

**NOWHERE TO HIDE:**

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***THE GREAT FINANCIAL CRISIS:  
CAUSES & CHALLENGES AHEAD***

**Dr. Michael Lim Mah-Hui**

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# OUTLINE

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- I – Crisis and Crises
- II – Origins of this Financial Crisis
- III – Challenges Ahead

# Recurrent Financial Crises – Do Bankers Ever Learn?

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- 1970-2007: 124 banking crises, average of 3.4 per year
- Big crisis every ten years
- 1980s – Latin America debt, US S&L
- 1990s – Scandinavian debt
  - Japanese lost decade
  - Mexico crisis
  - Asian Financial Crisis
- 2007 – Great Financial Crisis

# Financial Crises – Unique or Common ?

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- Two views – each crisis is different
- Financial crises - common conditions
  - Excess liquidity – internal (low interest rate); external (capital flows)
  - Loose credit discipline & loan growth
  - Asset bubbles – property & equity
  - Bubbles burst
  - State intervention

# Dejavu – Present Crisis & the Great Depression

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- "...the banker had gone from a person of sober rectitude to a huckster who encouraged people to gamble on risky stocks and bonds....It was also argued that the union of deposits and securities banking created potential conflicts of interest. Banks could take bad loans, repackage them as bonds, and fob them off on investors...

# Chernow continued

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- They could even lend investors the money to buy the bonds. A final problem with the banks' brokerage affiliates was that they forced the Federal Reserve System to stand behind both depositors and speculators." (Chernow, 1990:375) on objective of Glass Steagall Act to restore sobriety to finance

# Causes of Great Financial Crisis

## – Three Inter-related Levels

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- ❑ I – Theoretical-Methodological Flaws
- ❑ II – Industry Practices/Malpractices and Failure of Regulation
- ❑ III – Macroeconomic Imbalances

# Two Fallacies in Economic & Financial Theories

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- ❑ Fallacy of Efficient Market Hypothesis
- ❑ Fallacy of Composition

# Theoretical - Methodological Flaws in Economics and Finance

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- ❑ Efficient Market Hypothesis (EMH) - foundation of micro economics & finance
  - ❑ Assumes rational investors, all information known, orderly markets clear demand and supply at equilibrium prices
  - ❑ Fallacy of composition – study the whole (system) in terms of its parts. But whole is not equal to sum of parts
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# Efficient Market Hypothesis

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- ❑ EMH more applicable for consumer goods than capital-financial markets where higher prices stimulate more, not less, demand and v.v.
  - ❑ Investment decisions are about future expectations – inherently uncertain. Risks not predictable
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# Flawed Assumptions of Financial Risk Management

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- ❑ Fundamental assumption - individual asset price is random and unpredictable; but distribution of price outcomes is predictable and based on normal distribution
  - ❑ Problem - data do not fit theory
  - ❑ Don't find normally-distributed financial markets; find huge discontinuities
  - ❑ Fat-tails distribution
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# Flawed Assumptions

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- ❑ Under normal distribution scenario, this financial crisis and LTCM losses are back-to-back 25 standard deviations events; not supposed to occur
  - ❑ Prices not random like coin-tosses; distribution outcomes influenced by self-reinforcing positive feedback processes and not predictable
  - ❑ If this is correct then, the risk management techniques are fundamentally flawed
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# Impact of EMH on Policymakers and Industry Players

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- ❑ EMH - no room for asset bubbles or busts. This forms the foundation of central banks' unwillingness to intervene in bubbles
- ❑ Blind faith is asymmetrical
- ❑ Leave prices alone when they are going up; intervene when they are going down

# Hubris of Academicians

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- Robert Lucas in address to AEA, 2003- the “central problem of depression-prevention has been solved for all practical purposes.”
  - 2004 - Ben Bernanke in “Great Moderation” speech said modern macro-economic policy had solved the problem of business cycle.
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# Hubris of Financial Players

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- D. Rubenstein of Carlyle Group: “ I don’t think it’s a bubble...what’s happening now is a new investment technique...private equity that adds value”
- J. Anderson of Countrywide” “We have a wealth of information we didn’t have before. We understand the data and can price the risks”
- A. Greenspan on financial innovations: “dispersion of risks to those willing & able to bear...prevents cascading failures

# Admissions of Financiers

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January 23, 2008, George Soros:

- “Fundamentalists believe that markets tend towards equilibrium and the common interest is best served by allowing participants to pursue their self interest. It is an obvious misconception, because it was the intervention of the authorities that prevented financial markets from breaking down, not the markets themselves”
  - March 14, 2008, Josef Ackermann, CEO, Deutsche Bank: “I no longer believe in market’s self-healing power”
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# Animal Spirit and Certitude of Uncertainties

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- “There is nothing so disturbing to one’s well being and judgment as to see a friend get rich.”  
(Kindleberger, 2000:15)
- “I can calculate the motions of the heavenly bodies, but not the madness of people.” Isaac Newton (cited in Kindleberger:31)

