CFA Society Hong Kong

30 YEARS ANNIVERSARY

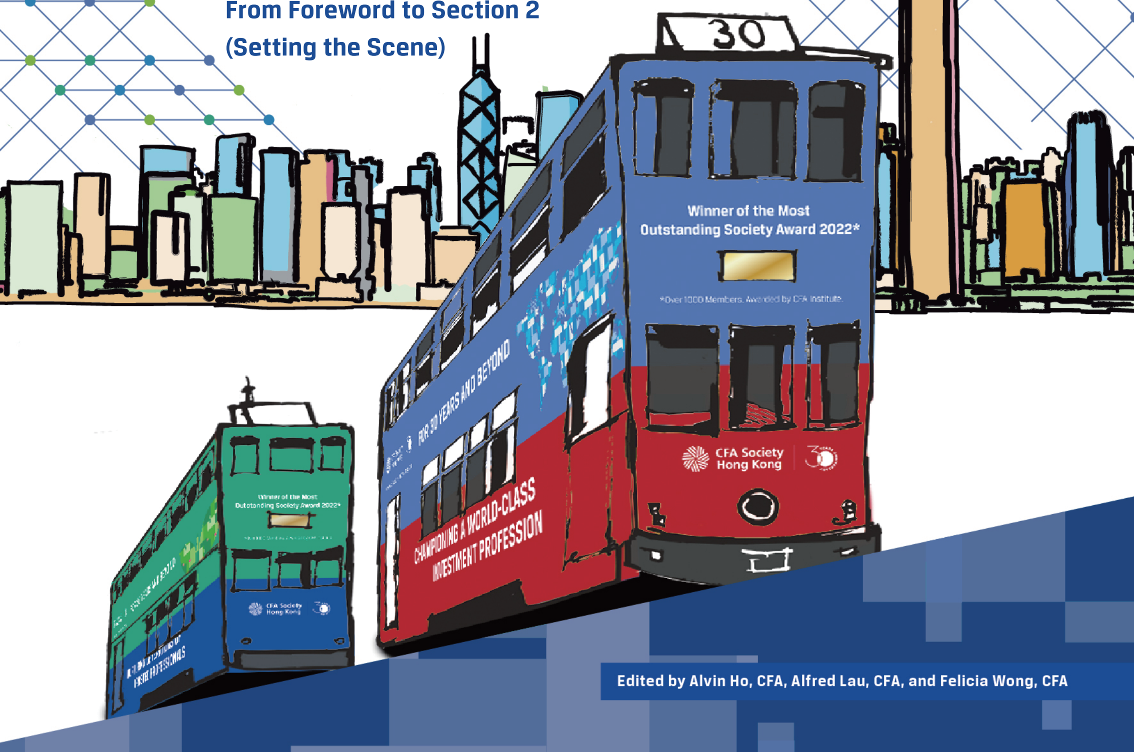
RISE FROM CRISES

- BOOK 1 -

How Hong Kong survived the financial and other crises, and rose to the occasion, over the past 30 years

30 tales from practitioners

From Foreword to Section 2 (Setting the Scene)



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This work contains excerpted chapters from *Rise from Crises*. For further content, please consult the other excerpted ebooks, or the complete volume.

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ISBN 978-962-354-257-9
December 2022

Foreword

Margaret Franklin, CFA
President and CEO of CFA Institute

As the Chinese characters for "crisis" imply both a sense of danger and a crucial point when something changes, it is only apt that this book, *Rise from Crises*, comes as the pandemic lays bare humankind's gravest problems, and galvanizes individuals, businesses, governments, and communities to act to address them with renewed urgency. A crisis can sometimes be the ideal opportunity to explore new approaches to managing operations, and defining good practices through analyses and new perspectives. From this point of view, the voluntary contributions that make up this book perfectly achieve that objective by offering a range of timely perspectives on crisis management, and the lessons that have shaped Hong Kong over the past three decades.

The keen support from volunteers, including business luminaries and leading academics, to contribute to this book mirrors CFA Society Hong Kong's incredible efforts to increase our relevance and influence in the investment management industry, expand the community that powers our mission, and diversify the ways we serve our members and the profession. CFA Society Hong Kong, with more than 6,000 members, has been an authoritative voice for Hong Kong's investment professionals over the past 30 years. It is inspiring to see how the Society has responded to adversity, not just by surviving, but thriving, and undertaking new programs and initiatives, all with the aim of reinforcing Hong Kong's position as a leading international financial hub.

I wish you happy reading.

Preface

In Confucius's sayings, when people reach 30 years of age, they would stand on their feet and become measured in interacting with their surroundings (Analects, 2:4). In biblical verses, the 30th birthday heralds the arrival of mature adults with the necessary wisdom to pick up their ministries, as shown by Joseph, David, and, last but not least, Jesus (Gen., 41:46; 2 Sam., 5:4; Luke, 3:23).

Therefore, it is appropriate that CFA Society Hong Kong (also known as The Hong Kong Society of Financial Analysts) marks its 30th anniversary with a book of our writings and reflections. The collection of essays, rounding up to 30, does not resemble the usual congratulatory M&A tombstones, the post-Sarbanes-Oxley disclosures, or post-Dodd-Frank disclaimers. Instead, it is a compilation of critically appraised compositions and expositions. These include personal setbacks and growth, assessments of the crises in their circumstances, and resilience in seizing career opportunities.

True to the heritage of Hong Kong as a place where East meets West, the lineup of the contributors in this volume exemplifies the multi-faceted forces of the Society. Under two-thirds of the contributors are CFA charterholders, half are non-Cantonese speakers, and one-third are female. The volume is also a testimony to the volunteerism of the CFA community. We do not take financial sponsors as contributions are voluntary, while CFA Institute and the Society provide crucial platform support.

For a “party” of this size, analyses, narratives, and viewpoints will naturally be diversified and, at times, opposing. We maintain that all contributions reflect the personal opinions of the contributors and should not in any way be construed as the views of the Society. On a sad note, we write with deep sorrow that the late Peter Phillips, a contributor, and a long-time volunteer of the Society, passed away after completing his submission. We thank him and every contributor for their time and support.

We also thank all the volunteers who have contributed to the founding and growth of the Society 30 YTD. Notable credits must go to George Long and Richard Mak, among others, for their helmsmanship, and, on occasion, personal guarantees and club memberships for events and office expenses the Society incurred. We look forward to another fruitful 30 years to come.

Alvin Ho, Chief Editor
Alfred Lau and Felicia Wong, Editors

Dedication

To Dad and Mom, for bringing and shaping me up; to Pheona for allowing me to indulge in my interest and hobbies with dubious NPVs—AH

To my peers, that we have learned together and helped each other over the past two financial crises—AL

To my family, who taught me to be resilient; to all who have inspired me along the way—FW

Section 1

Introduction

Chapter

Photo credit: Christiaan Hart

7.1

From a Fishing Village to the IFC Mall

— Alvin Ho, CFA

Hong Kong famously came to be called the world's freest economy by Nobel Laureate Milton Friedman, as Richard Wong, one of the leading Chicago disciples here, recounts recently (Wong, 2017, p. 3).[1] However, debates have been around about what the "free-ness" of Hong Kong precisely means. Many, including Paul Krugman, another Nobel Laureate, see Hong Kong as part of the Asian "miracle," spearheaded by Japan and later joined by the four Little Dragons, which employed a statist approach and drew "envy" (Krugman et al., 2018, p. 741-2). The future of Hong Kong has always been a subject of debates and conjectures, many sensational, some apocalyptic, but few prophetic.[2]

Social Contract under the Colonial Administration

As a colony ceded to imperialist Britain after the Opium War, the colonial administration ruled Hong Kong for about 150 years up to the return to China in 1997. Little was known about Hong Kong from the 1800s to the Second World War. Many British trading companies saw the colony as an entrepot to extract, trade, and export natural resources, including opium and other "illicit" products from China (Haggard, 1990, p. 116). After 1949 and the Korean War, Hong Kong's role as a trading port declined briefly because of the embargo employed by the U.S. against China.

However, the influx of people from Shanghai and Southern China to Hong Kong provided the city with new inputs for growth: capital and cheap labor. Hong Kong soon turned from a village shelter for merely 600,000 people in 1945 to an urban overcrowded city with a 2.3 million population in 1951, reaching over 7 million in the early 2010s (Wong, 2017, p. 22).

In concurrence with the pattern of global trade, which the Cold War dramatized, Hong Kong and the other Little Dragons followed suit with Japan and benefited from the demands of the postwar booms in developed countries. The rapid growth in light industries (textiles and electronics) in Hong Kong at the time maximized the transfer of private, mostly familial capital and technologies from Shanghai and other Chinese diasporas in the region to constitute the first wave of industrialization of the city.

This rise of Hong Kong is characterized economically as export-led and laissez-faire. Politically, the role of the colonial government in many ways resembled that of Japan and the other Dragons. Near absolute political or governmental autonomy vis-a-vis the society, especially on economic policies, was entrenched and preserved. However, in the case of Hong Kong, the explicit exercise of that absolute power had been rare. Lau Siu-Kai, a sociologist who later became a senior policy adviser, postulated a model of a “minimally-integrated social-political system” that underpinned the governance structure of the time (Vogel, 1993, p. 60-67, 80; Haggard, 1990, p. 116-123; Lau, 1983, p. 545).

The *doctrine of positive non-interventionism* described by the then Financial Secretary Philip Haddon-Cave in 1976 illustrates the have-the-cake-and-eat-it playbook whereby the government might intervene where it saw fit.[3] The doctrine came out of expedience for the small colonial office with limited, trusted expatriate staff and few policy tools. However, the essence of this "self-proclaimed" overall non-intervention framework was that the government would actively or positively intervene where markets were considered to have failed.

"The end of an era [of the economic miracle]" in the 1990s caused some to label the period a "myth" instead (Vogel, 1993, p. 94). However, Hong Kong was uniquely positioned when mainland China's 1978 open-door policy began to feed its impact first to Hong Kong and then to the globe. While Japan and the other Dragons each struggled with the changing demand and supply conditions, Hong Kong benefited from the opening of this massive hinterland. The city grew its manufacturing sector, albeit under a modified model. The labor-intensive, light industrial businesses were relocated to Southern China while the city's financial, client-facing, and auxiliary service-oriented sectors prospered.

The model was bolstered by a relatively clean government, a common law-based judicial system, and the high efficiency of its workforce, composed of the post-war baby boomers of the 1950s. Maturing workers, executives, and business owners were just about to take up their roles in an economy migrating from primarily manufacturing activities to tertiary or service-oriented business models. This "Second Reorientation," underlined by the structural metamorphosis, propelled the city forward. These new immigrants gradually released substantial demands for housing, mortgage, and other financial services, boosting the development of the property and banking sectors.

This was when the service industries in the city began to emerge, get into shape, and put their stamp on the global trade flows.

Passing the Batons from Hongs to Homegrown Capitalists with a Peg

Until the late 1970s, British trading companies, or hongs, and banks from England dominated Hong Kong's business and financial scenes. These hongs controlled many aspects of the economy, from airlines and public transport, to telecoms, banks, and dairy products. Emerging local businessmen, however, took advantage of the shifting market forces of the city. Notably, some local industrialists emerged to seize the opportunity left open by some retreating foreign moguls. This was perhaps best marked by Cheung Kong's HKD 639 million takeover of Hutchison Whampoa, a struggling British conglomerate held by Hong Kong Bank (which was later renamed Hong Kong and Shanghai Banking Corporation, or HSBC). [4]

Together with a few visionary industrialists and property developers, this group of homegrown capitalists, some tracing their birthplaces to mainland China, grabbed control of such crown-jewel assets as Wheelock (property), China Gas (utility), and HK Electric (utility).

Meanwhile, the city's economic infrastructure and institutional set-up had evolved commensurate with its needs. Perhaps the most important was establishing the currency board system in 1983. It was a time when the protracted negotiations between the British and Chinese governments about the future of Hong Kong faced challenges. Amid a crisis in confidence, the pegging of Hong Kong dollars to the U.S. dollar under a linked exchange rate stabilized the scene. It helped the city to withstand repeated speculative attempts before the handover.[5] The unification of the stock exchange, the predecessor of the Hong Kong Stock Exchange, in 1986 also helped shore up the capital markets and consolidated the hitherto untidy listing venues and trading practices (Jao, 2001, p. 31-34, 74-82; Feng, 2017, 151-158, 276-287).[6] With its relatively neat and small geography, the city became a contender to be one of the world's major financial centers, jockeying positions with New York, London, and others.

Perhaps, the creation of the One IFC in 1998 can be called upon as an excellent witness to these developments.

First Crisis:[7] Handover to the Asian Financial Crisis (1997-98)

Deemed to have started on 2 July 1997, the Asian Financial Crisis of 1997-98 (AFC) hurt businesses. It brought extreme public market volatility across the region from Thailand, Malaysia, and Indonesia to South Korea, with ripple effects lingering on for years (Krugman, 2018; Jao, 2001; Napier, 2021).

In Hong Kong, 13 months after the AFC began, the local government staged an unprecedented intervention to buy shares publicly and fight off short-sellers (Chan, 2019). It was a resounding success, despite the heavy criticisms from Alan Greenspan and Friedman. While Hong Kong's real economy suffered from the AFC, a policy trilemma, or the "impossible trinity" (Mishkin, 2016, p. 519), restricted the government's options. The mechanism that could adjust for such a regional slowdown and the U.S.-led tightened interest rates would be the real economy. Hence, real and financial assets saw their prices plummet until 2003 when SARS hit Hong Kong hard.

