

**Lessons Learnt from Financial Crises –
A Central Banker's Perspective**

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Working Paper No. 4

November 2010

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Acknowledgements



The Institute of Global Economics and Finance is grateful to the following individuals and organizations for their generous sponsorship:

Vincent H.C. Cheng

C.K. Chow

Lawrence J. Lau

K.L. Wong

China Development Bank

Henderson Land Development Co. Ltd.

The Hongkong and Shanghai Banking Corporation Limited

Sun Hung Kai Properties Ltd.

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Ninth Annual Asia Pacific Summit

Morgan Stanley

Mandarin Oriental, Singapore

10 November 2010

Introduction

1. The organizers have asked me to give a central banker’s perspective on lessons learnt from financial crises. I am not sure whether I have all the necessary qualifications to do so. First of all, I have retired for over a year now. Furthermore, given the traditional role of a central bank in monetary policy, some say that the Hong Kong Monetary Authority, at which I had the privilege of heading for sixteen and a half years before retiring September last year, is not much of a central bank. With the exchange rate of the Hong Kong dollar against the US dollar firmly fixed through rule-based currency board arrangements, it is the Federal Reserve Bank that determines monetary policy in Hong Kong, not the Hong Kong Monetary Authority. But I was unfortunate enough, during the time when I was in office, to have the opportunity to handle two rather severe financial crises in an international financial centre and I do not mind sharing with you some of my reflections. For the reasons I mentioned, my views cannot be considered to be representative of the central banking community.

2. I also wish to say at the beginning that having learnt lessons does not necessarily mean that mistakes would not then be repeated and debilitating financial crises would not recur. Regrettably, political reality simply does not allow the necessary remedies that emerge from the lessons learnt, which invariably means more regulation and less market freedom, to be implemented in full. As you may have noticed, even though the damaging

effects of the latest financial crisis on the economy are still being felt, memories of September 2008 are fading, doubtful practices are returning and reform proposals are being watered down.

Market Failure

3. The first lesson learnt among central bankers is perhaps that markets can fail. Adam Smith's invisible hand cannot always be relied upon to transmute individual acts of selfishness into desirable collective outcomes for all. In the real world, particularly in finance, there are factors limiting the full mobility of the invisible hand. They include information problems, herding behavior, market imperfection such as monopoly or oligopoly power, market globalization while regulation remains domestic, incentive distortions, derivative products or the tail that wags the dog, greed, fear, stupidity, criminality, leverage, speculative bubbles, irrational exuberance, uncertainty, manipulative and predatory behavior, policy blunders, political influence of self-interested groups, etc. These are common characteristics of modern day financial markets and, more often than not, they lead to and exacerbate stressful conditions in the financial system and, if left unchecked, can produce disastrous and debilitating results rather than desirable collective outcomes. They are, in fact, so prevalent and abundant that one would find it very challenging, if not impossible, to identify in finance an empirical example that resembles the idealized free market that we learnt in economics textbooks.

4. So, instead of the invisible hand efficiently steering the forces of supply and demand into interacting to discover a reliable price for whatever financial assets being traded, we invariably have a situation in which a combination of the factors that I mentioned producing sharp volatility and overshooting of the market price. Interestingly, volatility is what the market traders like, for it provides them with the opportunity to make more money. An efficient price discovery mechanism (and therefore a rather more stable price behavior) that encourages more investors and fund raisers to make greater use of financial markets to mobilize financial resources in support of economic activities is not a matter of interest to them, although this is what justified their existence in the first place. Market volatility and price overshooting can be so severe as to threaten the viability of some of the stakeholders of the financial system, or lead to a freezing up of the financial system altogether, thus resulting in market failure.

5. The Asian financial crisis of 1997-98 was a clear case of market failure. In Hong Kong specifically, free markets became markets that were freely manipulated. The fixed exchange rate of the Hong Kong dollar against the US dollar was repeatedly under severe attack. This was notwithstanding sound economic fundamentals, including the public finances being in good shape and with no external debt of any significance. The rule-based system that we have, and the absence of reserve requirements, rather readily and automatically translated capital outflow into sharp hikes in market interest rates, which in 1997 went up to 280% for overnight money, inflicting considerable pain to the economy but, thankfully on that occasion, also to those shorting the Hong Kong dollar. However, later in 1998, the manipulators managed to pre-fund themselves with Hong Kong dollars. Taking advantage of the sensitivity of interest rates to small changes in the monetary base, and the sensitivity of stock prices to interest rates, manipulative plays across the foreign exchange market, the money market and the stock market were organized. We faced the prospects of a complete meltdown of the financial system and were forced into conducting what then was highly controversial intervention in the stock market. We faced harsh criticisms of blatantly violating free market principles.