# Alternative Paradigm- Keynes & Minsky – Financial Instability Hypothesis (FIH)

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- ❑ Financial system inherently unstable
- ❑ Intrinsic uncertainty of future, rather than predictable risks of EMH
- ❑ Emphasize psychological-behavioral determinants of economic decisions
- ❑ Stability breeds instability. Financial markets swing from overconfidence to despair, fr hedge to Ponzi financing

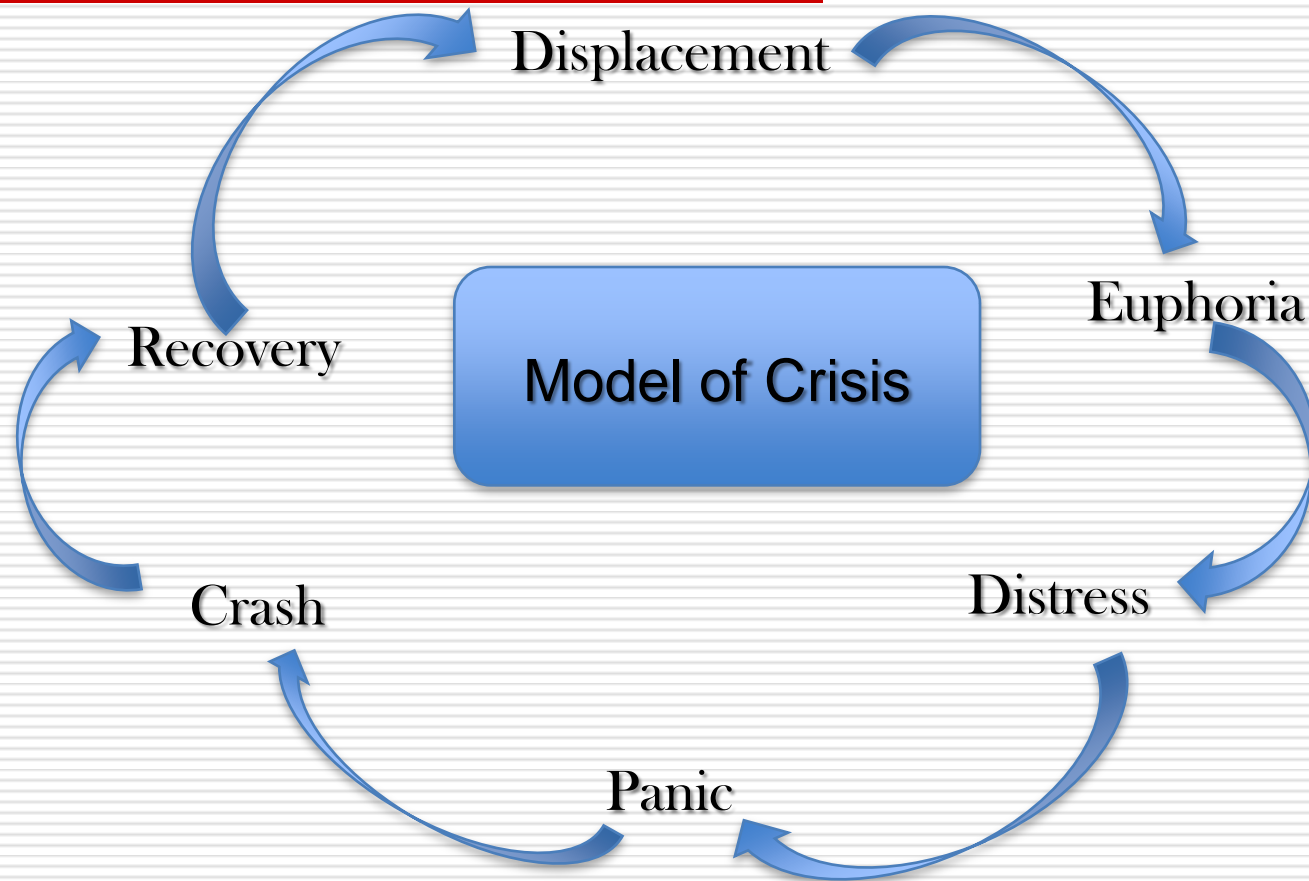
# Financial Instability Hypothesis and Minsky Moment

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- 3 types of financing
  - Hedging – cashflow meets P & I
  - Speculative – cashflow meets I, not P
  - Ponzi – cashflow does not meet even I. P paid fr borrowing & price increase
  - Mixture determines level of instability
  - Minsky Moment when euphoria turns to panic – throw out baby, bath water & bath tub
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# Model of Crisis-Kindleberger

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# Model of Financial Crisis

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- ❑ Displacement – Deregulation, financial innovations, low interest rate
  - ❑ Euphoria – loose credit, rising asset prices, high profits
  - ❑ Distress – defaults by subprime borrowers
  - ❑ Panic – Bankruptcy of Bear Stearn's hedge funds, collapse of CDO prices, freezing of money markets,
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# Model of Financial Crisis

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- ❑ Shut down of interbank and money markets, collapse of Lehman Brothers, and rescue of AIG
- ❑ Recovery - state intervention to save the market – interest rates cut, quantitative easing, recapitalization of banks, guarantee of deposits and new loans, huge fiscal stimulus

