

Foreword

by **Dr. Jim Walker**

According to many esteemed bureaucrats and politicians, the current global crisis could not have been foreseen. Mario Draghi, governor of the Bank of Italy, has claimed that events since August 2007 have been so extreme that only “cranks” could have forecast them. Alan Greenspan, one of the main architects of today’s problems, now says that there may have been something wrong with his “model” in the last few years of his Fed chairmanship. Notice that he does not admit that there was anything wrong with his stewardship. Such is the level of hubris that adorns governmental and technocratic structures worldwide.

The genesis of this crisis needs to be exposed. For sure, executives in investment banks and other financial firms were consumed with greed as they were encouraged by lax regulation and central bank promises to pursue growth at all costs. They rewarded themselves richly and are now being exposed as fraudsters, bad managers, and shallow thinkers. But hand in hand with them were the politicians and central bankers who benefitted from the growth and “prosperity” that a world built on leverage seemed to deliver.

In the UK the most castigated figure in the financial crisis is the ex-head of the Royal Bank of Scotland, Sir Fred Goodwin. As the government and the media point their fingers at him as the man who brought the City down, no one asks the question Who gave him the knighthood? That, like the

honorary knighthood doled out to Alan Greenspan, was bestowed at the behest of the then chancellor of the exchequer and now prime minister, Gordon Brown.

While the good times rolled, the politicians and the central bankers—celebrities one and all—took the kudos. Gordon Brown claimed to have banished the business cycle. Alan Greenspan assured investors and institutions that he could bail them out of any mistakes they made. The “Greenspan Put” became the stuff of legend—but was in reality the cancer that has spread through the system to such destructive effect today.

In early September 2007, while I was still the Chief Economist at CLSA Limited in Hong Kong, I wrote the following in our regular quarterly economic commentary:

On 9 August 2007 the world changed. It was the end of history for the risk-crazed, leverage-loving Greenspan-put bankers. On that day, the European Central Bank waded into financial markets with a US\$130bn injection to ensure liquidity in the European banking system. All of a sudden the problem that central bankers and politicians had continually claimed to be “contained” in the US supprime mortgage market exploded onto the world stage. It is sad that, even as we write, some commentators still appear on the media claiming that the problem is contained – contained in supprime, contained to the US housing market, contained to the debt markets, contained to the global financial system. The fact that they cannot agree as to where the problem is contained tells us all the truth: it is not contained. The 9 August intervention to stem a total seizure in European interbank flows (caused by the suspension of redemptions on three BNP Paribas funds and the earlier folding of a small German bank)

marked fairly and squarely the return of risk to the global economy. The five years of falling corporate paper spreads, emerging market spreads, junk bond spreads and volatility has now come to an end. It will not return for at least a decade, if ever. That is how long it will take to clear the damage from the crisis that has just begun.

—Eye on Asian Economies,
Apocalypse Begins: The Return of Risk,
14 September 2007.

Unfortunately, these comments have not faded into irrelevance since they were written. The global financial crisis has spread into the real economies of the world in the most insidious of ways. And although commentators will claim that we must be nearing the end of the downturn—after all, the average length of a recession is only 18 months, and we are well over that at this writing—the fact is that we are nowhere near through. That is what makes this book an important contribution to the debate on how to shape the U.S. and global financial systems that will emerge from the ashes of those once great universal investment banks.

For politicians who are constantly advised by the people who led us into this mess, this book is a must-read. For ordinary people it is an essential tool in understanding what has been going on in the world of finance for the last few decades, as well as what has gone wrong.

I first met Stephan in the early 1990s, and over the years we have crossed paths many times: when he moved to Asia with Guyerzeller and then as an investment manager with Genesis Asset Management in London. He is steeped in the knowledge of the investment world—its strengths and its weaknesses. In this book he lays bare the thinking and methods that lie behind modern financial management for lay readers. Risk, and its management, goes to the very core of everything that he writes.

In my view, one of his most important conclusions is that investment management processes will be forced to change as a result of this crisis. Fund management will have to return to basics. As Stephan observes:

"It would be safe to say that the simple and crucial purpose of these agents is to allocate capital. They are entrusted to channel a restricted amount of money to the best ideas and the best managers, producers, and innovators. They are enjoined to determine just where money can best work to produce the highest cash flow with the lowest possible risk. Financiers thus match capital with ideas, with managers, with the producers of the goods and services we want."