If the previous phase could be called the "Second Reorientation," the post-2000s rise may justifiably be the third. This time, the service sector, particularly the financial and securities sectors, experienced a new iteration. With China's entrance to the World Trade Organization in 2001, and the policy under which Premier Zhu Ronji advocated "state-retreat-private-advance," a vibrant private sector in the mainland emerged. Its hunger for overseas listings and funding came to the forefront.

Street markets' exuberance rivaled capital market buoyancy. The relaxation of travel policies between the borders of Hong Kong and Shenzhen brought substantial purchasing power from the mainland. The spending naturally spilled over to property and stocks, a classic double play of Hong Kong for decades.

Second Crisis: Tides of the Global Financial Crisis (2007-08) [8]

Warren Buffett hit the nail on the head by saying, "It's only when the tide goes out that you discover who's been swimming naked." Therefore, when the tsunami waves broke, many bankers needed to borrow leaves (greenbacks) from central bankers to cover their exposed bodies. Quantitative Easing (QE) has thus become the hallmark of the decades since the Global Financial Crisis (GFC) occurred.

Locally, the GFC hit Hong Kong with a variant of the subprime crisis. Structured products such as Lehman's minibonds amounted to about HKD 6 billion spread across over 6,000 bondholders (Feng, 2017, p. 405). Other derivative products like accumulators, colloquially dubbed as "I-will-kill-you-later," were reported to have an estimated outstanding balance of USD 23 billion. These figures were naturally not too big to fail.

In the U.S., the center of the storm, the root causes must be manifold for a crisis of this magnitude. The more lenient critics would cite "notorious" financial engineering, adverse selections (agency problem), and asymmetric information of credit agencies as "causes," leaving many actors as onlookers (Mishkin, 2016, p. 320-1). Across the Atlantic, some elected to defend the system or the relevant actors by citing the concept of "intellectual capture," suggesting that regulators, bankers, economists, and analysts were intellectually blinded by the prevailing mathematical models (Kay, 2015, p. 236).

For others, the outbreak of the GFC was fundamentally a failure to supervise by the world's only superpower. Regulators were "negligent in spotting the build-up of…toxic assets," "failing to regulate…," and "complacen[t]," wrote Julia Leung when she was briefly at Harvard. At the heart of the "comprehensive" solutions deployed to deal with the "disaster" was an inconvenient truth about a "policy particularism…the reality of… reserve currency dominance." [9]

Perhaps in less overt terms, Liu He, then a researcher, wrote in a 2013 comparative study that crises like the Great Depression and the GFC were precipitated by disruptive technological changes, first and foremost. But then, Liu also drew on lax regulations and monetary policies, pre-crisis income inequality, politicians who succumbed to populism, and the self-perpetuating crisis pathology as the distinctive features of the GFC. Therefore, Liu concluded with three "policy ponders." Chief among them would be the changing opportunity set presented to China. Before the GFC, the set crystallized in exports and foreign investments. After the GFC, and especially with shrinking global demand, the set changed. On the one hand, China's domestic markets would become a lever for global recovery. On the other hand, opportunities for acquisitions in technology and overseas' infrastructures would arise (Liu, 2013). These "ponders" are prescient, and may have irked many hawks in Liu's future opposing ranks in bilateral trade negotiations.

The post GFC rise of Hong Kong, unlike the one after the AFC, was very swift. As an open economy, it was one of the primary beneficiaries of QE and its many variants prescribed by actors across the globe. Bankers had seen IPO deals sealed quickly and unicorns sprung up from nowhere. However, torn between further relaxation (to stay competitive), vested interests and risk management, certain systemic weaknesses, such as land supply and gate-keeping functions of financial regulations, persisted.

Third Crisis: Unprecedented Pandemic-led Crisis (2020-Present)

While easy money had numbed investors to economic or financial risks, near-invisible droplets caused a black-swan event that spoiled the party. First reported in Wuhan, China, COVID-19 quickly spread through the world despite the World Health Organization declaring the contagious disease a Public Health Emergency of International Concern in January 2020 and a pandemic in March 2020.

Globally, major indices invariably corrected "unprecedently," as the crashes were unmatched by any previous events of a pandemic nature (Baker et al., 2020). Many studies pointed to the implementation of lockdown, social distancing, and other restrictive policies as the causes of the destructive force. Locally in Hong Kong, the pandemic came hard on the heels of nearly 18 months of upheavals described as "unprecedented pressure" by the city's leadership in the 2021 policy address (Office of the Chief Executive, 2021). While the city's bellwether Hang Seng Index did react negatively in July 2019, the tumble in March 2020 was twice as much. Major indices saw some swift rebounds as mainland China was seen at the time to be the first to come out of the woods. With its digital economy turbocharging, and exporters benefiting from its vast and stable supply chain, the statist model drew praise and envy briefly. However, 2021 saw a series of domestically derived "iron-fist policies" hitting many business forerunners whose shares were owned by international investors. These included the big-and-partially-failing property conglomerates and the tiny insect-like microlenders. The trends continued into 2022, when the return of inflation surprised a few people.

As events unfold, the city of Hong Kong, just like 180 years ago, sits right in the center of barters, exchanges, and diplomacy, on the one hand, guns, germs, and steel on the other. At this historic juncture for CFA Society Hong Kong, this volume aspires to serve one overriding objective—to tell our history and the rises, our ways. Each of the articles is written with reason, professionalism, and passion. They contain the stories we would save up and tell our grandchildren.

Section Outline

This volume comes in five sections. Section 1 here (and above) is a quick introduction. To further set the scene and exemplify the Society's volunteerism, our volunteers have compiled a table of Hong Kong's "then and now":

Data	Unit of Measurements/Explanation	1997-98	2007-08	2019-21	Source
Index Performance					
Dow Jones	% From Peak to Bottom	-21.00%	-47.50%	-38.40%	Bloomberg
S&P 500	% From Peak to Bottom	-22.40%	-53.00%	-35.40%	Bloomberg
Hang Seng Index	% From Peak to Bottom	-53.00%	-66.60%	-41.50%	Bloomberg
Shanghai Composite	% From Peak to Bottom	-32.10%	-72.80%	-23.30%	Bloomberg
Data: Big and Small					
CFAHK membership	Numbers of members at year end	337.0	5,294.0	6,661.0	CFA Society Hong Kong
Transportation traffic numbers	Daily Patronage (million)	10.3	11.4	8.9	Census and Statistics Department
Number of Regional Headquarters	# of firms	819.0	1,298.0	1,504.0	Census and Statistics Department
Emissions	Kilotonnes CO2-e	36,000.0	41,500.0	33,800.0	Hong Kong Government
Price of Baked Pork Chop Rice	HK$	21.0	27.0	44.0	Café de Coral, hk01.com
HKEX's average daily turnover	HK$ (billion)	10.7	72.0	166.0	Hong Kong Exchanges and Clearing

Figure 1: 30 years of Hong Kong in Numbers
Source: Various as cited (complied by volunteer Daniel Chan, Alfred Lau and Felicia Wong.)

Surprised, hey?

Section 2 aims to provide the macro foundations on which the city of Hong Kong operates. In Chapter 2.1, Nick Pollard discusses his views on leadership and experience across crises interactively, including a chartered-flight rescue act when Hurricane Ivan hit the Caribbean region. Christine Loh, in Chapter 2.2, employs the lens of “One Country, Two Systems” to examine the evolving natures of Hong Kong’s governance and policy responses during the three crises, concluding with a touch on the HKD peg. In Chapter 2.3, Jim Walker draws on the experience of the AFC and GFC to advocate his Austrian economic view that these crises are themselves the recoveries, and that destruction and defaults are indeed part of the creative process. In Chapter 2.4, Rocky Tung, Wivinia Luk, and Joyce Lee will discuss their lessons learned and consider the impact of technology changes on current challenges. Chapter 2.5 contains extracts from Russell Napier’s 2021 book on the AFC, for which he prefaces and adds a new reference to how the errors of reasoning have shaped the crisis and the aftermath. Hongbin Qu, in Chapter 2.6, shifts the focus to the mainland and discusses how before the GFC, Premier Zhu Rongji’s bold engagement with SOEs and big banks during WTO entry helped to deepen China's reform and indirectly cushioned Hong Kong from the global turbulence. In Chapter 2.7, Eric Lui charts and graphs the trajectories of global finance, showing how the "don't fight the Fed" mantra seems to have run its full course. Closing the section are Jeffrey Ng and Kevin Ow Yong, who in Chapter 2.8 account for the pandemic tale of two cities in a revived duel between Hong Kong and Singapore.

Section 3 comprises essays that reflect on the process of capital formation, i.e., the ecosystem of the sellside. Leading the pack is Erwin Sanft, who in Chapter 3.1 recalls his lonely moments in tracking mundane, earthly materials like cement and coal before the commodity booms took off. Hot on his heels in Chapter 3.2 is Candy Wong, who, in addition to reliving her personal AFC diary, gives an account of how she sees HK will survive or struggle by firstly looking inwards at the city's pension system and secondly by staying ultra-cost competitive. Water Cheung will follow up in Chapter 3.3 by recounting his crisis management in derivatives trading, structured credit products, and boutique merchant banking, concluding with four pairs of outs and ins. In Chapter 3.4, Mariana Kou presents in motion-picture style her roller coaster-like career in equity research from New York to Hong Kong, culminating in a switch to investment amid some sector upheavals. Striking a chord, David Ching, in Chapter 3.5, provides his witness statements on the lethal calls from HR at Lehman London and, more recently, the uneasy rhythms of the Fed's interest rate maneuver, blockchain, and web3. It is Agnes Tai who, in Chapter 3.6, reminds us of the days when a premier Hong Kong investment bank rose above its global and local peers by, among other things, sleepless nights in Central, and draws the comparison of the talent crisis. Bringing an Indonesian flavor to the volume, Simon Saputra, in Chapter 3.7, cites his early appreciation of living on the rich supplies of the "New York of Asia" and the similarity of Orang Kaya Baru to the Chinese new rich.

Section 4 has the shortest sectional word count, appropriate to the fact that it is coming from the buy side, or capital deployment in systemic terms. Kicking off for the group is James Soutar, who befittingly takes us back to the closures of the stock exchange in 1987 and draws a comparison to the present-day COVID-19 prevention measures with unintended consequences in both episodes. In Chapter 4.2, Ronald Chan tells of an incident where investors' forced liquidation turned out to be a blessing for the money manager in terms of performance and character building. From one incident to all seasons, Peter Phillips begins with a 45% drop in the HSI. He closes Chapter 4.3 by asserting, almost religiously, that a crisis of any magnitude will occur again, but the city of Hong Kong will manage. Sean Debow, who completed the CFA program in tandem with one of the editors here, adds rich anecdotes in Chapter 4.4, including the unsteady taxi ride to the Grand Hyatt Jakarta and the importance of on-the-ground, in-the-heart-of-the-storm research capability for all styles of investment. Lin Ning goes for singularity rather than multiplicity by zooming into his moments on 12 September 2008, the last business day of Lehman Brothers. In a no-nonsense way, Alex Au writes in Chapter 4.6 a mini random walk on Stanley Street, tracing the changing investor mix, the "A-share-rization" and the self-imposed high trading costs of the Hong Kong bourse, and closing his piece with some question marks. At the section's end, Song Shuang provides a refresher by citing her recent involvement in a CFA Institute's ethics campaign, highlighting a crucial fiduciary aspect of money managers.

Section 5, the last section, addresses the in-trend alternatives that cover private assets, real estate, and ESG. In Chapter 5.1, Janet Li braces for the storm and appraises the need for diversification, dynamic asset allocations, and portfolio-based lifelong learning. Going into the specific asset class, Alvin Ho, in Chapter 5.2, dives into the 30-year deal havoc of private equity in Greater China, where he sees Hong Kong as a center of gravity for capital in the past and a turbocharged connector going forward. This is expanded further by Scott Peterman, who in Chapter 5.3 discusses the untapped limits of the VC funding model, the broadening use of public markets, and the numerical and real potential of wealth management in the Greater Bay Area. In Chapter 5.4, Victor Yeung and Patrick Ma, in a joint effort, provide a detour to the three crises through their unique REIT roadmap, commenting that as globalization has run its course, the search for new titans should have begun yesterday. In Chapter 5.5, Ace Liu plies his crisis management skills on high-yield bonds, an asset class suffering heavily from real estate retrenchment in mainland China. On a different note, Priyanka Sanchania, a strong advocate of ESG, dissects in Chapter 5.6 opportunities arising from moving the measurements and motors of ESG closer to everyday actors in order to see the bangs for the buck. Closing the section is Ming Liang who in Chapter 5.7 provides an optimistic assessment of Hong Kong's role in the internationalization of the RMB, a currency of growing importance.

The complementary nature of these articles highlights the contributors' quality and shared passions. At the same time, the diversity in opinions and backgrounds speak volumes for the Society as a melting pot. We learned immensely from reading all the drafts and enjoyed corresponding with and, at times, hunting down the contributors, whether they were in Edinburgh, L.A., London, or Seoul. I cannot express my gratitude enough to each of them for their excellent and voluntary work.