# Three Imbalances: Imbalance 1

## –Wall Street dominates Main St

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- ❑ Important structural changes in U.S. economy since 1960s >
- ❑ Dominance of financial sector over the real economy
- ❑ Financial sector and innovations - from servicing real economy, now driving it > greater instability

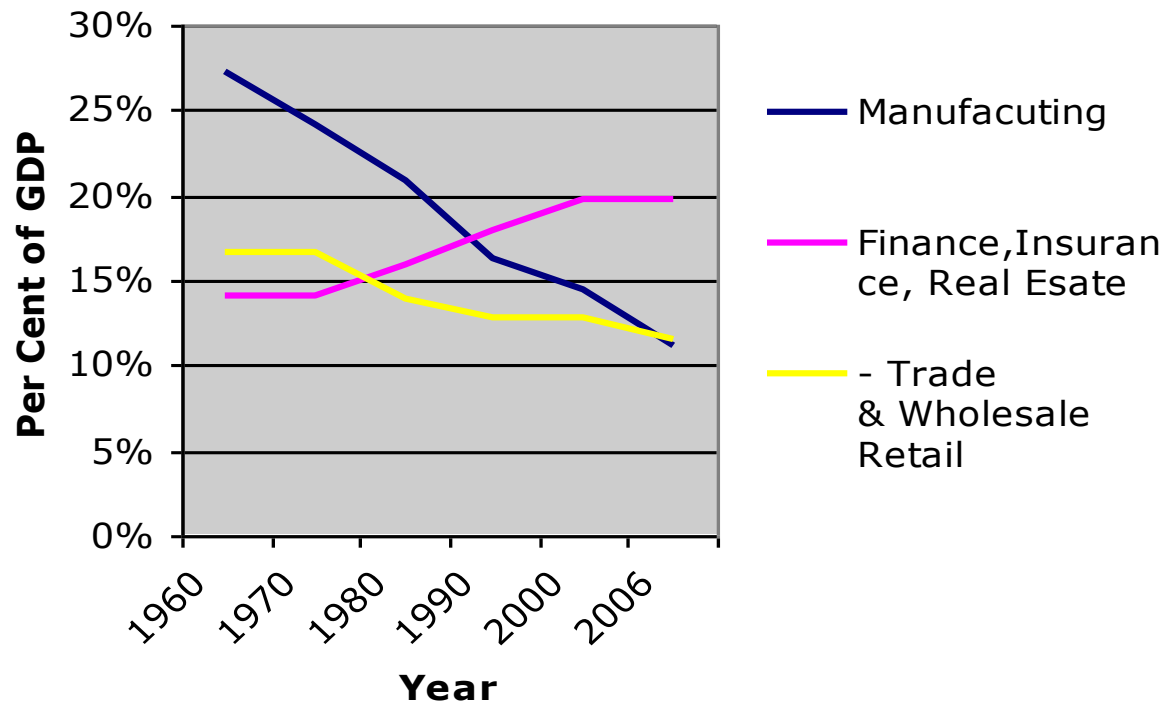
# Changes in GDP by sector

Finance rose to 20% fr 14%

Manufacture fell to 11% from 27%

Finance twice as large as next sector (trade)

