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Asia and the Subprime Crisis, Chi Lo (Palgrave Macmillan: UK), 2009; pp XI+125, £60.

Many lessons can be learned from the recent subprime crisis. Those lessons have not been systematically addressed, perhaps because everyone has been busy with 'fighting the fire'. This is not a normal crisis period, and hence, no normal post-crisis recovery was expected. The financial wizards seem to remain overly optimistic that the crisis will be followed by a normal economic recovery so that life can get back to normalcy. There was huge economic imbalances built up in the 1990s and early 2000s, all financed by massive debt in the developed world. The advent of financial derivatives, thanks to the deregulation, had only made these imbalances, making crisis more complicated. To unwind these imbalances from the web of complicated financial instruments spread throughout the world will take a long time. The loss of public confidence only adds difficulties to finding a solution. There are also significant implications of the crisis on the regulatory, macroeconomic and financial fronts in the post-crisis era. In this book, the author has drawn parallels between financial crisis of Asian emerging countries and developed countries of European Union and the USA. Though the analysis is China-centric, some sporadic focus on other emerging Asian countries to draw lessons from the crisis.

It is properly mentioned in the book that, the epicenter of the crisis has changed from Asia (Asian Financial Crisis of 1997) to Europe and the USA. The buzzwords have also changed, from currency pegs, excessive corporate borrowing and foreign debt in the Asian crisis to securitization, subprime mortgages, and collateral debt obligations in the subprime crisis. However, it is properly clarified that the causes and symptoms of the subprime crisis are quite similar to those of the Asian crisis. So to say that the subprime crisis is an unexpected shock is a denial of human mistakes - greed is prevalent in both the subprime and Asian crises. Before the Asian crisis, massive foreign capital inflows to the region significantly boosted bank lending and corporate borrowing. Foreign investors were attracted by Asia's high-yield securities in the blind faith that the regional currency pegs would hold forever and

robust economic growth would support Asian Corporates' payment ability forever. Similarly, massive capital inflows flooded the USA and financed its huge current account deficit, fuelling excessive demand for credit and mortgage loans. The latter were repackaged into mortgage-backed securities and other credit derivatives like collateralized debt obligations (CDOs). Investors outside the USA were attracted by the high yields of these structured products in the blind faith that the underlying parties had AAA credit ratings. Imprudence follows greed. Ten years ago, the Asians indulged in imprudent lending to corporates based on relationship to mega projects and property development of dubious nature. Due diligence and commercial viability were totally ignored. In the subprime crisis, imprudence is seen in the proliferation of subprime mortgage loans and the so called *ninja* loans (no income, no jobs and no assets for backing).

Seed of the Subprime Crisis

The book has appropriately diagnosed the subprime crisis. It has mentioned that the global major central banks, such as, the US Federal Reserve, the Bank of England and the European Central Bank (ECB) in particular, had run an overly loose monetary policy in a dynamic, entrepreneurial, globalised and capitalist system, and ended up turning the original good economic policy intension into the seed of another shocking crisis. But that did not mean that capitalism had failed. Rather, the subprime crisis was a result of regulatory failure in the capitalist system.

The US monetary policy was not the only problem. The creation of the Euro zone in 1999, which centralized monetary policies of the member countries into ECB, also played a crucial role in creating the global credit bubble. Monetary union eliminates currency risk but not credit risk. With only one currency, the Euro, and one monetary policy, credit spreads in some Euroland countries should have risen to reflect their underlying risks. But the ECB, in an attempt to ensure stability in the early days of the Euro, had kept an overly loose monetary policy for a long time. Thus, asset bubbles, fuelled

by easy credit, emerged especially in the peripheral, smaller Euroland countries, such as, Ireland, Spain, Greece and Portugal.

Contesting Factors

The book has contested that the current subprime crisis is a 'black swan' event. The term *black swan* comes from the ancient western concept that all swans are white. In that context, a black swan was a metaphor for something that could not exist. Ever since black swans were discovered in Australia in the seventeenth century, the term *black swan* has been used to connote the actual happening of a highly unlikely event with unprecedented and devastating effects. The subprime crisis itself is not a *black swan* event, though the resultant credit crunch and confidence crisis may qualify. This is because all the events and factors leading up to the current crisis were known. From a macro perspective, the Asian crisis and the subprime debacle have similarities in their causes and symptoms - namely a prolonged period of low interest rates leading to moral hazard, imprudent lending, regulatory oversight, excessive investment, and asset bubble. But the advent of financial derivatives has made today's subprime crisis more complicated.

The deepening of the US subprime crisis after September 2008, despite the Fed's repeated massive liquidity injection, shows that the markets had failed to clear on their own and the global financial system had stalled. There would be two possible outcomes of the crisis - either a global financial meltdown or a full-scale government bailout. History and the Government actions suggest the latter. There is a conflict of interest problem, which often takes the form of a principal-agent problem. In the Asian financial crisis, bank managers just ignored shareholders and public interest and lent indiscriminately to companies and projects under political or influential business pressure. In the US subprime crisis, investors in mortgage based securities (MBS) and CDOs expected mortgage lenders and banks to keep their credit standards. But in the 'originate and distribute' model, in which the mortgage lenders and banks originate the loans and sell them off at once, they had little incentive to scrutinize and

keep the credit standards. Typically, mortgage lenders made the loans and at once sold them off to banks. The banks, in turn, securitized them and sold them off to investors throughout the world. The banks aimed at maximizing only their fee income from securitization but not the interest income from the loans. So they had the incentive to securitize and push the products off their books as soon as possible. Credit standards dropped sharply in the process, and no-one had any clues about the ultimate ownership of the underlying loans. So, when the US housing bubble burst, defaults surged, setting off a domino effect on the mortgage derivative instruments and shattering public confidence in the banking system as a whole.