Acknowledgments

In preparation for the article, the author has benefited from the insights shared generously by Dr. Tsun Se Cheong, Prof Terence Chong, and Richard Mak, CFA. All mistakes and omissions are mine. Research assistance for the table is credited to the respective individuals as cited. We also commend the efforts of the Café De Coral team, who dug into their corporate archive for a taste, showing remarkable longevity. Last but not least, for the digital version of the insert pages, Christiaan Hart's portraits of trams artistically blend tranquility, velocity, and visibility, capturing the sunrises after storms. The Society thanks them for their contributions.

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Notes

1 Friedman produced a TV series in the 1980s and spent an entire episode on the free market of Hong Kong. His opening line was famous, “if you want to see how the free market really works, this is the place to come.”

2 In June 1995, Fortune announced the “Death of Hong Kong.” The Economist reported on 29 June 2022 that Hong Kong lost out in two of the magazine’s three “measures” of Asian financial centers. Two days later, on the city’s handover day, it postulated that Hong Kong is under “an anatomy of erasure.” It is so because, as it writes, the city is “seen ever less as an engine of growth.”

3 Such doctrine could be a source of confusion to the public and observers (including perhaps the Nobel Laureate?) that the colonial administrators might appear to actively refrain from intervening in the market. This is “lost in translation,” wrote Anthony Cheung, a professor who had once joined the government (Cheung, 2021, p. 110).

4 The size of the plastic flower maker, a young, listed company of just HKD 700 million, earned the deal such colorful acclaim as “snake swallowing elephant” by business historians. (Cheung and Wong, 2007, p. 368)

5 Historians count that there were five speculative attempts between 1984 and 1987, and many other regional and global financial crises had repercussions in Hong Kong before 1997 (Feng, 2017, p. 286).

6 However, as some contributors of this volume will write, the 1987 stock market crash presented the city with a major crisis for its still nascent bourse.

7 The word “first” is necessarily contextual to this publication only. There were many crises, financial or otherwise, that took place before 1997, such as those in 1967, 1973, and 1987.

8 The events in 2007-08 are also sometimes referred to as the Global Financial Tsunami. In this book, we adopt the more common contemporary usage.

9 The consequence of this dominance, Leung commented, is that it is “[a]ble to print as much money…that no other countries…could follow.” The “spillover effects of …QE2 and QE3…outweigh the benefits, as surging capital inflows [to the rest of the world] have…driven up debt levels…and their disruptive reversals may destabilize financial markets” (Leung, 2015, p. 13-24).

Section 2

Setting the Scene

Macro Foundations,

Country and System,

East and West

Chapter

2.1
Leading through Crisis: A Q&A with Nick Pollard

— Nick Pollard

During times of crisis, strong and agile leadership is necessary to help teams and organizations navigate through uncertainty. Successful leaders must be able to embrace fear and change, adapt quickly, and transform challenges into opportunities. Nick Pollard, Managing Director, Asia Pacific, CFA Institute, offers insights and inspiration on how to accomplish this.

INTERVIEWER Can you share some insights and ideas that can help leaders stay strong and resilient in times of great uncertainty?

POLLARD I think crisis comes in all shapes and sizes. In situations that demand someone seizing control, you need to know who you have around you, and engage those people quickly, so that they have the ability to contribute; be as open as you possibly can with them; and communicate constantly. Find some unifying objectives that people can latch onto. In the aftermath of the Global Financial Crisis of 2007-08, I came out to Asia-Pacific. I worked for an organization that was very client-centric, and had some very strong and longstanding client relationships. For us, that unifying objective was preserving the bank, and preserving the relationships we had with our customers. It begins by having a great team around you, finding a shared objective, and communicating all the time about the progress you're making towards it.

INTERVIEWER Who did you turn to for advice and counsel in crises? What lessons did you learn, and do you still apply them?

POLLARD When the Global Financial Crisis of 2007-08 happened, I was the managing director of the front office of Coutts in London. In that very first week, we organized two investment conferences in our offices. People were angry, and scared, and many of them had a great deal of their wealth with us. A customer got particularly vociferous, and I was listening to this very aggressive question and thinking, "How am I going to answer this?" Before I did, another customer stood up and said, "I know we're all scared, but these guys are here in the room. I have four other bank accounts. None of those bankers are talking to me. I have no idea what's going on." The magical impact of that was that it's not me being defensive. It's another customer saying how much they appreciate just the fact that we're present and listening. It was a real turning moment in that conversation, and the mood in the room changed. The lesson from that is that you need an element of courage that you're going to have to front up to what the challenges are.

INTERVIEWER Leaders or organizations handle crises with different results. What do you think led to their success or failure?

POLLARD An aspect of crisis I like is the immediacy of decision-making. You've got to make a decision there and then to be able to get through this.

18 years ago, Hurricane Ivan hit the Caribbean region, including our Cayman Islands office. We decided we were going to send a plane to the Cayman Islands to get our people off. I volunteered to go and make this happen. I flew to Fort Lauderdale and chartered a Boeing 737. Our businesses in the U.S. had also sent three trucks of clothing, food, and medical supplies, which we distributed to the locals in the Cayman Islands. When we landed there, about 100 people got on the plane. We still had 200 or 300 seats left, so we offered to take anyone there to Miami, and about another 100 people got on. It was that instant decision-making that I found totally liberating. It was exciting, swift, and there wasn't a right or wrong.

INTERVIEWER In what ways can the investment profession best serve their clients during times of crisis?

POLLARD First of all, you need talented and trained staff. The skills you learn as a CFA charterholder are going to be ones that give confidence to your customer that you know what you're talking about. To help people through difficult times, you need to prepare them for what those times may look and feel like.

The Global Financial Crisis was a bit of a shock. I think people are a lot more informed now about why that happened, and their banks have told them about why that happened. Do they feel any more comfortable that it won't happen again? Probably not. But at least they have an idea of what they may go through. Really good organizations also educate their customers, as much as they train their staff.

INTERVIEWER What changes do you expect to see in leadership post-COVID-19? Why?

POLLARD Communication, because it's not all going to be face-to-face in the way that it was. Travel, in my view, is not going to go back to what it used to be, because we proved that we don't need it. We're all going to learn to communicate better. From a working-from-home perspective, we've learned that you can do so much by working remotely, but nothing supplements that kind of conversation in the pantry that you just can't do when you're at home.

2.2

Anatomy of Three Crises and "One Country, Two Systems"

— Christine Loh

Introduction

While the Basic Law provides the framework for how the Hong Kong Special Administrative Region (HKSAR) is to function from 1 July 1997, it needed actual situations for details to be filled out. A recurring question before and after 1997 is whether Hong Kong would "survive" under Chinese sovereignty. The concern was that the mainland would "interfere" even though Article 22 of the Basic Law provides an explicit policy of non-interference. Now that the HKSAR has been in existence for 25 years, it has become clearer that the notion of "non-interference" as the yardstick to measure the potentials of the HKSAR doing well, is overly simplistic, because the world does not stand still and the reality of constant change requires adaptation. This essay looks at three episodes that Hong Kong experienced as part of larger regional and global crises. They are analysed from the perspective of the evolution of the "one country, two systems" principle and what observations could be made about Hong Kong's survivability as a part of China.

a. The Asian Financial Crisis 1997-98

Trouble had been brewing in the background before the storm hit in mid-1997. Asian economies were overheated and had overborrowed. Currencies were overvalued. These conditions created vulnerabilities that international speculators sought to exploit. The crisis started in Thailand in May 1997, when traders and hedge funds betted against the Thai baht, which was pegged to the U.S. dollar. As pressure mounted, Thailand was forced to unpeg its currency on 2 July 1997, which led to a massive devaluation of the baht. Traders made speculative attacks on other currencies too that rocked the economies of Indonesia, Malaysia, South Korea, and the Philippines. Stock markets collapsed, and capital flowed out of Asia. Most memorable was Malaysia imposing capital control. It may be said that Asia was unready at the time for “liberalized” capital markets, where hot money could sweep in and out.

Hong Kong was not spared. Real estate prices had ballooned, and stock prices were inflated. International sentiments were against Hong Kong surviving well as a part of China. As Hong Kong watched the crisis unfold in Asia, speculative activities started to focus on the city in August 1997, and pressure intensified in October. To defend the Hong Kong-U.S. dollar pegged exchange rate system, interest rates had to be raised. Financial professionals will remember Black Thursday, 23 October 1997, when the overnight HIBOR shot up to 300%. Raising interest rates did stop speculative activities for a time but it was not possible to keep interest rates high as the cost to the whole economy would be considerable. Speculators returned in 1998 with a new strategy – they were determined to test the Hong Kong system. They first talked down market sentiments before attacking the currency and stocks at the same time. Trading volumes and stock market values started to drop, creating a double whammy for Hong Kong.

Hong Kong's financial regulators came up with a strategy to defend the Hong Kong system that the market did not expect. On 14 August 1998, the government entered the market to buy HSI constituent stocks and futures. Having a buyer immediately buoyed the market. No one knew the identity of the buyer until it was revealed by the Financial Secretary, Donald Tsang, and the head of Hong Kong Monetary Authority, Joseph Yam, after the market closed that day. The government continued to buy over the next ten trading days, ending on 28 August, accumulating tens of billions of U.S. dollars' worth of stocks. This had the desired effect – speculators went away licking their wounds; they realised they could not break Hong Kong.

Reflections on the 1997-98 crisis

With the passage of time, we can see the "Big Picture" more clearly:

1. The health of the Hong Kong dollar is an important indicator of political and socio-economic stability. The peg system was created in 1983 to provide confidence in the future of the city and had to be defended at all costs. This was vitally important in 1997-98.

2. Beijing backed Hong Kong in an existential crisis. The then premier, Zhu Rongji, told local regulators that the mainland's foreign exchange reserves would stand behind Hong Kong.

3. The "free market" could not be used as a guise for wanton destruction, and governments have a duty to intervene in the public interest.

Hong Kong's critics included major international opinion leaders at the time, such as Nobel Laureate economist, Milton Friedman, and the then chairman of the U.S. Federal Reserve, Alan Greenspan. A major speculator at the time was financier George Soros and his Quantum Fund. Soros admitted some years later that Hong Kong did a good job to thwart his efforts to undermine the currency and stock market, although he insisted that he had the right to do so. Greenspan wrote in 2001 that Hong Kong made the right call in 1998. Joseph Yam explained that, "financial globalization, while enabling the international diversification of investments, has its ugly side. Free markets are not markets to be freely manipulated."

The Global Financial Crisis in 2007-08 showed why Hong Kong made the right call a decade earlier. Many of the critics of intervention in 1997-98 supported bank bailouts and asset/deposit guarantees a decade later when they could see the risks to their own financial systems and economies. The immediate cause of the crisis was the collapse of subprime mortgage market in the United States, but it could also be said that it was greed and longstanding regulatory failure that permitted the massive build-up of bad mortgages that led to the crisis that rocked America. The bailouts included huge government purchases of "toxic assets" and shares. The spillover effect had a big impact on a number of European economies.

In 2018, some hedge funds shorted the Hong Kong dollar, believing that the HKSAR's foreign exchange reserves were low. Their attack was unsuccessful once more and suffered major losses.

b. Remembering the SARS Epidemic in 2003

SARS (Severe Acute Respiratory Syndrome) was the first epidemic outbreak of the 21st century. Hong Kong had just about recovered from the Asian Financial Crisis. The economy was chugging along when SARS spilled over from Guangdong Province in February 2003. Hong Kong was seen as the epicenter of SARS because, as an open society, news circulated freely, much of which spelt "doom and gloom," encouraging yet another "end of Hong Kong" narrative.

The World Health Organization (WHO) imposed a travel advisory on 2 April 2003 covering Hong Kong and Guangdong. Hong Kong became a "ghost town" – Fitch Ratings downgraded its sovereign outlook from stable to negative, Malaysia imposed a travel ban on Hong Kong, a university in America would not accept summer students from Hong Kong, Hong Kong exhibitors could not participate in a trade show in Basel, a trade show in Las Vegas had reservations about allowing participation of Hong Kong exhibitors, and Hong Kong athletes were banned from the Special Olympics World Summer Games. The travel ban was short-lived, and decisions were subsequently reversed for the Las Vegas trade show and Special Olympics, but in totality, the SARS experience made Hong Kong people feel like pariahs, putting enormous emotional strain on them.

SARS killed 299 people and hospitalised over a thousand people in Hong Kong. Nevertheless, Hong Kong's scientists played a major role in the identification of the SARS coronavirus. SARS was contained after several months. While the sudden freeze in economic activities was disconcerting, especially for the travel and hospitality sector, the Hong Kong economy recovered quickly.

Non-interference as a structural weakness

The experience of SARS showed the policy of non-interference between the mainland and Hong Kong presented a structural weakness of "one country, two systems" that needed to be corrected. There was no structure in place for public health communication between Guangdong and the HKSAR. No one on either side had identified at the time that there could be public health emergencies when the two sides would need to cooperate. The level of risk appreciation for infectious diseases affecting the region was low.