**Chart 1 : U.S. GDP by Selected Sectors, 1960-2006**



# Secular decline in avg real GDP growth fr 4.4% to 2.6% (1960-2006)

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1960-69 - 4.4%

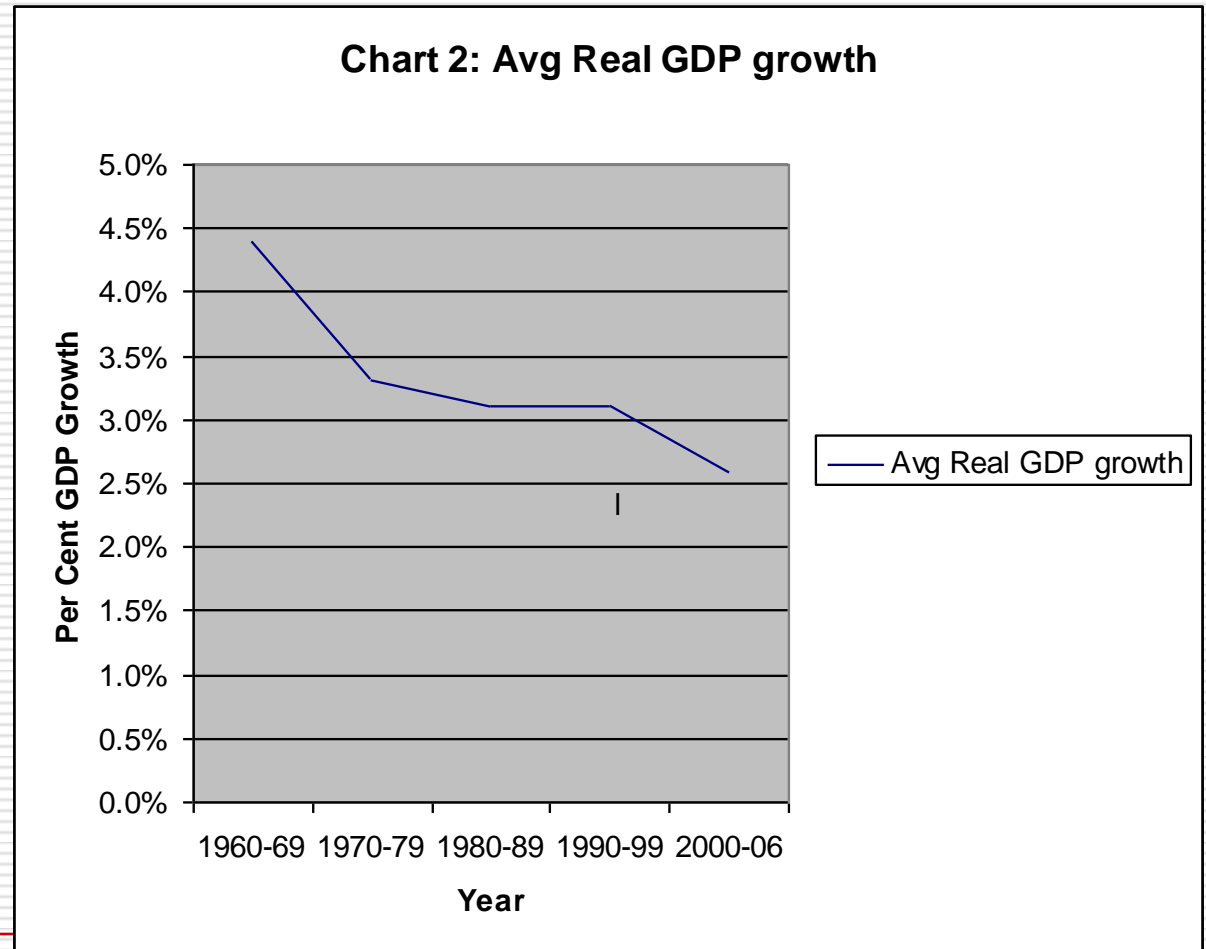
1970-79 - 3.3%

1980-89 - 3.1%

1990-99 - 3.1%

2000-06 - 2.6%

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# Debt-driven Economy, 1960-2007