6. In the sub-prime crisis of 2008-09 that originated in the US, there was also market failure. Market freedom encouraged financial innovation, which enabled the transfer of credit risks, presumably to those in a better position to assume them, through securitization and the creation of complex financial products. But this went way over board. Incentives in the financial system got badly distorted, leading to a serious erosion of credit standards; and the complex financial products became toxic in nature. And, as you know very well and as is now very well documented, when the prices of the assets supporting those credits experienced a significant downward adjustment, the whole financial system seized up and the all important function of financial intermediation in support of the economy badly disrupted, threatening to send the economy into a deep recession. The authorities took a little longer than I had expected to realize the serious implications of what was unfolding, being rather worried about moral hazard and still hoping that the free market would somehow sort itself out. There was also much political objection against the government getting involved. But eventually they did, as the harsh consequences of a systemic failure sank in. There was then, as you are aware, extensive intervention. This amounted to the government underwriting the solvency of the financial system – buying its assets, guaranteeing its liabilities and providing liquidity and capital – so that it can continue to function to support economic activity. The intervention was

so extensive that our stock market intervention in 1998 paled in significance by comparison. I felt exonerated.

7. Markets can fail; and when they do, to the extent of damaging the public interest, the authorities have the responsibility to put the markets back on track. This may require unorthodox interventionist action, for example, simply putting up a fight in the market place, or comprehensively underwriting the solvency of the financial system. There is also the alternative of temporarily limiting market freedom, for example, the imposition of capital controls. Whatever action deemed appropriate, the financial authorities need to be prepared. They need to be in a position to take such action promptly. This means having the necessary legal framework in place, the necessary mechanism for exercising the legal authority, and the necessary financial resources to ensure credibility of their action. And all this needs to be underpinned by a good track record of prudent macroeconomic policies. There is also a need for detailed contingency planning. This is a tall order, particularly for many emerging markets, which by definition harbors a strong desire to embrace market freedom as a means of bringing prosperity to the people.

Harnessing Market Potency

8. Prevention is of course better than cure. There is little doubt from the experience of the two financial crises of the last two decades that market freedom in finance is crisis prone. But this is not to say that market freedom in finance has not worked to enhance the wellbeing of the people. There is no natural match between the risk appetites of those with surplus money and the risk profiles of those in need of money. There is a need for a market system capable of pricing and allocating risks, and with financial intermediaries transferring and transforming risks, so that financial resources are mobilized efficiently to support economic activity, in the domestic as well as international dimensions. But we clearly cannot take the efficiency of the market system for granted in performing this task. To me, lesson number two is simply that the potency of the free market operating in the financial system is to be respected and harnessed. The question, as always, is how. While this is not an easy question to answer, it does seem that to harness financial market potency for the good of the people there is a need for a greater degree and perhaps a different form of government involvement in the financial system.

9. But there is, as of now, no consensus on what constitutes the optimal degree and form of government involvement in the financial system that ensures financial stability while not stifling financial innovation that promotes financial efficiency. Interestingly, the two financial crises both point to deficiencies in the capitalist, free market model in delivering financial stability. By contrast, in jurisdictions where there is a considerably higher degree of government involvement in the financial system, in terms of, for example, ownership and management, and controls over financial flows of different nature, as in the case of the Mainland of China, the track record in the maintenance of financial stability has been a lot better. But, obviously, this is at some expense of financial efficiency, as evidenced, for example, by the relatively large intermediation spread in the banking system. Depositors get a relatively lower rate of return for their savings and borrowers incur a relatively higher cost of funds.

10. The ideological gap, nevertheless, is narrowing. We have seen authorities in the capitalist, free market systems assuming control of financial institutions, giving directions to banks to lend in support of the economy, handing down restrictions on the compensation of senior management in financial institutions, although some of these are temporary, crisis management measures that will be phased out. We also notice, at the same time, the socialist market economy of China confidently but cautiously continuing with financial reform and liberalization, enthusiastically embracing the market and embracing globalization. I certainly hope that, in the fullness of time, an optimal, middle ground can emerge and take the form of global standards for the regulation of financial markets and the supervision of financial institutions, while allowing for domestic adaptations to cater for varying circumstances.