When SARS emerged, the HKSAR authorities tried unsuccessfully to contact their counterparts in Guangdong in February 2003 before asking Beijing to help but to little avail. It wasn't until 11 April that an agreement was reached between Hong Kong and Guangdong to exchange information about diseases, cooperate on medical issues, create a disease notification system and set-up a border quarantine. This groundbreaking agreement was important because Hong Kong had little previous contact and knowledge about the system on the mainland, and mainland officials were not supposed to, and did not have the habit of, reaching out to their Hong Kong counterparts. The SARS outbreak was therefore an episode in the ongoing transition for Hong Kong to be a part of "one country" that nevertheless functions as a highly autonomous second system. The lesson was how to create structures and relations that enabled effective communication and cooperation in a public health crisis. Beijing needed to play an overarching role to bring the authorities in Guangdong and the HKSAR together, which it eventually did in mid-April with President Hu Jintao's visit to Shenzhen. Since SARS, mainland and Hong Kong scientists have been cooperating more intensely in conducting research on infectious diseases. Moreover, the mainland further relaxed tourist visits to Hong Kong, especially residents of Guangdong, as a measure to help boost the post-SARS economy.

c. Pandemic-led Crisis 2020 - Now

At the time of writing, the world has yet to fully come out of the COVID-19 pandemic. SARS 2003 was like a test run for Hong Kong of what to do in an infectious disease outbreak. The reaction from the local authorities was fast when news emerged that there was a new disease in Wuhan. While the Wuhan and Hubei authorities were at fault for not coming clean about the emerging outbreak immediately, the central authorities took control on 20 January 2020 and mobilzed massive resources that contained the new coronavirus on the mainland by April-May 2020.

When much of the world was locked down in 2020, Hong Kong was a safe haven where life continued, albeit with various masking and social distancing restrictions. However, the inability to travel became a major inconvenience, especially for international business that use Hong Kong as an operating base, as other jurisdictions started to relax restrictions towards the latter part of 2021. Critics argued that Hong Kong's strict travel-cum-quarantine rules could put Hong Kong's international finance center standing at risk, given that the competition—Singapore, London, and New York were "living with COVID" as their vaccination rates rose. It did not help that Hong Kong had high infection rates and numerous fatalities from the highly transmissible Omicron in early 2022. An alarming aspect was the rapid escalation in the daily COVID death rate to one of the highest levels in the world. By early February 2022, the Hong Kong authorities had to ask the mainland for help in dealing with the massive surge in cases. The mainland responded by providing wide-ranging assistance to the HKSAR. While it was fighting a surge of Omicron cases in various locations on the mainland, the authorities sent experts to Hong Kong to understand the situation and provided advice. The mainland also sent manpower to help with testing services and at care homes, while ensuring that food and medical supplies were delivered to Hong Kong. The high infection rate had depleted local manpower for in health and cross-boundary transport services.

Betwixt and between

COVID-19 provides an important picture of "one country, two systems." China's approach to the pandemic has been and remains unique in the world. Its early lockdown of Wuhan and Hubei crushed the virus in 2020. As COVID-19 swarmed the world, China was able to relax restrictions by April 2020, although travel in-and-out of the mainland remains restricted even today, including from Hong Kong. China had developed a zero-COVID policy that involved mass testing, tracing, and quarantining. It started to vaccinate people in 2021 when a local vaccine using traditional technology became available. When the highly transmissible but milder Omicron variant appeared, Western countries shifted to "living with COVID" as vaccination rates were high, and hospitals could cope. China continued to fight COVID-19 through aggressive testing to identify the sources of infection and with targeted lockdowns. China is not yet ready to "live with COVID" as its healthcare system would be unable to cope if infections spread as predicted by epidemiological modelling although by late August 2022, the mainland was beginning to show a measure of relaxation even though there were outbreaks here and there.

Hong Kong stands betwixt and between the mainland zero-COVID strategy and pressure to open up travel as an international finance center and business hub. The challenge for both Hong Kong and the mainland is to do much better with vaccinating the elderly, who are more vulnerable to infection. It is a critical step to further relaxation. Hong Kong could well be the first part of China to do so (steps are underway at the writing of this essay), and yet, Hong Kong should not be a source of infection leakage to the mainland. What is comforting is that should the Hong Kong system be overwhelmed by an emergency, the much larger mainland system would provide a backstop to provision of food and essential supplies, including manpower.

Conclusion

The three examples noted in this essay enable us to draw several broad observations.

Firstly, the successful implementation of “one country, two systems” is an on-going process of adjustment for both the HKSAR and the sovereign power in Beijing. The national government has an interest in the HKSAR doing well under the “one country, two systems” principle and would come to its aid when needed. While the HKSAR exercises day-to-day autonomy in the management of local affairs, it makes sense for the HKSAR and the mainland to strengthen communication and cooperation in areas that could have regional or national impacts.

Secondly, the notion of “interference/non-interference” as the yardstick to measure Hong Kong’s survivability was always overly simplistic—every society must adapt to constant change. Hong Kong itself must adapt to not only change within its own society but also rapid change on the mainland. It is a relatively new experience for Hong Kong people to be part of a large nation that is reforming at speed across the board. To see Hong Kong’s future through a narrow lens of “interference/non-interference” would limit thinking about both risks and opportunities.

Thirdly, while the U.S. dollar peg has helped to maintain confidence, it forces Hong Kong to cede monetary policy to the Federal Reserve. In 2022, Hong Kong has had to intervene in a major way to support the peg. The economic cycles of America and Hong Kong are not always in sync, which means Hong Kong could not use monetary tools to suit its own needs, which is why there are periodic debates about whether Hong Kong might consider alternatives. This debate will continue, and Beijing will presumably have a view on this important issue.

Lastly, there are circumstances in geopolitics and geoeconomics that are exacerbated by many complicated forces that affect Hong Kong and the world, such as the Russia-Ukraine crisis, and rising tensions with respect to U.S.-China relations, especially as it affects Taiwan. The governance of the HKSAR requires having a heightened sense of such risks to our economy.

Hong Kong needs to develop local talent and competence to be able to assess risks and to have strategies to deal with them, as well as to recognize and capture opportunities. This essay provides three examples in the hope that they might enable deeper reflection on the implementation of “one country, two systems.”

2.3
A Tale of Two Crises

— Jim Walker

"In short, and this is a highly important point to grasp, the depression is the 'recovery' process, and the end of the depression heralds the return to normal, and to optimum efficiency."
— Murray N. Rothbard, America's Great Depression

The accepted wisdom among mainstream economists is that the boom which follows crisis is the recovery. That is not the case in my world of Austrian economics. In that world, it is the crisis itself that is the recovery process. It is the "destructive" part of Joseph Schumpeter's famous creative destruction process. It is an essential feature of the boom-bust cycle which removes bad companies from the system, increases bad debts in the banking sector, and lays the groundwork for a sustainable recovery. Human nature being what it is, increasing bad debts in the financial sector are not viewed positively and policymakers try to avoid them at all costs. But as history would show, this is the only way that debt disappears—through default, not repayment.

Moreover, each new boom is equally unsustainable. They sow the seeds of their own downturn as overexuberance and policy mistakes lead to a renewed buildup of debt. Booms and busts are just an integral part of the capitalist system. Again, this is where Austrian economics further departs from the mainstream: economic cycles are internally generated (in economics jargon, they are "endogenous") and not at all reliant on "exogenous" events like the COVID-19 pandemic, Ukraine war, or unusually large movements in oil prices.

In the Austrian economic cycle, it is the squeeze on profits, typically the result of too much credit being poured into the system in specific areas such as housing, that naturally brings the boom to an end. When that happens, recessions follow because profits drive investment, and investment, not consumption, drives the economic cycle.

But not all crises are the same, even though they are usually generated by the same factors. Let us look at two that have taken place over the last twenty-five years to show (a) how the system can be cleansed and rebooted, and (b) how the original crisis can just keep on rolling because of policy mistakes.

1997: The Asian Phoenix

Twenty five years ago, on 2 July 1997, the era of the Asian Miracle came to a crunching end when the Thai baht was forced off its de facto peg to the U.S. dollar. The ramifications of abandoning the peg were immediate and severe for Thailand, but soaring interest rates, currency instability, economic distress, and, in one instance, political upheaval, then spread around the region. By the end of the year, Asian currencies had been trashed, and recessions were under way in Hong Kong, Korea, Indonesia, Malaysia, and Thailand. The Asian Tigers' teeth had been pulled.

The warning signs had been on the wall for some time. The Mexican peso crisis of late 1994 was the canary in the coal mine for emerging-market quasi-fixed exchange rates. The boom in import demand caused by an overvalued currency resulted in a balance of payments crisis and, ultimately, the collapse of the peso and widespread Mexican debt default. This prompted us to write a report at CLSA entitled, "Could A Mexico Happen In Asia?" The sub-title was, "Not Likely, For Now," but we warned that a crisis would probably take place within two to three years if policies weren't changed. We singled out Thailand as the weak link.

At the beginning of 1995, Asian economies looked relatively healthy. Inflation was moderate, current accounts were in surplus and economies were booming. But the fixed exchange rate danger was clearly there. The Mexico outcome could have been avoided by active policy management but that would have required lower growth and more currency volatility. Central banks were keen to keep the "miracle" going and, as a result, they failed to appreciate two things: first, that foreign capital, especially of the portfolio sort, could be fickle, and, secondly, given the opportunity, businesses will borrow at the cheapest interest rates available (surprise, surprise). That is especially the case if there is a divergence in local and international interest rates while an exchange rate is perceived to be fixed.

During 1995 and 1996 the Asian boom continued. It had been on the go for fully six years by that time. We were told, as analysts worried about rising inflation and overheating signals, that there was no need to fret. The quasi pegs (and currency board in Hong Kong) had been around for a decade and they had delivered unprecedented economic growth, not to mention stability. The problem was that local interest rates had to rise to address the higher consumer price inflation but, in turn, the fixed exchange rates encouraged businesses to borrow in U.S. dollars. The credit boom, always an accompaniment to crisis, was not damped by higher domestic rates but fed by cheap, offshore borrowing.

However, that was not what caused the bust. As always, the bust arrived because corporate profitability began to fail. Rising costs, in response to local inflation, squeezed margins, and the ongoing boom encouraged more and more companies to enter the red-hot sectors in the various economies, mostly property. With rising competition for resources and increased supply relative to demand, profits were hurt even more. Local banks belatedly recognized that corporates were in distress and began to pull loans. That exacerbated the distress and, the final nail in most emerging market crises, encouraged savvy local businesspeople exit the domestic currency and “diversify” into overseas assets.

Foreigners (speculators) are often blamed for triggering the Asian Financial Crisis of 1997-98, but that is quite wrong. It is always domestic actors that precipitate crises because they are much better informed about the difficulties that competitors/ suppliers/ financial companies are facing, and they have more assets in domestic currencies than foreigners. Offshore investors are usually the last to sell the currency in crises.

Rising from the Ashes

The economic downturn reached its peak in 1998. The International Monetary Fund (IMF) was called in to assist Thailand, Korea, and Indonesia. (Malaysia refused its help and instead imposed capital controls). As in Mexico, currencies corrected dramatically, and with the global economy in good shape —the U.S. and EU were both growing at 3-4% annually in real terms—Asian exports began to recover sharply. Capital spending was still subdued, property sectors were still in deep distress, but manufacturing industries and the services sector, especially related to tourism, boomed.

By 2003 Thailand had fully repaid its IMF loan. Indonesia and Thailand in particular—although the Philippines also followed a similar path—adopted strict fiscal deficit and government debt limits. Those remained in place until the outbreak of COVID-19 in 2020. Exchange rates were allowed to find their own level and, apart from Hong Kong, have floated in Asia, in a managed way, for the last 25 years.

The 5-7% real GDP growth rates of the pre-Crisis period have long gone, but solid performances across most of the region, and the rise of China as an alternative market to the West, have buoyed economic activity in East and Southeast Asia for the last two decades. When the Global Financial Crisis hit in 2008, not a single Asian financial institution came under pressure. Exports stuttered but economies were resilient, and the only question we have had over the last decade was why the word "Global" was used to describe a peculiarly Western and advanced economy problem?

Hard lessons were learned in the Asian Crisis: companies went bust, debts were defaulted on, and labor forces across the region suffered. The long-term government of President Suharto in Indonesia fell amid social unrest and violence, but by and large most Asian institutions and governments survived intact. Sadly, learning from crises is not a universal trait.

2008: The Western Leopard

Following the terrorist attacks on the U.S. on 11 September 2001, the Federal Reserve took the extraordinary measure of cutting the Fed funds target rate to 1.75%, its lowest level ever. (The target rate was introduced in 1982). It continued to cut rates through 2002 and 2003, stopping only at 1%. That rate was held steady, against all expectations, until mid-2004. Thus, the seeds of the U.S. sub-prime property explosion, and property and credit booms throughout Europe, were sown. As ever, excessively cheap credit and a policy encouragement for bankers to lend, lend, lend, were the makings of the next bust.

In December 2006 we published the first of our series of "Apocalypse" reports at CLSA. They were not popular internally (equity markets boomed for another ten months) and most clients thought we were talking nonsense (although some didn't put it as kindly as that).

Warning signals such as the inversion of the U.S. Treasury yield curve were ignored and, in our eyes, official tolerance of the U.S. property bubble smacked of extreme complacency, if not arrogance. Anyway, as with all booms, this one ended in bust—but a bust that nearly took the whole financial system with it. Mortgage companies and originators of mortgage-backed securities, mostly Wall Street stalwarts, failed to appreciate that house prices could go down as well as up. Their fellow bankers in Hong Kong could have taught them otherwise. But the experience of the last

60 years in the U.S. suddenly reversed. The collateralized debt obligation models couldn't cope with a negative price input. Large swathes of mortgage-backed assets became worthless.

