Did We Learn Our Lessons from Past Financial Crises?

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The answer is yes, some of the time, and no, some of the time!

Let me begin with a positive example, in which people did learn something useful from failures and modified the rules. Maritime insurance, or marine insurance, started in the Lloyd's coffeehouse on the bank of River Thames in London in 1688. At first anyone could place a bet against any ship returning. But then so many people began to bet against the ships returning that the underwriters lost a great deal of money all the time, and more than the worth of the ships and cargoes combined. Then they discovered that the non-returning ships were often scuttled or sunk by the people who had betted against their return. Of course, the actual owners of the ships had no real incentive to do so, unless they had over-valued the ships and/or their cargoes, but there was an abundance of moral hazard on the part of the non-owner bettors. Thus, was born the rule that one must have a proven insurable interest to buy insurance, and only up to the amount of the insurable interest. This means that, for example, I cannot buy fire insurance on your home, unless I am also the lender on your mortgage. This has been a good and durable rule for the insurance industry, which still applies today.

However, in the late 1990s, a derivative instrument called "credit-default swap (CDS)" was introduced. It is a form of insurance against the default of a bond by its issuer. If the bond issuer defaults, the seller of the CDS pays the buyer of the CDS. But there is typically no insurable interest requirement—anyone can buy a CDS—he or she does not need to be a bond-owner (except in China). One can immediately see the moral hazard that it encourages if people with no insurable interest can also buy insurance on the bond. Brooksley Born, the Chair of the U.S. Commodity Futures Trading Commission (CFTC) from 1996 to 1999, argued for the regulation of the CDS as well as other similar derivatives, unsuccessfully. Credit default swaps were responsible for the demise of AIG, a large U.S. insurance company, on account of the failure of Lehman Brothers in 2008, which triggered the Global Financial Crisis. As a financial instrument, the CDS is still going strong today.

Did we learn anything from the Tulipmania, which happened in the Netherlands during the 1630s, and was probably the first big asset price bubble in history. Between 1634 and 1637, the price of a single tulip bulb rose to phenomenal levels and then collapsed quickly and suddenly. This was precisely the "irrational exuberance" that the late Federal Reserve Chairman Dr. Alan Greenspan talked about. The dotcom technology stock price bubble in the U.S. between 1995 and 2000 had a similar trajectory as the price of tulip bulbs. It is possible that the recent craze about artificial intelligence stocks would ultimately have a similar fate.

The East Asian Currency Crisis of 1997 was caused by both currency mismatch and maturity mismatch on the part of the East Asian private borrowers. But both types of mismatches continue to occur today. The recent defaults of the leading Chinese real estate developers on their foreign currency-denominated (mostly U.S. dollar) bonds are cases in point. The Chinese developers really have no business issuing foreign-currency-denominated bonds as all their revenues are in Renminbi, the Chinese currency. The recent failure of the Silicon

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Valley Bank in the United States may also be traced to a severe maturity mismatch between assets and liabilities—buying long-term bonds with deposits that are known to be short-term. It was of course the failure of its bank management, but it was definitely also a failure of the bank regulators. However, in the aftermath of the East Asian Currency Crisis, almost all East Asian central banks try to maintain large foreign exchange reserves so that they can withstand predatory attacks on their respective currencies.

A Ponzi scheme, supposedly invented by Charles Ponzi in the early 20th Century, is basically a fraud in which early investors are paid with the new investment of later investors. It can continue for a long time as long as sufficient numbers of new investors can continue to be recruited. The late Bernard Madoff was a master of this scheme. He operated an investment fund from the early 1990s to 2008, a 17-year stretch (others claimed that his scheme lasted almost five decades). He was brought down by the Global Financial Crisis of 2008, during which he was overwhelmed by redemptions by his investors. However, we are still facing Ponzi schemes of various kinds today. Cryptocurrency is also in reality a form of Ponzi scheme in which the early investors benefit at the expense of later investors. However, an issuer of cryptocurrency is also a creator and issuer of money. Between 1863 and 1935, private "National Banks" in the U.S. were authorised to issue U.S. currency, subject to federal oversight. In 1935, the U.S. Government decided to centralise control of the national money supply in the Federal Reserve System and remove the right of private banks to issue money. Allowing cryptocurrencies to circulate freely in the U.S. will mark the return of privately issued money and will affect the security and stability of the entire U.S. monetary system.

The recent failures of some large Chinese real estate developers also had some features of a Ponzi scheme. In China, developers that sell "flat future"[3] to buyers have immediate access to and use of the sale proceeds, unlike in other jurisdictions where the proceeds would be placed in escrow accounts in banks, to be released only upon completion of the flat and the issuance of an occupancy certificate. Because of this immediate availability of the sales proceeds, a distressed developer has the incentive to sell even more "flat futures", even though there is little or no probability that these future contracts can or will be fulfilled. The net result is that a huge number of people are stuck with having paid for or taken mortgages on housing units that are never going to be delivered by their developers.

The Enron scandal in the U.S. of 2001 was due to off-balance-sheet activities which hid the true state of the company. Enron collapsed and brought down at the same time its auditor, Arthur Andersen. The Sarbanes-Oxley Act (2002) of the U.S. was supposed to prevent similar incidents in the future. However, it is important to note that the Act itself did not outlaw off-balance-sheet activities per se. Investor vigilance is still necessary.

Why do financial crises still persist, after all these experiences? I believe it is because many people want to get rich quick, they fear losing out, and they all think, wishfully, that "This time it's different!". But we should know better. Thank you very much!

[3] A "flat future" is a contract between a buyer of a flat in a housing development yet to be constructed or completed on the basis of plans and its developer. The buyer puts up the money and the developer promises to deliver the flat in the future.