GDP rose - 27x

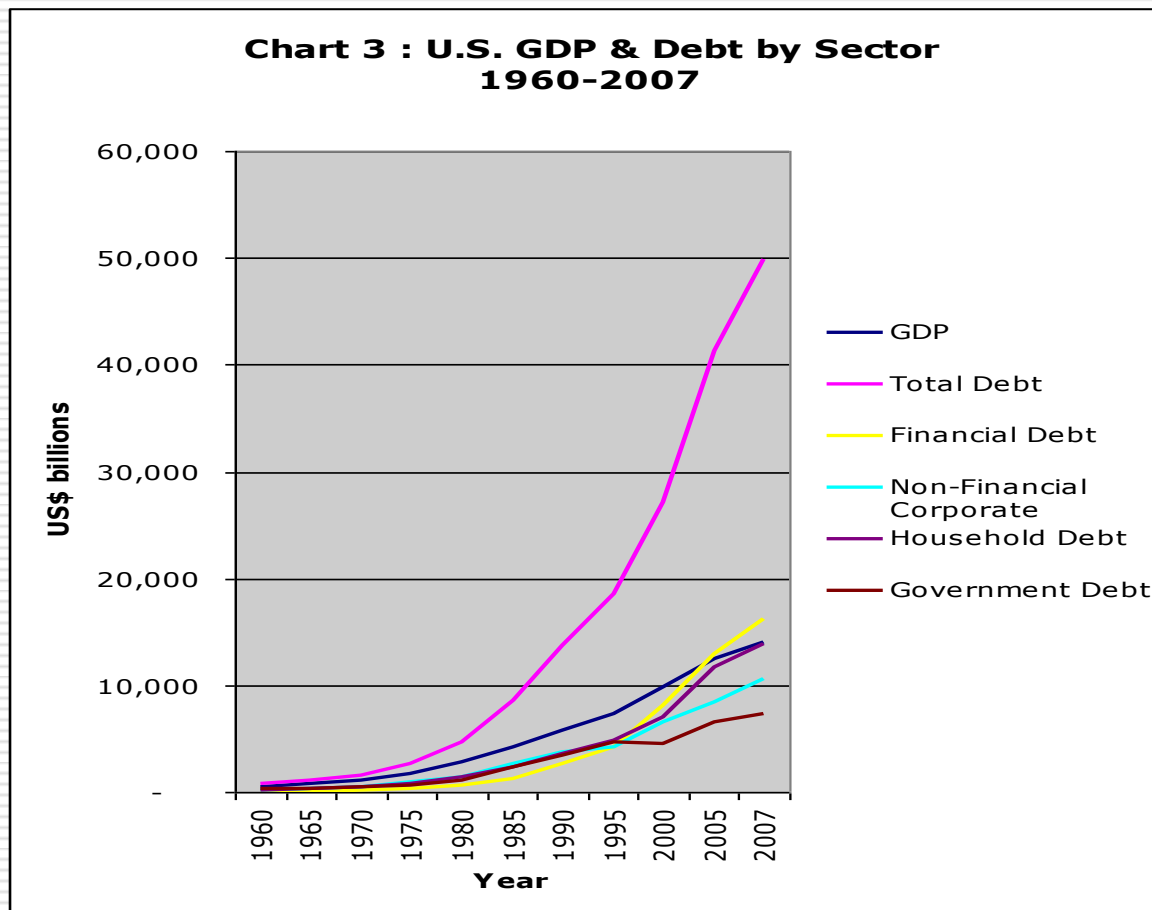
Total Debt - 64x

Financial -490x

Household- 64x

Non Financial Corp – 53x

Govt- 24x



# Use of Debt - for financial engineering rather than investment

➤ Corporate debt rose from 44% GDP to 191%

➤ Gross Corporate Investment stable around 10%

➤ Debt to inflate financial asset prices



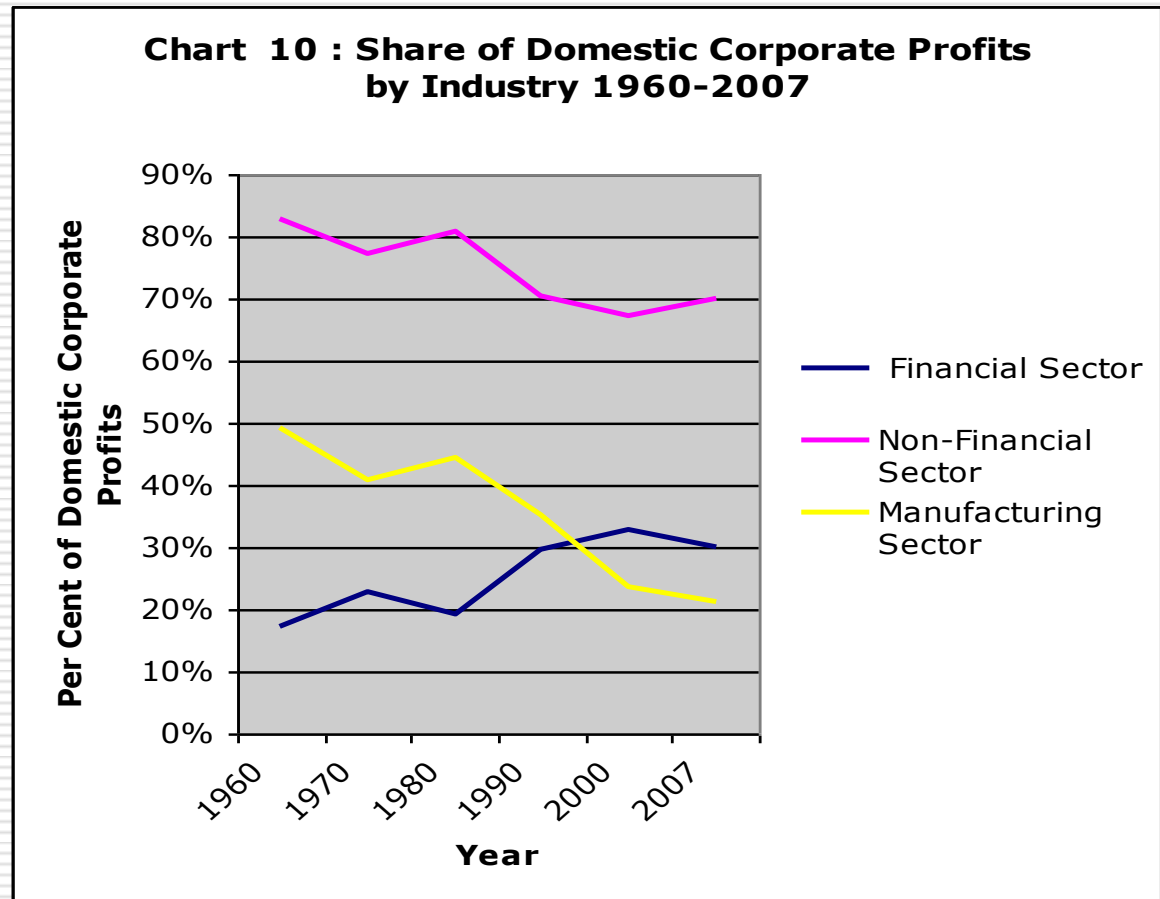
# Share of Financial Sector Profits vs Manufacturing Profits, 1960-2007

Finance – rose to 30% fr 17%

Mfg – dropped to 21% from 49%

Non-fin – dropped to 70% fr 83%

\$1 trillion mean reversion for financial profits



# Historical Excess Wage in Finance (controlling for skills, education, employment risks)

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# Regulatory Capture(R Posner)

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- ❑ Financial sector spent \$5b last 10 yrs
- ❑ \$1.7b on political contribution, \$3.4b on over 3000 lobbyists in Capitol
- ❑ Goldman Sachs - \$46m; Citi -\$108m
- ❑ Robert Reich – political democracy hijacked by corporate rich
- ❑ Revolving door- Wall St and Penn Ave
- ❑ ~~AIG – lobbied for Office of Thrift with 1 insurance specialist to regulate it.~~