By 2007 the U.S. was in recession but the worst of the crisis, which had then spread to Europe, hit in 2008. Unlike the Asian Crisis, though, there was no IMF discipline imposed on recalcitrant Western central bankers. Instead, the response to crisis was to bail out the system, not with penal interest rates like those applied in Mexico, Asia, Russia, Brazil, and Argentina in the previous decade, but with the cheapest money ever produced. Moreover, central banks didn't wait for low interest rates to encourage new loan demand: they just printed money out of thin air (quantitative easing) and bought government and other assets to "liquify" the system. Self-awareness and acceptance of error are not a feature of Western central bank policymaking.

But this was an entirely new response to economic crisis. The old notion of commercial banks being bailed out, but only with penal interest rates and severe strings attached, was jettisoned unceremoniously. Instead, it was savers that were abandoned. Those on fixed incomes who had saved for old age found themselves with no income flow as bank deposit rates dropped to zero. Thrift and careful financial planning were deemed the enemy. Saving was bad, borrowing was good. Fiscal discipline was out, risk taking was in.

The advanced economies recovered from the 2008-09 recession—although the role of China in producing much of the demand for that recovery is conveniently ignored nowadays—and pushed corporate and government debt levels to new highs in the aftermath (further reducing the ability of central banks to normalize interest rate policy). There were hiccups along the way, especially in southern Europe, but the process seemed to be relatively seamless and, apart from those pesky savers, relatively painless.

The promise at the outset of the era of extraordinary easy monetary policy was that central bank balance sheets would return to pre-crisis levels when "the time is right." It turns out that over the course of the last 14 years, the time was never right. As soon as central banks began to "normalize" monetary policies, strains in the system appeared quickly. Instead of the Fed's balance sheet shrinking, new rounds of quantitative easing were required to keep the system from imploding. A good primer on what has gone on behind the scenes in private equity and the repo market in the last few years is the book by Christopher Leonard, The Lords of Easy Money. It is well worth a read.

And as close-to-zero interest rates have persisted, the rise of zombie companies has become global. By 2016 the Bank for International Settlements (BIS) estimated that 15% of companies listed on advanced economy stock markets earned less in annual profits than the interest payments on their debt. Research undertaken by the Organisation for Economic Co-operation and Development (OECD) has shown that zombie companies stifle economic vibrancy by hoarding labor, using resources, and accessing capital through the banking system to the detriment of potential startups. Both economic growth and investment spending are reduced as a result. The long-term consequences of avoiding a shakeout in the recovery phase of the cycle, i.e., the crisis, was lower growth, lower productivity, and lower company formation rates.

New Spots Now?

The economic and financial crisis of 2007-09 has never been truly addressed. The world has moved from easy money policies to ultra-easy money policies, and then, in a coup de grace, to the response to the COVID-19 pandemic. Buoyed by the experience of the 12 years following the crisis when consumer price inflation—although not asset price inflation—had remained at bay, central banks and governments thought they could continue to tempt fate. In 2020 central bank balance sheets exploded to new highs, fiscal deficits also hit records, and interest rates were pushed towards negative territory in Europe (following Japan's lead and experience—which could hardly have been taken as a positive by any sane person). As we all now know, consumer price inflation responded this time round, well and truly accommodated by the money printed by the central banks.

As a result, interest rates have been forced up and the Federal Reserve promises that it will deliver on quantitative tapering. The jury is still out on whether it will be able to deliver in that regard. The lesson is clear: markets are nervous about any sustained monetary policy tightening because they know that the debt overhang of 2008 has never been addressed; in fact, it has worsened.

Asian countries in 1997 were forced to take the hard medicine of IMF conditionality, austerity, recession, and cleansing. They have been the better for it in the last two decades, and remain some of the soundest countries in the world as regards government debt and growth potential.

Western countries, following the Financial Crisis, took every step possible to avoid pain and the “recovery” that Rothbard described as depression. This has placed them in the unenviable position of being unable to restart the creative destructive process without extreme pain. The Global Financial Crisis was an opportunity missed in the West. The “rise” from that crisis is likely to produce one of the worst global depressions in the last 100 years in 2023 and 2024.

2.4
Lessons Learned and What Lies Ahead

— Rocky Tung,
Wivinia Luk,
Joyce Lee [1]

Change is the only constant—it is almost a cliché, but it is also a universal truth.

With its well-earned reputation as one of the world's most influential financial centers, Hong Kong actively builds on its competitiveness and strength to ensure its spot as a leader. While Hong Kong continues to stand at the time of writing as one of the top three leaders in the Global Financial Centre Index (HKSAR, 2022) [2], the past 30 years included many ups and downs amid the success of the city.

The development of Hong Kong is unique. Riding and thriving on its unrivalled advantage as the gateway to and from the mainland China market, the city has evolved from its humble roots as a fishing village, into a thriving port, a manufacturing powerhouse, and, now, a world-class international financial hub. The road to such value-add enhancement, however, has not been linear.

Success Formula: Agility and Resilience

It is undeniable that the financial world has evolved dramatically over the past three decades. From key events such as the burst of the dotcom bubble in the early 2000s and the meltdown of economies amid the Global Financial Crisis (GFC), to the lingering challenges presented by the Pandemic-led Crisis beginning in 2020, Hong Kong's financial services sector has faced many challenges. Coupled with the advent of new phenomena and developments, such as the increasing connectivity between mainland China and other international financial markets, the accelerated adoption and advancement of technology, and the emergence of new opportunities around sustainability and fintech-related matters, these experiences have shaped and reshaped the world and the financial services industry, including that of Hong Kong, multiple times.

While these events and challenges might have brought severe and negative impacts on our economy at different times, they also taught us a few lessons and showcased Hong Kong's agility and resilience as our strengths. It was exactly Hong Kong's agility and resilience, together with its solid financial foundation, that led the city's resurgence, rebound, and emergence from adversity time and again.

The challenges we faced were indeed the agents of change, catalysing the advancement of our market in many ways. For instance, as a result of the GFC, governments and regulators around the world have put stronger emphasis on investor education and information disclosure, which has since led to enhanced sophistication of clients (Klapper, Lusardi & Panos, 2012).[3] Businesses and practitioners, on the other hand, might not be so welcoming to such changes, given the added cumbersome and costly administrative burden. This explains why we are of the view that serious considerations should be given to the design of regulatory frameworks.

In short, striking a fine balance between market development/ innovativeness and investor protection—no matter that they do not appear to be mutually exclusive—is necessary, for it can keep a market's agility and resilience intact.

Lessons from the GFC: Weightier Regulatory Burden on Businesses

As a result of financial crises—most notably the recent GFC—there has been a proliferation of measures with the aim of preventing negative events from happening in the future. A wide range of international financial regulatory reforms have been introduced, such as Basel III and the International Financing Reporting Standard 9 (Borio, Farag & Tarashev, 2020).[4] With the interconnectivity of the financial world, markets around the world have acted accordingly and collectively.

Given its status as the leading international financial center in this time zone, Hong Kong is no exception. Local regulators followed the global lead on mitigating financial risks and strengthening regulatory response to new financial trends. The introduction of the professional investor regime in Hong Kong to ensure safeguards for retail investors, for instance, was a convenient example. A more recent illustration would be the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill (2022)[5] gazetted this year, aiming to ensure adequate investor protection for virtual asset investors.

Well-intended as they are, these new regulations have undoubtedly added administrative burdens and compliance costs to businesses operating in every market. Customers for financial services need to endure more cumbersome, undesired, and, at times, redundant and repetitive administrative procedures. Investors in such firms have, therefore, been hurt with lower potential return, ceteris paribus. These are just some unintended spill-over effects.

We, as policy research professionals, call for proper regulatory impact assessment to be in place. While a well-thought-out regulatory and supervisory framework is recognized as the key to minimising damage from a crisis to the real economy, the need of maintaining market resilience should not be compromised (Liang, 2022). [6]

Technology: A Blessing or a Curse?

In recent years, digital transformation has become a major emerging trend in the financial services industry. While the net impact of technology advancement on the industry tends to be positive, the potential negative shocks to the economy should also be studied.
Rogers (2003)[7] explains this by theorizing it as the Diffusion of Innovations framework, that firms and individuals adopt technologies at different phases for a variety of reasons. According to Tung (2020): [8]

> Rogers (2003) identified the four key elements of an innovation as the perception of innovations, communication channels, time, and social systems. As a long-standing theoretical framework, the diffusion of innovations theory makes three distinct contributions in the area of social change: (a) defining the attributes of successful innovation adoption, (b) highlighting the significance of networks and peer-to-peer communications, and (c) comprehending different needs of various user segments. (p.23)

Some may argue that the silver lining of the Pandemic-led Crisis is the expedited adoption of various technologies—from the skyrocketed popularity of videoconferencing to the rising global adoption of retail faster payment systems (BIS, 2021).[9] Hong Kong, for instance, saw a total of 10.6 million registrations on the Faster Payment System, with a total HKD 32 million total turnover value in June 2022.[10]

To be sure, technology and innovation have brought a mix of unprecedented opportunities and challenges to the financial services industry. The growth of technology companies has caused seismic shifts for business operations, listing landscapes, and investment appetites. Notably, deal activities have been dominated by industries related to fintech, artificial intelligence, digital healthcare and medical devices. Taking the scene in Hong Kong as an example, in the first half of 2022, of the total fundraising amount (HKD 17.8 billion) on the Stock Exchange of Hong Kong, 51% was contributed by tech, media and telecommunications, and healthcare/ life sciences companies (KPMG, 2022).[11] The tech industry also averaged more than double the cross-industry average in terms of total shareholder return in 2021, according to BCG (2022).[12]

Even before the pandemic, with investors placing their bets on these companies, public concern over the implications of these businesses had heightened, particularly in relation to overvaluation of the sector (Dong, Hirshleifer & Teoh, 2017).[13] Ultimately, any reversal of investor sentiment towards this sector could lead to a knock-on negative wealth effect.

Notwithstanding the implied risks, the pivotal role of these tech giants in expediting growth in our economy should be acknowledged. From our perspective, to ensure that growth of the sector will remain sustainable—

that is, that such innovative firms can continue to draw investment interest from long-term investors, which will directly or indirectly ensure that the cost of financing will be manageable—meaningful policy efforts should come into play to ringfence investor confidence. While compromising the development of a value-adding sector should not be an option, potential disruption to the financial system—the lifeblood of the real economy—should also be mitigated.

Preparing and Staying Ahead

Changes are inevitable. When global efforts are mooted to make changes to the regulatory framework, investors and professionals in the field are required to adapt swiftly. CFA Society Hong Kong, representing the CFA charterholders, one of the prominent groups of professionals who contribute to the ultimate benefit of societies locally and globally, should be well prepared to adjust to these challenges and uncertainties.

Be prepared and plan for the potential risks—crises happened in the past are good case studies. Government and individual attempts to meaningfully improve the resilience of economies and reduce the exposure to risks ahead of crises could thereby minimize the cost, impact, and duration of the crises (Rhee & Posen, 2013).[14] To name a few, possible impacts that could lead to reciprocal impacts include, immediate reduction in market liquidity, and loss of confidence in the capital held by financial institutions.

Be aware of the recurrence of crises, keeping abreast of market trends and secular developments—“What we know about the global financial crisis is that we don't know very much", Paul Samuleson once said (The Globalist, 2001).[15] While we are no experts in dealing with these crises, the need to look beyond forecasts and to emphasize understanding and mitigating risks is critical (Kenny and Morgan, 2011).[16] Spotting the early warnings, and reacting promptly and collectively, could be the best solution in achieving optimal results.

In the evolving socioeconomic environment, the complexity of these challenges is aggravated. Good stewardship and high ethical standards are important at all times to secure trust and validate ambiguities. It is essential to recognize the legitimacy and limits of real-time assessment, and to adapt to changes through continuous innovation and learning.

Against this backdrop, it is encouraging to see that CFA Society Hong Kong has been leading the industry and market practitioners to be prepared for the paradigm shifts of investing and adapting to disruption. For instance, the collaboration with CFA Institute to introduce the "Certificate in ESG Investing" in Hong Kong in 2021 is a remarkable support for members to better embrace changes and stay at the forefront.

These are the crises of our time. Going from strength to strength, we shall continue to deliver the highest standards of excellence and empower the investment industry to realize the greatest potential of Hong Kong and the world.

Notes

1 The authors work for the same organization, which is an advisory body to the Hong Kong SAR Government. Views and opinions expressed in this article, however, are of their own and do not reflect such of their employers.

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2.5

Extract from the Asian Financial Crisis 1995-98: Birth of the Age of Debt

— Russell Napier

The following article contains three parts:

1 the Introduction and Conclusion written by the contributor for this volume,

2 the comments or assessments he made at the time of the publication (2021) of The Asian Financial Crisis 1995-98 and in the texts below appeared after the line of asterisks, and

3 the contemporaneous opinions or strategies written during the period of the crisis and in the texts below, appeared as indented texts.