Over the last 20–30 years the investment management process has become a game. With so much money sloshing around the global economy it has been hard to make losses (until recently). Fund managers would seek to rotate funds at the beginning of each year or quarter from performing sectors and companies to underperforming sectors and companies in the almost certain knowledge that the laggards would become the recipients of the next wave of easy credit and money. The thinking, to a large extent, was that every dog has his day.

Instead of sound financials and proven returns, money managers became obsessed with "growth" stories and "concepts." Make a loud enough noise about a political event (the election of a market-friendly president, for example) or create enough hype about the speed of economic advance (China being the perfect example) and money would pour in. Earnings, the source of value of all companies, were often an afterthought. The game was to be the first to arrive and not the last to leave. It was something akin to buying and selling houses in the U.S.,

because after all, prices would never go down....

Well, the game has changed. It has changed in U.S. housing and it has changed in money management. This crisis, for all the pain that it is inflicting on ordinary people, has one silver lining: It will bring sense back to money management and investing.

“The theory of Modern Finance relieved the financial industry's frustration with the multidimensionality of risk in a system that largely sets prices according to expectations and offered a far simpler, more definite way to manage risk, one not based on experience, know-how, judgment, and business sense, but one that could be controlled from boardrooms, replicated and applied by drones, and taught at universities, business schools, and chartered financial accounting schools around the world.”

Investment is about the allocation of scarce capital. In order to produce a sustainable return, the companies that asset managers invest in have to be good at what they do, run by competent, honest people, and be located in jurisdictions where policymakers promote sound, stable growth. Money management is not necessarily an exciting profession. It is about seeking out returns that will make savers better off than if they put their money in a bank. Possibly not much better off, but at least a little. Trusteeship over other people's money is a sober, serious business, not show business.

In sober, serious businesses one of the keys to success is to acknowledge what one doesn't know and what one is not capable of doing. That is true also in academia and in government. Stephan's explanation of central bank management and the whole edifice of modern financial theory demonstrates that these were lessons forgotten by the great and the good in both spheres. His focus on central bank

misunderstanding of inflation goes to the heart of our global problems today. As he says:

“Incredibly, central bankers rejected the notion to consider asset price inflation (increases in the price of equities, housing, etc.) and instead focused on the meaningless core inflation that seemed to concur with their view of the world.”

By choosing to focus on one single manifestation of inflation, core consumer prices, the world's central bankers unleashed a tidal wave of credit on the global economy. They claimed that they could not spot asset price bubbles on the way up (not acknowledging what they did not know but rather just sticking their heads in the sand) but that they could “take care of them” on the way down.

The rest of us involved in global markets could easily see the credit bubble growing (the numbers were there, after all) but, according to the guardians of monetary stability, the amount of money and credit outstanding was irrelevant—as long as core CPI did not rise.

The result was that the world's most powerful central banks, while acknowledging that we live in a globalized world, acted as if each country was a hermetically sealed unit. In the U.S. in 2003, Bernanke and Greenspan's perceptions of nonexistent deflation led them to lower interest rates to 1%. They flooded the system with money. Unfortunately, much of that money spilled over into the rest of the world—European banks, commodity-producing countries, and China, to name but a few. Plentiful dollars along with plentiful euros and a carry trade encouraged by the guardians of the yen and Swiss franc resulted in a global boom of unprecedented proportions. Until the music stopped.

We truly are in the **Eye of the Storm**. This sorry tale will have many more twists and turns as yet unthought-of by the politicians and central bankers. It will be painful in the extreme for exporters of manufactures and commodity producers. Ordinary working people in the developed and developing world will pay the price of our leaders' collective incompetent stewardship. Like the Icelandic government, many of them deserve to go, ignominiously. Of course they won't. Politicians have a habit of wriggling off the hook because they are good at pointing the finger in someone else's direction and at manipulating the media.

Many hopes are pinned on China as a bastion of stability and as a new source of growth, but these will be dashed in the next few months. The recent rise of China has been as much the product of globalized credit flows as the growth in credit default swaps and securitized debt. It will be no more able to hide than the once great houses of Bear Stearns, Lehman Brothers, and AIG. If there is one thing that the global integration of financial systems achieved over the last 20 years, it was to ensure that when boom turned to bust it would do so for everyone.

This book will help readers understand exactly what has been happening with a broad historical context and also give you the tools to make sense of what is still to come. It will be a turbulent ride.

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