11. The major international financial forums have spent a good part of the last two years working on how to repair and reform the financial system. The Financial Stability Board has a long and ambitious agenda, so has the Basle Committee on Banking Supervision. I have been involved in these committees before and I know how serious and professional they are in generally promoting the public interest of ensuring that the financial system works well and specifically tackling complex issues. I applaud their efforts. Many strategic areas are being addressed, reflecting preoccupations of the memberships of these forums – the supervision of systemically important financial institutions and the associated moral hazard problem of their being too big to fail, the operation of OTC derivative markets, reducing reliance on credit

rating agencies, macro-prudential policy tools and frameworks, system-wide oversight arrangements, etc; and specifically the Basle Committee on Banking Supervision is looking at improvements to the quality of capital, the coverage of risks, a leverage ratio, various capital buffers to address pro-cyclicality and a new framework for minimum liquidity standards, which collectively is now referred to as Basle III. And all these new standards will have a higher degree of international legitimacy than before, given the wider membership of the international financial forums and as they are being put under the umbrella of G-20.

12. Indeed, to the extent that they are relevant, these efforts are, by and large, mirrored at the national level, with individual jurisdictions being rather proactive in pushing for financial reform. This is understandable given the amount of public funds that has been mobilized to stabilize the financial system and bail out financial institutions, and therefore the intense political pressure to take action to prevent recurrence. There is, notably, the Dodd-Frank Act in the United States and similar initiatives in Europe. While international consistency is still very much an issue, the prospects of the financial system being made to work better in support of the economy seems reasonably good.

Conflict of Interest

13. But as governments get more involved in the financial system, whether it is in pushing for the much needed financial reform or subsequently in actually regulating it more intensively, I think there is a phenomenon in finance that they should always bear in mind. There is a fundamental conflict between the private interest of the financial intermediaries in maximizing profits in whatever they are doing and the public interest of ensuring financial stability and promoting financial efficiency. Put simply, and some of you may not be happy to hear this, the bigger the profits and the bonuses for the financial intermediaries, which de facto means a higher intermediation spread, the less efficient is the financial system in financial intermediation. Indeed, with the middle man taking quite a big cut, the rate of return for investors must necessarily be lower and the cost of funds for the borrowers higher than would otherwise be the case.

14. Thus lesson number three is for financial authorities to manage that conflict pro-actively, remembering that the public interest should at all times prevail. Finance is about

financial intermediation – the channeling of money from those who have a surplus of it to those who are in need of it. It is the all important function that supports economic growth and development. An efficient financial system is one that provides attractive risk-adjusted rates of return for investors and provides funds at relatively inexpensive costs to those in need of them; in other words, an efficient financial system is one with a narrow intermediation spread. If you can concurrently observe, on the one hand, financial intermediaries and those working in them respectively making astronomical profits and bonuses year after year, and, on the other hand, investors are getting high returns and borrowers getting cheap funding, something might be wrong. The anomaly needs to be explained. The authorities need to satisfy themselves that this anomaly, which may be welcome by all, was not made possible at the expense of deterioration in the structural robustness of the financial system.

15. Let me illustrate with an example. The anomaly, with the benefit of hindsight, was quite obvious over a period in the United States before the crisis of 2008-09. But virtually no one raised any query on it. Rather, the regulators were quite happy that financial innovation, in the form of credit risk transfer through securitization, was enabling the different risk appetites of investors and the risk profiles of fund raisers to be matched more efficiently. Sub-prime and other CDOs were giving investors a higher rate of return at apparently no higher risks. Many more people were able to borrow money to buy their own homes, even those who were not able to come up with any down payment, and borrowing costs came down generally. And the intermediaries, for their innovative efforts, were seen to be getting their just reward, or so they claimed.