Introduction

Investors, whether professional or amateur, who lived through the Asian Financial Crisis were viscerally impacted by the experience. The loss of value of investments is common but this was more than that despite being a very large loss of value. The MSCI Asia ex-Japan index fell 70% in USD terms. From 1995, belief in an Asian Economic Miracle was replaced by the fact of an Asian Financial Crisis and a condemnation, particularly by foreign investors, of something they now called "crony capitalism." If truth be told, nothing had changed very much in how Asia worked, but foreign investors' perceptions had been transformed from one form of illusion to another. Such a scale of transformation is not supposed to happen in capital markets. A traditional education in finance is based upon a belief in a high degree of efficiency in capital pricing, if not complete efficiency. However, there was little that was rational about the boom that pushed most Asian asset prices sharply higher in the first half of the 1990s. There was little that was rational about the willingness of investors to see only structural ruin in Asia in the summer of 1998 and sell assets at what turned out to be ridiculously low valuations. My book The Asian Financial Crisis 1995-98: Birth of The Age of Debt maps the crisis, but importantly, in my opinion, maps the change in consensus opinions over the period. History rarely records the errors of reason by those who lose in financial markets, yet it is mistakes about the future that result in the overvaluation and undervaluation of equities. In the following extracts from the book, you will get some feeling for the scale of errors involved as a miracle became a bust, and also the hysteria that ensues when to some "the sky is falling." They don't tell you about the screaming on the roller coaster that is a major equity bear market in financial textbooks. You will hear some of it, however, in the extracts from The Asian Financial Crisis 1995-98: Birth of The Age of Debt that now follow:

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The end of the so-called Asian economic miracle and the events of the Asian Financial Crisis were about much more than money. They were about a conflict between very different societies fought on the battleground of capital markets. It was the first major battle in a war that continues to this day and will shape the rest of the 21st century. It is a war that was instigated by a Thatcher/Reagan revolution that launched a new form of capitalism that sought to change the world, armed with excessive amounts of debt, in pursuit of profit. While initially it looked like an old form of what might be called laissez-faire capitalism, it very quickly became a new form of capitalism probably best labelled financial capitalism. It was a form of capitalism that combined individualism with the aggressive use of balance sheet management for primarily personal profit. As early as 1983, Michael Milken was helping corporate America supercharge returns through the issuance of a record amount of speculative credit instruments known as junk bonds. The particular beneficiaries of this form of financial engineering were corporate management and incentives were soon put in place, primarily in the form of stock options, to incentivize such behavior. The world has seen speculative corporate debt binges before, but this one was launched in a period when interest rates had just begun a decline that would last 40 years. The heady mix of ever cheaper debt combined with ever more stock options incentivized corporate management to export financial capitalism to the world. A simple narrative developed that it would sweep all before it.

The rise of financial capitalism occurred as the Berlin Wall fell and Communism collapsed. It was widely assumed that the rest of the world would adapt to a capitalist system and the new financial capitalism found itself with a seeming myriad of opportunities for profit and, it was *argued, only weak competition. The fact that many stock markets across the world, closed primarily by Communist regimes, had reopened was one signal that the change to a more capitalist structure was underway. However, these were dangerous surface signals because in many societies the new form of capitalism spreading from the U.S. was incompatible with local societal beliefs and structures. Each society in Asia was different in its own way, but in North Asia in particular, there was a much more communal approach to societal organization that could not and has not been reconciled with financial capitalism. This book charts the battle between the new financial capitalism and the various other forms of capitalism that existed then and still exist across Asia.*

The Asian Financial Crisis was for many a victory for financial capitalism over the various forms of Asian capitalism. This book will explain why in fact there was no such victory. Asian capitalism adapted but fundamentally did not change. In North Asia in particular, their form of social capitalism was strengthened by the confrontation in 1998 that left them with significantly undervalued exchange rates and benefiting from the new debt-charged consumption growth of the developed world. The Asian Financial Crisis set the scene for an age of debt in the developed world and this brought crises that have forced developed governments to confront financial capitalism in their own backyards. The result is that the age of financial capitalism is ending and something more akin to the social capitalism of Asia is being created. This book looks at that battle fought in the capital markets in Asia in 1998 and explains how a seemingly lost battle set the scene for the dangerous overextension of financial capitalism. In that overextension, financial capitalism reached extremes that led to financial collapse and societal repercussions that were ultimately unacceptable to both peoples and their *political representatives. When the history of the 21st century is written, it will begin with the Asian Financial Crisis of 1998, which created global financial conditions that created the age of debt and triggered a structural shift to a new form of social capitalism in the developed world. The repercussions from events in Asia in 1998 have been and will be much wider than merely financial.*

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In Hong Kong at midnight on 30 June 1997, the former colony was handed back to China. I attended a party in a hotel suite with a view across Victoria Harbor. We watched the ceremony live on television and for me the most dramatic moment was when members of the PLA, now based just a few blocks away from where I stood, marched onto the stage of the Hong Kong International Convention Centre.

The next day… the Thais chose the early morning of 2 July to announce the devaluation of their currency.

It was a very strange feeling when I heard the announcement. In some ways it was a vindication of opinions I had held for the past few years. However, it was also clear that the economic, social and political consequences of the move would be terrible for the people of Thailand, not just for investors in the Thai stock market. It was not as if this move by the Thais meant a victory lap and retirement, it meant even more work.
The end of certainty produces volatility. When historical relationships break down, market participants find themselves without guidance and looking for the new relationships which are the new certainties. In the intervening period of flux, most established relationships are likely to be challenged. At some stage there will appear to be few certainties, and great opportunities are created.

That proved to be an accurate statement, but the problem was that my job was to find some of those "new relationships" and to ring the bell when those "great opportunities" materialized. While some of the old skills I had learned could be useful, there were new skills to be learned if I was to have any chance of advising institutional investors what was to happen after 'The End of Certainty'. So far all we had come up with was some basic discount analysis that suggested the Southeast Asian markets were grossly overvalued. However, the two key inputs in those calculations, the discount rate and corporate earnings growth rates, were themselves now subject to huge uncertainty.

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One day, Gary Coull came to my office and said that if I really believed this so strongly, I should write an article for the South China Morning Post, explaining my reasoning. The article I wrote was published by the South China Morning Post on 27 October, the same day the Dow Jones Index posted its largest ever points decline to that date, driven by expectations of further exchange rate devaluations in Asia, and the consequences for both global credit quality and economic growth:

> // The six million people of Hong Kong represent the services economy of 1.2 billion people of China. That hinterland is still the home of the world's cheapest labor. Following the recent adjustments in Southeast Asia the hourly wages of Shanghai are 90 U.S. cents per hour, still only half that of Indonesia and a third that of Thailand... It seems to be going largely unnoticed that one of the world's great economic powers has just altered its macroeconomic policy with the aim of supporting a minor currency. We are talking about the decision by China to reduce interest rates and stimulate

demand to support the Hong Kong dollar. China's aggressive cut in lending rates shows the political willingness to reflate and the belief in the need for easy money... In this rich man's panic nobody seems prepared to ask: 'What happens if the foreign investor stops selling?' The answer is that we probably revert to net buying of Hong Kong dollars as the proceeds from the labor of Hong Kong's seven million mainland employees continue to flow into Hong Kong dollars ... In a world where deflation looms, shouldn't you align your wealth with those companies who benefit from access to the world's cheapest labor? The commanding heights of the financial capital of these 1.2 billion people are now going for a song.

"HK economy is living in a different world," South China Morning Post, 27 October 1997

That article was well timed, and by 30 October, the South China Morning Post declared "Bullish brokerages fuelled bungee rebound," citing that 27 October article among other similar optimistic commentary. By 31 October, the overnight deposit rate in Hong Kong was back to where it had been on 5 October, very close to U.S. levels. This first serious battle to defend the peg had been successful, but there was to be another and much more serious battle in the summer of 1998.

I had noted in this article in the South China Morning Post that a key reason to invest in Hong Kong was that China was cutting interest rates to stimulate growth in China and to support growth in Hong Kong. That this would not lead to a devaluation of the renminbi did not seem to be an outlandish forecast, as China already had a large stockpile of foreign reserves and a current account surplus that was 4% of its GDP.

China was in a very different position from when it had last devalued its exchange rate. However, as the October 1997 crisis passed and 1998 wore on, investors began to lose faith that China could provide economic stimulus while also maintaining a stable exchange rate. That change in opinion was to produce another major surge in Hong Kong interest rates and another major decline in the price of Hong Kong equities. Even from its lows in October 1997, the Hang Seng Index was to fall a further 33% before it bottomed on 13 August 1998. Why it bottomed on that Friday in August was one of the greatest surprises of the entire crisis.

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// 11 February 1998, Hong Kong

Seasons come and seasons go...However, I continue to encounter among investors a deep lurking fear which appears to be almost primordial in its origins. There is a belief in a werewolf, a bogeyman, a banshee who will prevent such stability. While those were some of his guises in previous generations, today he is called the hedge fund manager... This is a modern myth. Hedge fund managers go to great lengths to conceal their movements from their competitors, like any other investor. They are market participants like others and thus they do get it wrong. They buy as well as sell. Most crucially, they exploit fundamental weaknesses to move markets and gain profits. Their biggest coups have all been based upon the probing and revealing of such weaknesses... The weakness has been exploited and the currency board system is now working to produce an increased position of strength. This return to strength will also be based on capital inflows. It is my belief that this strength will be significantly boosted next month as Zhu Rongji clarifies his position on infrastructure spending, low-cost housing investment and easier monetary policy. Then the foreign investor will see a political commitment to sustaining and in due course boosting economic growth in China…Weakness comes and weakness goes. "Seasons don't fear the reaper."

'Don't Fear the Reaper', The Solid Ground Newsletter, 11 February 1998

There was in fact very good reason to fear the reaper in the form of the hedge fund manager. Even with a major improvement in Hong Kong's external accounts under way, the hedge funds did return both to short the Hong Kong dollar and to short Hong Kong equities simultaneously. By doing this they drove up interest rates, and this pushed the price of Hong Kong equities lower—a mechanism they had seen in action both in October 1997 and in January 1998.

I continued to think that it was "lunatic" to short the Hong Kong dollar, given the rapid improvement in Hong Kong's external accounts, but I did not consider that this short would just be a mechanism through which profits were made elsewhere. The so called "double play" of shorting both the Hong Kong dollar and the Hang Seng Index created profits from shorting equities as interest rates soared, as the currency board system acted to ensure the stability of the exchange rate.

A devaluation of the Hong Kong dollar did not have to be forced to create a profit from the "double play." How the "double play" was eventually thwarted by government intervention stunned the world of finance.
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// 17 March 1998, Regional

...As with the collapse of Rome, even the very heartland of capitalism...saw an eradication of free market capitalism during these ‘dark ages’. However, free market capitalism was not eradicated. It survived at the fringes of the global economy. Eventually, following decades of disorder, new disciples for free market capitalism appeared. One such disciple, Milton Friedman, claimed in his treatise Right To Choose that he had discovered the last working remnant of free market capitalism on a little island called Hong Kong....one man is widely credited with the preservation of the laissez-faire system in this colonial outpost: Sir John Cowperthwaite (financial secretary 1961-71). To quote Professor Alvin Rabhushka, Sir John was: [b]rilliant, well-trained in economics...I will raise a glass to Sir John Cowperthwaite, the great reunification and the breakthrough to Northumberland.

‘Saint Patrick, Sir John Cowperthwaite and the Breakthrough to Northumberland’, “The Solid Ground Newsletter”, 17 March 1998

After a mild contraction in late 1998, the boom in Chinese exports continued through 1999 and into 2000. When China was allowed to join the World Trade Organization (WTO) in December 2001, the export boom accelerated even further. The capitalists of Hong Kong played a huge role in funding and managing that boom, and local mainland business owners were soon as adept, if not more so, in the game of investing capital to maximize returns.

The "great reunification" did occur, but it was between Hong Kong and China. Sir John Cowperthwaite's legacy, which created a colony with limited government interference in business, was to have a major impact in speeding up the economic development of China. That Hong Kong would be the major beneficiary from the continued economic reform in China was really not questioned by anyone in 1998, but it did not stop the drain and then flood of capital from the SAR through the end of spring and into summer 1998.

Investors were convinced that the devaluations elsewhere in Asia had left the Hong Kong dollar very overvalued, and this consideration more than outweighed the positives that flowed to the SAR from its links to China. As spring turned to summer, investors increasingly thought the unthinkable: that China, far from being an asset for Hong Kong, was a huge liability, as it would have to devalue the renminbi.

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From the end of August 1998 interest rates had been ticking up again in Hong Kong. It was widely understood that this was the result of what was known as the "double play" ...

I had argued from September 1997 that such a play would not be attempted because it would fail... It was clear that some investors disagreed with my prognosis that the improvement in Hong Kong's external accounts made further attacks on the currency board system futile, and by August 1998 the "double play" was back on. It is not clear just how much money was borrowed to achieve the aim of pushing interest rates higher by selling Hong Kong dollars, but it was enough to push interest rates higher and by 13 August they were 300 bp higher than

U.S. rates. The tactic was working, because in the first nine trading days of August the Hang Seng Index had fallen by 16%.

Sometime in that period Gary Coull came to see me and said that someone connected with the government had asked if we might have any ideas about what could be done to counteract the so-called "double play." I only had one idea, and that was that China could announce it was diversifying some of its U.S. dollar foreign exchange reserves into Hong Kong dollars. The prospect of such inflow into the Hong Kong dollar would, I argued, more than deter capital outflow, keep interest rates low and prevent any profits being made in shorting the Hang Seng Index… I wrote a brief paper on that idea which went to Gary, and that was the last I heard of that. Somebody, though, did have an idea that was to be actioned, and that action really horrified many people in the financial markets, in Hong Kong and well beyond.