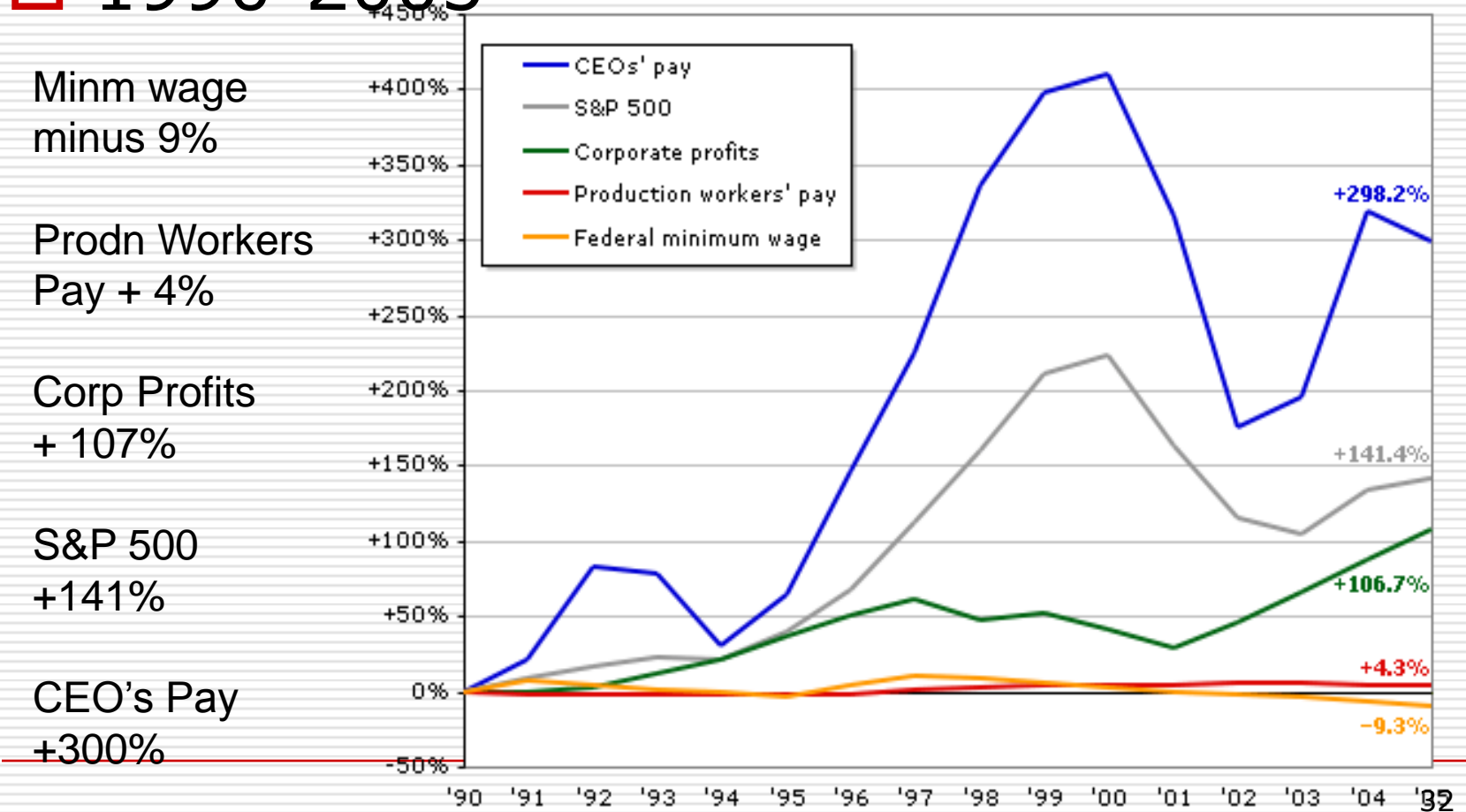
# Imbalance II - Wealth and Income Imbalance

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- ❑ 1970-2006 - income inequality worsened
- ❑ Gini Index rose to 47 from 38 – U.S. nearer to L.American than developed countries. (Philippines 46, Guatemala 48, Japan 25)
- ❑ Top 3% HH earned 20% of total income
- ❑ Bottom 20% earned < 5%.
- ❑ Wealth even more unequal – Gini of 80
- ❑ Top 20% owned 85% of wealth, bottom 80% owned 15%