16. The deterioration in credit standards was tolerated, because the specially structured financial products, attested by the rating agencies, were able to transform those credit risks and have them transferred to those in a position to assume them. The banking supervisors did not raise any objection to the creation of sub-prime mortgages by the banks, since these were quickly taken off the books of the banks and so depositors' money was not at risk, overlooking of course the possibility of re-intermediation when guarantees provided by the banks for the repayment of market funding to SIVs sponsored by them were called upon when stress developed. And so the production lines of toxic assets were kept running and toxic assets were exported to the rest of the world to gullible investors awash with liquidity. Regulators should not stand in the way of financial innovation; and they did not. Finance was allowed to attain a life of its own. It very much became an industry that generates wealth on its

own. And along with wealth came political influence and regulatory forbearance or benign neglect, and leaving it all to the almighty, free market. Soon that life of its own became one that gave bigger and bigger emphasis to, or even priority in, serving the interests of the financial intermediaries over the public interest in performing the basic function of financial intermediation that originally justified their existence. It also gained a degree of potency that turned out, as we all learnt, to be quite destructive.

Central Bank Independence and Mandate

17. It is for public officers to protect the public interest, but they must operate within a framework that enables them to do so effectively, supported by an incentive system that attracts the necessary skills and standing to do a proper job. This then is the fourth lesson. It takes a lot of courage for regulators just to ask the simple question that “if it is sub-prime, why lend?” Similarly, for example, for regulators to insist on a 70% loan to value ratio for mortgages, when property prices are on the rise; or, in relation to certain innovative activity, to say that: “I don’t understand this, so you shouldn’t be doing it”. While central banks and others with responsibility over the financial system are rightly concerned about compensation practices in the financial industry, they too should be concerned about their own. In establishing the Hong Kong Monetary Authority in 1993, one of the things I insisted was to benchmark remuneration packages against those of the private sector. Although politics have led to this policy being watered down considerably over the years, I would like to think that it has contributed significantly to Hong Kong successfully coping with the two financial crises, and the collapse of the property bubble and other destabilizing events in between.

18. Independent central banks that work to a well defined mandate are obviously another important element of that framework. I do not think that the recent financial crisis has led to any significant erosion of central bank independence. But a number of central banks have, nevertheless, been called upon by their governments to help maintain financial stability and ensure that financial systems continue to operate to support the economy, although these functions have not been explicitly defined in their mandates. Given the severity of the situation and the damage being inflicted on the economy, all responded positively to these requests, coming up with imaginative and unorthodox policies, to the extent that they are not prohibited by law. Some have interpreted this cooperative attitude of the central banks as an

erosion of central bank independence. Others expressed concern about the central banks straying too far off well established mandates, warning against, for example, the dangers of inadvertently going down the slippery slope of monetizing budget deficits.

19. These comments are well intentioned. They perhaps point to the desirability of introducing suitable modifications to central bank mandates, such as the inclusion of explicit responsibility over financial stability, and correspondingly granting central banks the necessary authority to enable them to deliver. Quantitatively defined single objective mandates for central banks, such as inflation targeting, seem now to be too simplistic in the increasingly complex financial environment of today. They also limit the scope in which the central bank can contribute to making the monetary and financial systems work better for the community, such as promoting economic growth. Asset bubbles are not just relevant to central banks because they affect the inflation rate. And the control of the central bank over the quantity and price of base money need not, at all times, be exercised only for targeting inflation, even though inflation is not an issue of current concern.

Rough Seas

20. Lest anybody asks me whether I hold the same view in respect of targeting exchange rates, let me hasten to add here that not all jurisdictions can afford the luxury of having its central bank operating with multiple objectives and being flexible in pursuing monetary and financial policies in the public interest. Free and open emerging markets continue to be vulnerable to the potency of international finance, particularly when there is so much liquidity being generated as a matter of domestic policy in the developed markets, which pay very little attention, if at all, to the effect of their action on the rest of the world. This then is the fifth and final lesson that I wish to leave you with. Emerging economies that embrace free and open markets continue to face a difficult task in the maintenance of monetary and financial stability. The volatility of international capital demands the maintenance of relatively large prudential and financial cushions if they are to cope and not be tossed around in these rough seas, hence the substantial accumulation of foreign reserves in the last decade or so. It also sets a higher standard for the macroeconomic policies being pursued. For some, a credible currency anchor may be the only practical option available to them. The alternative of imposing selective controls or taxes on capital flows, whenever there is a need to do so, is

another option that can be considered; but it entails possibly lower efficiency in the international allocation and use of capital, which is not particularly suitable for a jurisdiction serving as an international financial centre. The long term solution is, I think, a multi-polar international monetary system that offers greater diversity and flexibility than the arrangements we have now. But this is the subject for another day.

21. I thank the organizers for giving this opportunity to a retired central banker to speak his mind and thank you for listening.

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10 November 2010