take no risk at all. Commercial banks enjoy deposit guarantees by government and they often also function as important nodes in the payment systems. For these reasons, they should be regulated and not allowed to go into investment banking. Though investment banks have more leeway, it does not mean that they can operate in a totally unregulated manner. At the very least, they should abide by the principle that the risk taker should have the capacity to absorb the full risk without transmitting the risk to others. An analogy may be used: Formula One drivers are allowed to display their skills on special race circuits, but not on roads used by normal traffic.

While derivatives are useful financial instruments for those directly involved in the business, abuse of these has a toxic effect. This is especially so when BFFs assume risks that are beyond their capacity to bear. When they go bust, those who buy their products are left to suffer. It is not too far-fetched to compare derivatives to certain medical drugs. Used appropriately for patients who need them, the benefits are obvious. Abuse of them is harmful and can even be deadly.

BFFS should heed the warning of Peter Drucker that they should stop taking risky positions using their clients' money as a way of making profit. Rather they should innovate and find ways to add value to the clients. It may be added that BFFs must not harm the interests of society. In their earlier days, BFFs were very innovative and played a crucial role in promoting economic growth. They invented the letter of credit, check, insurance, stock exchange, credit card, etc. In the electronic business environment, they have the work cut out for them. The sad thing to note is that most of the financial innovations of electronic business are the works of non-BFFs.

Returning to the current financial crisis, there are clear signs that it is hitting the real economy, with recession a distinct reality rather than possibility. If managed well, the world may avoid a depression. The costs to tax payers are obviously immense, amounting to trillions. And like in the past financial crises, the worst hit are those workers who lose their jobs to pay for the sins of the "best and brightest bankers". Other countries also have to pay a heavy price. At the same time, the recent crisis has dealt a massive blow to the position of New York City as the premier world financial centre.

The bright side of the picture is that the world has gathered much experience in managing financial crises. Most important of all, the underlying real economy is not damaged in the way that it has been affected in history — by wars, political chaos, famine and other natural catastrophes.

Moreover, relatively speaking, the emerging economies especially China are not so severely affected by what is happening in the US. This book will look at why Asian economies have been less affected by the global financial crisis thus far and some like Japan have even managed to go on a buying spree of American financial institutions. Is corporate governance the main reason here? Or culture, management styles or even a state-led model? Did the Asian sovereign wealth funds help to be the last line of defence against the excesses of the crisis? All these commonly-cited features of the so-called Asian state-led model of development will be examined in this book. In this trend of thought, debates surrounding the hybrid Chinese model of capitalistic free marketplace and authoritarian political system will also be examined.

The crisis has also prompted some to turn to regulation as a panacea. Is Asian-style state-led models with its characteristic governmental intervention and host of regulation the defence mechanism that protected Asian economies from the crisis?

In the discussion of proposed solutions to the financial crisis, it is often pointed out that unilateralism is to be condemned, especially in the European case where non-coordination is often cited in comparison with the US's prompt and coordinated response in coming up with the $700 billion bailout package. In the spirit of coordination versus unilateralism, this book will examine

Asia's response. Is Asia yet another example of unilateral action towards the crisis or is the $80 billion Asian crisis fund the first instance of a coordinated East Asian response to the crisis. Would this truly underpin the creation of an East Asian regional order that would eventually lead to instruments like the Asian Monetary Fund or currency swaps leading to a full-blown convertible regional currency? Is the Asian way of quiet diplomacy also applicable to their management of the global financial crisis? Is the preferred channel of bilateralism an alternative or hindrance to the East Asian response? Can Northeast Asian powers truly reconcile with each other to create a regional order that would eventually have an impact on the global financial system?

Ultimately, is the much vaunted decoupling of Asian economies from the US proven by the financial crisis or to the contrary? Can East Asia create an insulated regional order or will this crisis prompt greater intra-regional coordination and a collective response in dealing with extra-regional state and non-state actors in the global economic and financial systems?

The crisis has revealed certain fundamental issues of the information economy. Financial services have been rightly seen as a good example of information economy. This book re-affirms the need for value adding, due regard for societal interest and that there is no free lunch.

Finally, to give our readers a flavour of views from the business world, we reproduce excerpts of a speech in the Appendix containing the reflections of Mr. Ho Kwon Ping, a trained economist who was once a journalist and who is a successful entrepreneur now.