On the morning of Friday 14 August, representatives of the SAR's three largest stockbrokers were called to a breakfast meeting at the China Club in Hong Kong. They were invited by the local government's Finance Bureau, but were surprised when they arrived to meet Norman Chan of the Hong Kong Monetary Authority (HKMA), the body that operated the currency board system. The HKMA placed large buy orders for Hong Kong equities that morning. Those purchases were to be carried out in secret that day, and the buying was to last for ten days. The plan was to deprive the speculators of the prospect of profiting from their short position on the Hang Seng Index, and thus nullify their prospects of profits from the double play—their cost of borrowing Hong Kong dollars had already risen to make one part of the trade less attractive. If the plan worked, the speculators would be forced to close down their shorts on both the Hong Kong dollar and the Hang Seng Index, and interest rates *would return to normal. It worked, and the Hang Seng Index rose that day, and so far it has never returned to the levels witnessed at the height of the "double play." The Hang Seng Index rose 8.5% that Friday, and after the close the Hong Kong government announced the plan. There was instant outrage, particularly from the financial community. It was seen as the end of Hong Kong by many. This was clearly the end of the "positive non-interventionism" that Sir John Cowperthwaite and others had bequeathed to Hong Kong. It was a sign that the state would be allocating resources and not the private sector. Alan Greenspan criticized the action and Milton Friedman called the action "insane." Capital outflow from Hong Kong accelerated as this fear of what the apparent end of laissez-faire policies meant for the future of the SAR. So, while the Hang Seng Index continued to rise, Hong Kong interest rates went even higher and closed at a peak of 19% on 28 August.*

There were many in financial markets who thought that this intervention would mean the end of the currency board system...

... I went downstairs and walked through Admiralty and stopped at every bank I could find. What I saw were indeed the large queues of people that I had been told about... However, there were also plenty of local people who were switching from U.S. dollars to Hong Kong dollars, given the very attractive interest rates then on offer. I could see the financial community panicking, but I did not see the people of Hong Kong panicking and the currency board held firm; and as of 2020, the Hong Kong dollar remains pegged to the U.S. dollar at its 1998 level.

...A few weeks later though, I wrote the following:

> With so much nonsense currently talked about in reference to Hong Kong's structure, it is worthwhile returning again to the role which net buying or selling of the Hong Kong dollar plays in determining all the other key factors which set Hong Kong's asset prices. Recently I read an article on Bloomberg by David De Rosa, stating that Hong Kong had joined Malaysia in choosing the road of the isolationist as the way forward. When people start describing Hong Kong as isolationist, yet presumably laud the free market approach of European nations such as France, it is time to get back to the very basics. For almost all of its history, Hong Kong has operated a currency board system. It continues to do so. Thus, asset prices will be determined for the net demand for the Hong Kong dollar. It really couldn't be simpler... This analyst believes that the destructive market forces in Hong Kong have run their course.

On 17 August Russia devalued the ruble, and on 19 August it defaulted on its foreign currency debt. Investors had bet against the exchange rate value of the Hong Kong dollar, but had bet big on the stability of the ruble because Russia was "too nuclear to fail." It was a bad month to be in the currency speculation business. When shocks of this magnitude occur and gearing is high, there is likely to be a casualty. It was the scale and provenance of the casualty that was to shock financial markets.

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The key legacy of the Asian Financial Crisis is that Asian nations did consider that the wealth of their nations could only be secured by the mercantilist policy perhaps still best summed up by the title of Thomas Mun's 1664 mercantilist classic, Treasure by Foreign Trade. It is a treasure supposed to defend Asian nations from a crisis and the external imposition of a form of capitalism local policymakers regard as inimical to their own values. It has been a pursuit of treasure that has created a deeply unstable global financial architecture prone to collapse, and has led to wealth inequality and deep political divides.

The Asian Financial Crisis created a scramble for foreign reserves in the region that was permitted because it was much easier to permit it than oppose it. That it brought near-term benefits to both Asia and the developed world helped politicians to accept that it was an acceptable policy. However, the consequences of those easy political decisions, made in the aftermath of the crisis, have created the unstable non-system that will continue to deliver the economic, financial, social and political instability that has already plagued the 21st century.

The age of debt was birthed in the crisis described in this book. How it developed, how it will end and what you can do about it will be the subject of the next book.

Conclusion

A new global financial architecture was created after the Asian Financial Crisis and that, in my opinion, was even more important, in shaping our future, than the crisis itself. Today there is much focus on the so-called Global Financial Crisis (GFC), and the shadow of its legacy that continues to change the political and geopolitical future. However, that crisis itself came from somewhere. If you want to understand where it came from and how the clash between the various Asian forms of capitalism and the U.S. form of capitalism will play out, there are few better places to start than with an understanding of the Asian Financial Crisis.

2.6 How Zhu Rongji's Reforms Transformed the Mainland and Helped the City to Withstand Crises

— Hongbin Qu

Introduction

China is facing multiple challenges including a shrinking labor force and slowing growth. What can, and likely will, China do to meet these challenges? To find an answer, one must realize that this is not the first time the country has faced daunting challenges. Back in the 1990s, the economy faced even bigger challenges, such as loss-making state-owned enterprises (SOE) and mounting non-performing loans (NPL) in the banking system. Taking a quick review of what Beijing did to tackle these issues may shed some light on possible solutions to the problems today. Under the leadership of Premier Zhu Rongji, the authorities launched a series of radical reform programs to sustain economic growth. Chief among them were SOE reforms, banking restructuring, and reforms associated with World Trade Organization (WTO) entry.

SOE Reforms

In the early 1990s, SOEs accounted for over 60% of industrial output and more than 70% of total urban employment in China. But the lack of market-based incentives and autonomy in determining what to produce led to low efficiency. Around 40% of SOEs were making a loss, threatening economic stability. To tackle the problem, Premier Zhu introduced a radical reform program that had the following two main components:

Privatizing small SOEs

The overall reforming and opening-up policy started in 1978 had led to rapid changes in market conditions and consumer demand. But SOEs, especially smaller ones, were unable to make the necessary adjustments and produce the products the consumers wanted. Many of them could only survive by relying on government subsidies and protections. Realizing this would not only curb productivity growth but also meant a huge financial burden for the government, Premier Zhu decided to let the really bad ones go under, or sell most of them to the management team or outside investors. This was indeed one of the most radical reforms in four decades, because it caused over ten million SOE workers to be laid off during the process. To cushion the social impact, Beijing also provided both basic welfare and training support for these laid-off workers. More importantly, the program not only reduced the government's fiscal burden, but also revitalized these privatized SOEs by improving their corporate governance and making them profit-driven. Many of them soon became industrial leaders, contributing to the country's transformation into the world's factory floor.

Corporatization of big SOEs.

Unlike wholesale privatization in many East European economies in the 1990s, Beijing's SOE reform plan was designed on the principle of "grasping the large, letting go of the small" (zhuada fangxiao). Up to 1,000 large SOEs were retained. However, the policymakers realized the need to do something to increase these big SOEs' efficiency. Firstly, making these SOEs commercially-driven by resetting KPIs for SOE managers, and separating their social welfare affiliates, such as hospitals and kindergartens from the core business. Secondly, restructuring big SOEs' corporate governance through corporatization and listing on stock markets. Almost all the big SOEs were corporatized in the period 1995-2003. To increase transparency and impose market discipline on SOE managers, Beijing pushed some big SOEs to list in stock markets, both local and overseas, kickstarting a decades-long boom of IPOs of Chinese enterprises in both local and overseas markets. Boosting and diversifying their capital base aside, the stock market listing also increased transparency and made SOE management more accountable to shareholders.

Banking Restructuring

Heavily burdened by policy lending to inefficient SOEs, the country's banking system was at the edge of crisis in the mid-1990s. Official estimates suggested that non-performing loans reached around 30% of total loans, or about 20% of GDP. Private sector analysts indicated that the ratio would be higher if international accounting standards were applied. To prevent this NPL problem from dragging down the overall economy, Premier Zhu had no choice but to take bold actions to restructure the financial system.

The first move was to introduce the country's first Central Bank Law and Commercial Bank Law to establish a legal framework for a modern financial system in 1995. The former confirmed the People's Bank of China (PBoC) as the country's central bank, executing both monetary policy and regulation of the banking system (the PBoC's banking regulation department was spun off in 2018 to create a separate agency, the China Banking and Insurance Regulatory Commission); while the later laid the foundation for transforming state banks from policy lending agencies into commercial banks. Meanwhile, the government also established three major policy lending banks to take over the policy lending responsibility from the state banks.

The second step taken was the abolition of the long-standing credit quota system, under which the PBoC set an annual credit quota for each sector and banks were asked to lend out to SOEs according to these quotas. This move gave banks much more flexibility in lending, though their total lending was still guided by the regulation of loan/deposit ratios and monetary policy targets.

Then came the hard part—tackling the NPL problem. Beijing's plan had two key components: one was to clean up the existing NPLs and the other was to prevent new NPLs. Four state asset management companies (AMCs) were set up in 1999 to purchase bad assets from the big four state banks and to gradually dispose of and recover these assets in over ten years. The four AMCs bought over RMB 1.4 trillion in bad assets or around 15% of the total loans from the big four state banks from 1999 to 2000, and another RMB one trillion from 2003 to 2004, mainly financed through AMC bonds, borrowing from the PBoC and equity funding from the Ministry of Finance. Then these AMCs gradually disposed of the distressed assets through various tools including debt/equity swaps, M&A, and management reshuffles. Information on the overall recovery ratio is not available, yet a 36% recovery ratio in the initial years was indeed a hard-won achievement.

To improve the management of state banks to prevent new NPLs from rising, all major state banks were restructured and progressively listed in Hong Kong and Shanghai. Beijing policymakers saw stock market listing more as a tool to reform state banks than anything else, aiming at improving corporate governance, incentive structure, risk management capability, and accounting standards. Indeed, there is some hard evidence suggesting these big banks saw their profitability and asset quality improve significantly post-initial public offering. Since big state banks were dominant players in the country's financial system, these reforms laid a foundation for maintaining financial stability and providing funding support to fast economic growth in the following decades.

WTO Entry

On top of market-oriented reforms, Premier Zhu had also taken some major steps toward integrating China into the global economy. Chief among them was pushing through a comprehensive reform package for the trading system, industrial policies, and regulatory regime to join the World Trade Organization (WTO). Chinese leaders also saw WTO entry as means to accelerate economic reforms. Indeed, to meet the requirement of WTO membership, China would have to bring its trade regulations closer to international standards. Tariff and no-tariff protections for domestic firms also needed to be reduced, forcing local firms to compete in the world market. The government's preferential policies for SOEs would have to be gradually eliminated to level the playing field for all firms. Meanwhile, key service sectors also needed to be liberalized gradually to introduce competition from both domestic private and foreign players. Unlike previous opening-up policies that mainly focused on special economic zones and other coastal cities, reforms associated with WTO entry had essentially integrated both interior and coastal regions into the global trade and investment system. As a result, annual inflows of foreign direct investment surged from around USD 50 billion in 2001 to over USD 120 billion in 2010. Meanwhile, benefiting from the access to advanced technology and markets, domestic private firms also expanded their business rapidly. By 2010, China's share of global exports had reached over 10%, more than doubling the pre-WTO level, making the country the world's export champion. So the WTO accession was not only instrumental in transforming China into the world's factory floor, but also laid the foundation for China to achieve average GDP growth of over 10% from 2001-11, the golden period of fast and high-quality growth.

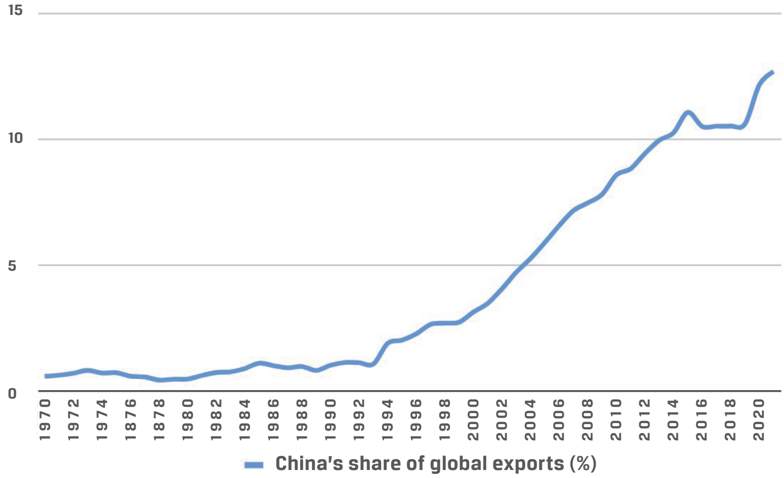

Figure 2.6.1: The rise of a global trade titan
"The Listing of Chinese State-Owned Banks and their Path to Banking and Ownership Reform," The China Quarterly, 201, 125-155.

Impact on Hong Kong

These bold reforms in the mainland also had a huge spillover effect on Hong Kong through two main channels. First, as a key ingredient for SOE reforms, Beijing encouraged quality SOEs to list in both domestic and overseas stock markets, with Hong Kong being chosen as the main platform for overseas listing. This kickstarted a decades-long boom of IPOs in Hong Kong, with over 1,350 mainland companies listed in the stock markets in Hong Kong since the early 1990s. This has not only boosted the Hong Kong stock market's attractiveness to global investors but also laid a foundation for further expansion of financial integration between the mainland and Hong Kong in the bond and currency markets in recent years. All this has boosted Hong Kong's role in the global financial system.