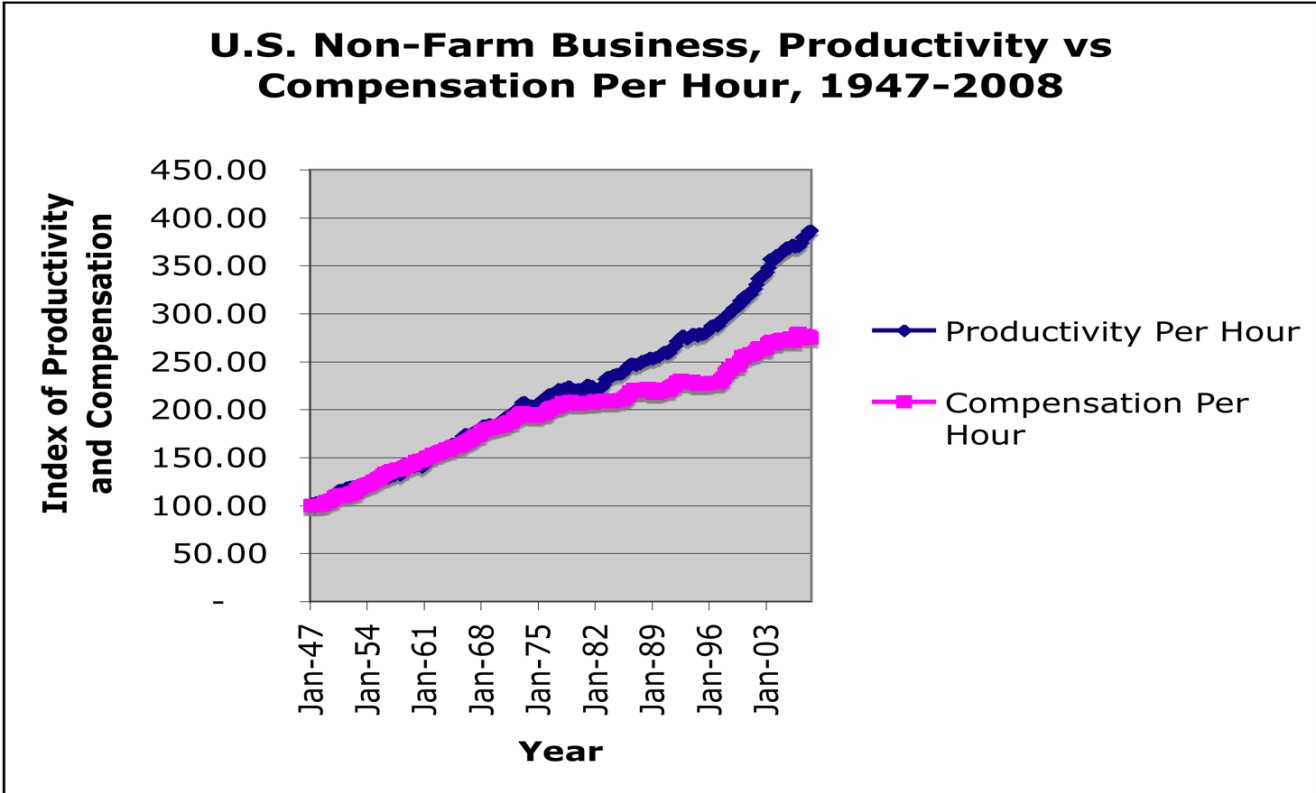
# CEO's Pay, Corp Profits, S&P 500 Prodn Workers Pay, Fed Min wage

□ 1990-2005



# Productivity vs Wages

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# Greenspan Puzzled and Concerned

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- “We know in an accounting sense what is causing it (the divergence)... but we don’t know in an economic sense what the processes are.”
- He is worried that if wages for the average U.S. worker did not rise faster political support for free markets might be undermined.

# Relationship between Inequality and Financial Crisis Neglected

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- Under-consumption for majority.  
“Solved” through assumption of debt.  
Household debt rose 64x as wages stagnant. **Debt Bubble**
- Excess savings for minority > chase for yields > financial innovations > **Asset bubble.**