Hence, those who argue that the subprime crisis was a *black swan* event are either naive or in denial. Despite numerous analyses of the subprime crisis, its causes and impact are still misread in many cases, especially from the Asian perspective. As the subprime-induced credit crunch pulled down asset prices indiscriminately, what was at first a liquidity crisis soon turned into a solvency crisis for individual banks, prompting the global authorities to employ radical measures such as partial bank nationalization, troubled-asset purchases and other forms of direct market interventions to contain the *credit quake* or *financial tsunami*, as it is called in Asia. Asia's policy response has remained relatively calm in this subprime debacle because it has learnt good lessons from the 1997-98 Asian financial crisis.

Subprime Generalised

The word 'subprime' in relation to mortgages in the USA generally refers to those mortgages targeted at borrowers with impaired or low credit ratings and low income level who may find it difficult to obtain finance through traditional sources, such as, prime mortgages and Alt-A. Subprime borrowers have the highest perceived default risk, as compared with Prime and Alt-A borrowers. In essence, subprime borrowers are those who have a history of loan delinquency or default, those with a record of bankruptcy, and those with low income levels relative to their mortgage payment ability.

The US subprime crisis was quickly transmitted to Europe, as the European banks were some of the largest holders of the US mortgage-related derivative instruments. During the good times, they loaded up the MBS and CDOs with cheap US dollar funding. But when the sub-prime crisis broke, US$ funding sources of all sorts, including money market funds, bank depositors and other investors, withdrew cash *en masse*. European banks soon found their funding increasingly difficult and expensive to replace. When the credit market eventually seized up after the failure of Lehman Brothers in September 2008, the domino effect was quickly felt in Europe, pulling down big banks like Fortis and HBOS and forcing them into government hands for rescue.

When the financial contagion hit Asia, it wreaked havoc in the regional financial and currency markets, even though the regional banks had very limited exposure to the sub-prime toxic assets. However, the overall impact on the regional financial system was relatively small. Asia's strong fundamentals, including large current account surpluses, huge foreign reserves, low foreign debts and high savings rates, have helped shield its financial systems from the *financial tsunami*. However, the region's heavy reliance on export growth has significantly pushed its economies deep into recession as global demand contracts under the weight of the post-bubble adjustment in the developed world.

While Asian growth experienced a V-shaped rebound a year after the Asian crisis of 1997-98, thanks to its young and vibrant economic structure and a quick return of confidence, don't bet on the same happening in Europe and the USA. Even if the US Troubled Asset Relief Programme (TARP) manages to turn confidence around and the European authorities finally wake up to reality and join in a concerted bailout effort, history shows that the post-bubble adjustment in developed economies will take a long time. Thus, to correct their mistakes, banks will have to become more boring, generating less profit from fancy financial engineering, and more heavily regulated relative to the past two decades. Granted, restrictions will hurt economic opportunities and profitability in the next economic upswing, but

it will be a small price to pay for greater protection from another, perhaps bigger, banking crisis in the future.

The correct message from these failures should be that Asia should ensure that any move away from traditional banking practices towards more innovative techniques is accompanied by enhanced risk management. It will be extremely unfortunate if the wrong message gets out and delays or even deters further financial liberalization in the developing world. Asian regulators should take the subprime crisis lesson seriously to improve their regulatory systems. As Asian financial markets expand into new terrain, policymakers should put in place measures to deal with risks posed by financial innovation, but should not shy away from financial liberalization or suppress financial innovation.

Bailout Approaches Converged

Before October 2008, there was no coordination between all the subprime crisis countries. They had only taken *ad hoc* steps to stem the crisis. Central banks had cut interest rates, governments had acted to strip toxic assets off bank balance sheets and regulators had injected capital into the banking sector. These moves were country-by-country solutions and had no broad coordination between governments, despite the fact that the global financial system was linked. No wonder they had failed to calm the markets and prevent the crisis from deepening.

Asia does not have a financial crisis, despite the global impact of the financial tsunami stemming from the western world. This is mainly because the Asian banking systems, except Korea, have de-leveraged since the aftermath of the Asian crisis. This is in sharp contrast to the over-leveraging of the US and European systems, which sowed the seed for the subprime crisis. This difference in the banking system fundamentals between the east and the west is best summarized by the loan-to-deposit ratio. Since the Asian crisis, Asian banks, except Korea, have de-leveraged significantly, while their western counterparts have indulged in lending.

The Painful Lessons

Despite all these micro, macro and unconventional measures taken by the global authorities to tackle the global credit crisis, the root problem has yet to be dealt with effectively. That is because what the western policymakers have done is to sustain household leverage and consumption at any price, when the only exit from the 'credit quack' involved a return to thrift by the over-leveraged.

The book is properly timed and appropriately mentioned that the subprime crisis was rooted in the irresponsible social behaviour of the USA and most of the developed world in the past two decades, which prioritized the desire for current consumption over the ability to pay for it. Financial engineering and deregulation had encouraged borrowing and discouraged thrift to finance excess spending *via* a gigantic credit bubble. That, in turn, led to huge global economic imbalances and distortions. This root cause explains why it is so difficult to solve the crisis. Desperate to preserve the value of asset prices inflated by this huge liquidity bubble, western policymakers have avoided the painful solution of allowing market clearing. The bailout programs, liquidity injections and fiscal stimulus packages are all meant to sustain asset prices, when these asset prices really need to fall to market levels so that they can be cleared.

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