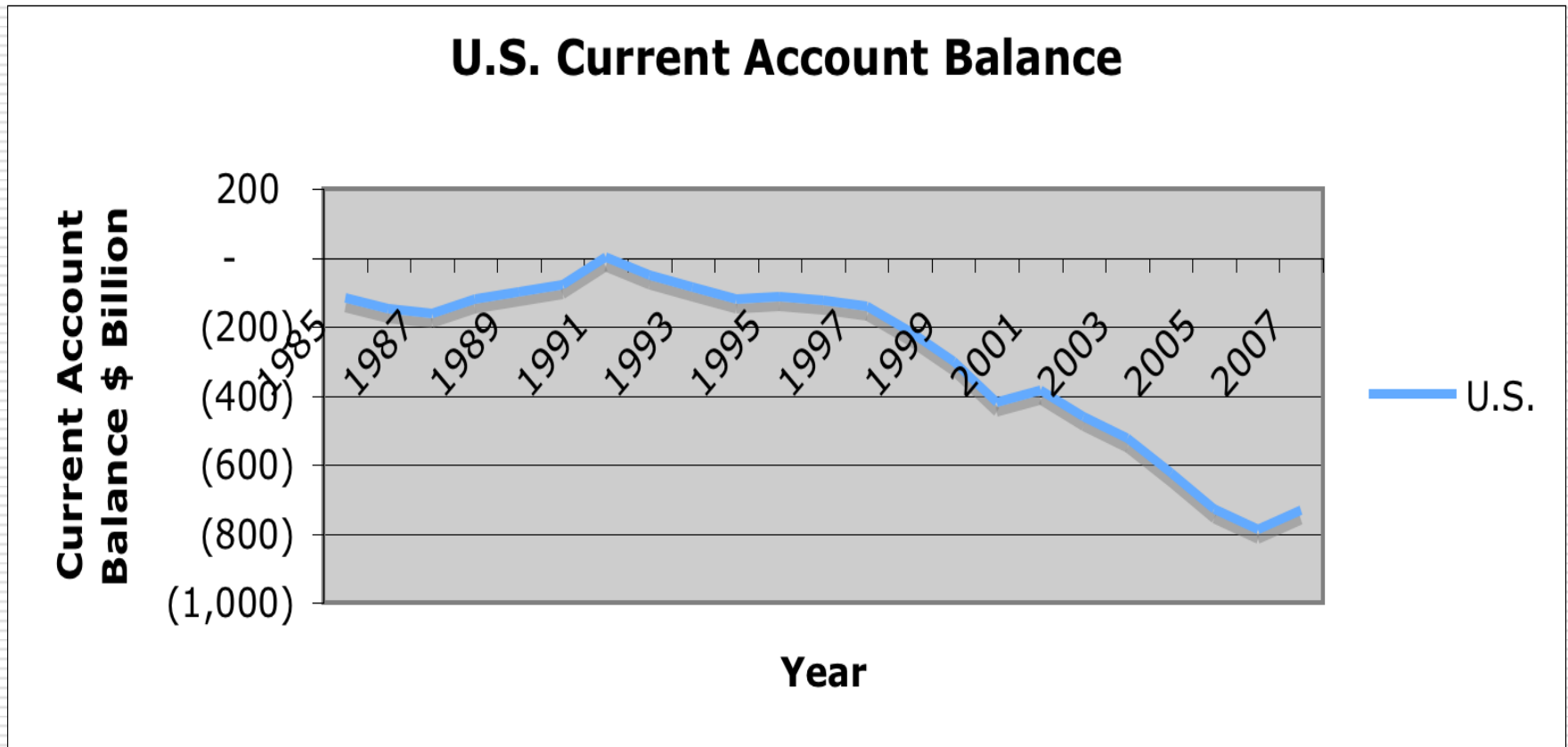
# Elizabeth Warren, Chairwoman, U.S. Congress Oversight Panel

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- “Years of flat wages, low savings, and high debt have left the American household extremely vulnerable, and any effective policy has to start with households.”

# Imbalance III – Current Account Imbalances

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# What does global current account imbalance mean?

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- ❑ Asia and Emerging Markets (EM) over-saving and U.S. overspending
- ❑ Irony - poor countries are financing consumption of rich countries
- ❑ Bernanke blames Asian savings glut but ignores U.S. overconsumption glut

# Challenges Ahead. Financial Sector – Any Lessons Learned?

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- ❑ Finance inherently unstable & at center of crises, not side show.
- ❑ Central banks - pay attention to asset bubbles not just CPI & wages
- ❑ Central banks to lean against the wind, not pick up debris approach
- ❑ Bring back finance to serve real economy and not casino economy

# Challenges for Finance - continued

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- ❑ Need to regulate financial products like Food & Drug Administration
- ❑ Regulation to include off balance sheet, shadow banking system, tax havens and regulatory arbitrage
- ❑ Banking, including investment banks - focus on mobilizing capital for investments rather than speculation
- ❑ Never abandon credit discipline

# 3 Challenges for Asia – No.1 – Relook Export Growth Model

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- ❑ Asia cant export its way out of recession with weak growth and huge debt facing G3
  - ❑ Look to domestic and intra-regional markets
  - ❑ Domestic mkts constrained by income imbalance & lack of social safety net
  - ❑ Will they follow US debt model or redress inequality
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# Challenge 2 - Capital Controls: Time for Reconsideration

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- ❑ Speculative short-term flows overwhelm trade & investment flows > misallocate capital
  - ❑ Undermines monetary policies & destabilize real economy
  - ❑ Tobin tax & capital gains tax – coordinated basis
  - ❑ Counter-cyclical capital and liquidity requirements to reduce mismatches
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# Challenge 3 - Alternatives to US Dollar as International Currency

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- ❑ Multiple international currencies – Euro, yen, yuan.
- ❑ International reserve currency not linked to national currency
- ❑ Revival of SDR
- ❑ Yuan – experiment for trades with E Asia and Russia.

# Conclusions

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- ❑ Policies and reforms must be grounded in proper identification of causes. Cure must flow fr diagnosis
- ❑ Identified the causes at 3 levels
- ❑ Meaningful reforms beyond short term resuscitation of economy must take account of these factors
- ❑ Revise understanding of economic financial theories & risk management

# Conclusions

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- ❑ Since financial industry is inherently cyclical and unstable, policies must be **counter cyclical**
- ❑ Financial industry cannot self-regulate
- ❑ Need stronger and smarter regulation and financial products protection agencies
- ❑ Financial industry must serve productive, not speculative purpose

# Conclusions

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- Countries must address economic inequality issues where wages not commensurate with productivity increases, where most rewards accrue to capital.
- This leads to current account imbalances – excess savings in countries like China and excess consumption as in the U.S.

# Conclusions

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- Are Asian economies re-examining Anglo-Saxon model of finance and traditional export-led growth model?
- Is the world moving away from emphasis on pure growth to a more ecologically and socially sustainable type of growth?
- Are we willing to learn lessons fr this crisis or shall they come to nothing?

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□ THANK YOU