The second main channel through which the reforms in the mainland affected Hong Kong was trade. As discussed in the previous section, Zhu Rongji's bold reforms, especially the WTO entry, were instrumental to the transformation of the mainland from a rural economy to the factory of the world. As a result, cross-border trade and investment flow in the mainland surged. As the trade and investment gateway of the mainland, Hong Kong has benefited enormously from this in the past decades. In recent years, growth in re-exporting business in Hong Kong has slowed partly due to further strengthening of the direct links between the manufacturers in the mainland with global markets. But Hong Kong remains the gateway for the mainland's both inward and outward direct investment, and plays an increasingly important role in facilitating the trade of services in the mainland.

Conclusions

With many SOEs making losses and the banking system's NPL ratio topping 30%, China's economy faced daunting challenges in the 1990s. To prevent an economic crisis, Premier Zhu started a series of market-oriented reforms. His SOE reforming program not only reduced the government's fiscal burden of supporting loss-making SOEs but also revitalized many big and privatized small SOEs. The banking reform measures resolved the mounting NPLs and significantly improved the performance of state banks. In addition, radical reforms associated with WTO entry effectively integrated both interior and coastal regions into the global economy. All these reforms not only dealt with the challenges but also boosted productivity, leading to over 9.5% average annual economic growth from the early 1990s to 2010. Hong Kong was a beneficiary then and, not least, now.

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2.7
What Lessons Have We Learned from the 2008 GFC?

— Eric Lui

My Life and the Economies

My life and my work are so intertwined it's hard to go a couple of my waking hours without thinking about finance and the global economy. After all, the last two decades of my life were spent analyzing the markets and making sense of what to a layman was a random set of data. Behind the façade of information and numbers lies a story or stories that the evidence is trying to tell (or scream in some cases) to humanity. I am both privileged and humbled by my expertise or abilities to be able to form that picture, before explaining to the general public what the data, evidence, and trends foreshadow and what is lurking around the corner. With my skills, I feel obligated to warn investors ahead of time, in order for them to brace themselves and react before what is for sure to come and hit them smack in the face. There are times when I wish I was wrong because some of the findings and outcomes I've reached from my objective and neutral analysis yield results that send chills down my spine.

The 2008 Global Financial Crisis should still be fresh in most people's recent memories given the impact it has on the world. The former Fed's president, Alan Greenspan, calls it a once-in-a-century crisis, while others see it as something unprecedented. According to the calculations of the International Monetary Fund (IMF) at the time, the estimated losses on U.S. loans and securitized assets were as high as USD 1.4 trillion.[1] If combined with the evaporation of the value of the stock market and property at the time, the figures would even be more mind-boggling.

Here we are at the time of writing in 2022 with lives seemingly back to normal without seeing another "tsunami" hitting the market after 2008, yet one ought to ask what lessons have people learned from the GFC. I personally believe the answer is a simple "nothing," especially from the point of view of monetary policies after the GFC. History will once again repeat itself. As the Fed starts reversing its course of monetary policy, the next tsunami can be just around the corner and it's closer than anyone anticipates, just as was the case in the months leading up to the 2008 crisis.

The Ultimate Cause of the GFC

There are many causes behind the 2008 crisis. The first trigger point might have been the subprime problem or the failure of the U.S. financial institution Lehman Brothers, but with all things considered, the ultimate cause that set off a chain of reactions and sent the market into a downward spiral of no return must have been the credit bubbles.

Before the subprime crisis in July 2007, the Fed intervened between 2001 and 2003 responding to the bursting of the TMT bubble in early 2000, by cutting rates a total of 13 times, and reduced the target Fed funds rate from 6.5% to a record low of 1.0%. Subsequently, in an environment where the cost of funds was extremely low, a large amount of liquidity (funds) flowed into the financial markets. According to the Bloomberg U.S. Financial Conditions Index (an index to measure the availability of liquidity in the U.S. market; the rise of the index means that the market liquidity is becoming more relaxed, and vice versa), the index rose from about -2.4 to a record high of +2 at that time, which is signal of unusually loose liquidity (Figure 2.7.1).

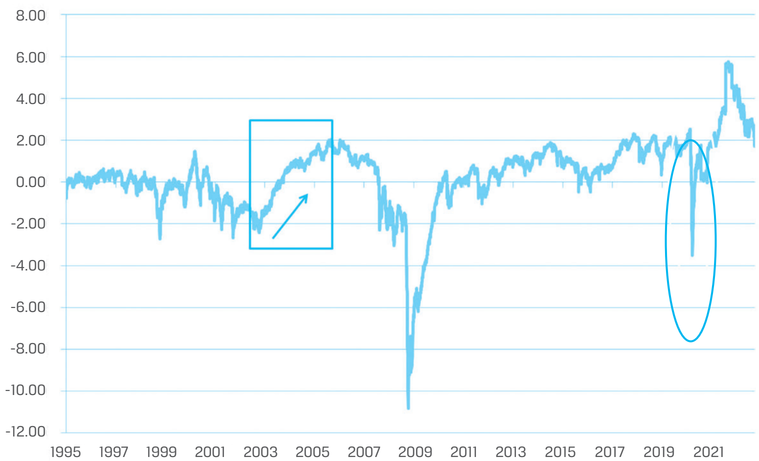

Figure 2.7.1: Bloomberg United States Financial Conditions Index Plus
Source: Bloomberg Finance LP. 09/2022

However, the abundant liquidity of the market coupled with an environment of abnormally low interest rates led to substantial funds influx into different assets, which resulted in the subsequent property market bubble and the stock market asset bubbles. Therefore, when the Fed began to gradually raise interest rates during 2004-06, the market's loose liquidity began to reverse and the aforementioned Bloomberg Financial Conditions Index also slowly fell from the high point. Consequently, liquidity gradually tightened and a credit crunch followed, which in turn evolved into the 2008 crisis that everyone knows about. In hindsight, the root cause of the GFC was a result of the central bank's implementation of an unusually loose monetary policy and excessive credit inflation.

Fed's Response to the GFC

In response to the GFC in 2008, the Federal Reserve adopted an ultra-loose monetary policy; namely, quantitative easing (QE). Through large scale purchase of treasury bonds (and MBS) programs, injecting massive amounts of liquidity into the market, the QE policy did save the depressed U.S. economy and the collapsing financial system. In other words, ultra-loose monetary policy, a.k.a. QE, defused the financial crisis. Nonetheless, while the spate of crises in 2008 was resolved, the Fed and the world's major central banks seemed not to learn a lesson from the crises. Ironically, they all went back to printing money (the QE policy) and letting tomorrow deal with itself. They became addicted to the quick fix and cure-all of QE for solving all problems from market shocks to economic slowdowns, to even the Covid-19 pandemic, just to name a few.

It’s worth noting that the Bloomberg Financial Conditions Index tumbled in early 2020 when the pandemic hit the world. That reflects a significant tightening of the market liquidity conditions at the time. The tightening was only second to the GFC. However, the Fed then pushed a new round of even larger scale QE, which led to a V-shaped rebound in the Bloomberg Financial Conditions Index. The index soared to a record high of nearly 6.0 in September of the following year. That is a good indicator the market liquidity conditions have tightened from the previous extreme and moving to the other extreme of exceptional easing. The scale of the easing (QE4) is even larger than the total of three rounds of previous QEs.

The Fed’s assets have risen from less than USD 1 trillion in 2008 to nearly USD 9 trillion in 2022 after executing four rounds of QE. Moreover, the scale of QE3 between 2012 and 2014 and QE4 in 2020 is larger each time than QE1 in 2008 (Figure 2.7.2). The size of any QE is always larger than the previous QE. It is also worth noting that, due to multiplier effect, the actual credits released by QE are a few times the QE’s scale.

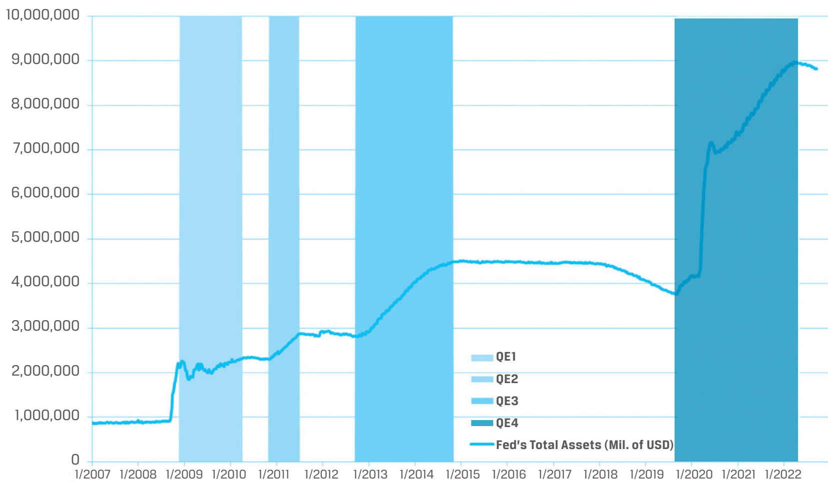

Figure 2.7.2: Total assets of federal reserve since 2007
Source: Bloomberg Finance LP. 09/2022

When Liquidity Flows Reverse

It is inconceivable that the Fed should keep frantically flooding the market with liquidity. It's as if the Fed has no other effective monetary policy options. The Fed has kept interest rates way too low for an extended period of time and has kept credit excessively inflated. These combine to cause the irrational performance of many assets and the formation of bubbles. When monetary policy reverses, as it is currently, market liquidity begins to tighten and a credit crunch will ultimately emerge. A new vicious cycle of shocks once again finds its way back into the financial markets.

The issue is that the U.S. arbitrary pouring out liquidity such as for the GFC is more likely than anticipated to have effects well beyond its borders, particularly in the emerging markets including Hong Kong. Two reasons are:

First, the continuous, unchecked quantitative easing has flooded the world with credit, especially emerging markets. According to the Bank for International Settlements, the overall credit level of non-financial institutions quadrupled between 2008 and 2021 in emerging markets, a jump from USD 20 trillion to nearly USD 80 trillion.

Hong Kong is especially in a vulnerable position. The fact that the Hong Kong dollar is pegged to the U.S. dollar puts Hong Kong in a passive role, in the sense that Hong Kong pursues the Linked Exchange Rate system, so that, coupled with the free flow of funds, it will naturally feel the massive influx of capital when the U.S. opens the QE floodgates. In fact, the Hong Kong monetary base has skyrocketed more than fivefold since 2008, just following closely the patterns and footsteps of the U.S. situation. Figure 2.7.3 shows the two economies are in fact very much in sync with one another. In other words, when a large amount of liquidity pours into emerging markets, the level of leverage continues to rise, thereby forming bubbles in assets such as the property market in Hong Kong. Hong Kong property prices have risen by about 280% since 2009, albeit off the peak for months. The risk lies in the time when the U.S. tightens the constant streams of capital injections that have been propping up the markets previously. The pressure then formed from credit contractions in emerging markets cannot be underestimated.

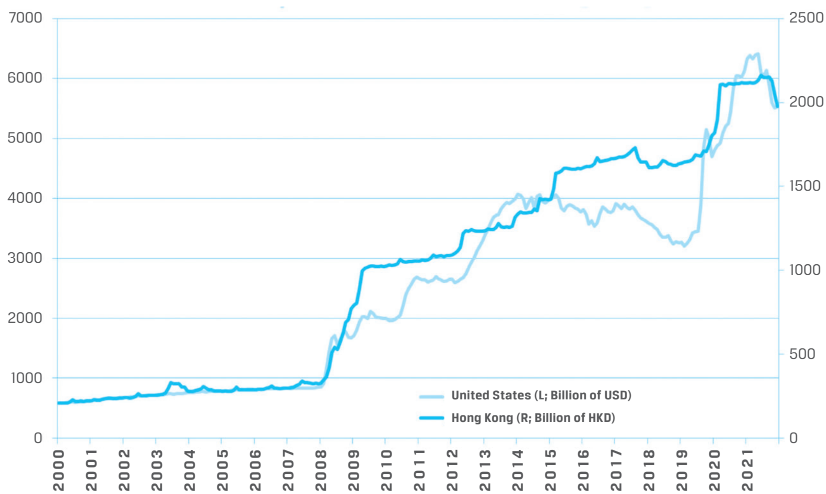

Figure 2.7.3: Monetary base of the U.S. and Hong Kong
Source: Bloomberg Finance LP. 09/2022

Second, the strength of the U.S. dollar is directly proportional to the extent of QE. It is an interesting phenomenon to see the U.S. dollar strengthening instead of weakening in the past decade or so despite the GFC and the continuous QE exercises. This is especially evident in the last rounds of QE due to the outbreak of the pandemic in early 2020. That is, the more money is printed, the more valuable the U.S. dollar is (Figure 2.7.4).

Besides major central banks following suit and offsetting the pressure on the U.S. dollar, this phenomenon may be related to rising asset prices along the course of QE, attracting more funds to actively absorb U.S. treasuries and stocks, thus supporting the dollar. Moreover, in the wake of the Asian Financial Crisis of 1997-98, many emerging countries and regions in Asia including Hong Kong have actively strengthened their external reserve bases to enhance their greater defensive readiness in anticipation of another major market adjustment. Therefore, after the Asian Financial Crisis, both the central bank's forex reserves and the level of U.S. treasuries have shown a persistent upward trend until recently (Figure 2.7.5 & 2.7.6). Of course, the regional economy gradually recovered after the Asian financial turmoil, while China's accession into the WTO in 2001 boosted foreign trade significantly, at the same time increasing the level of foreign exchange reserves.

Figure 2.7.4: The U.S. Dollar Index and QE
Source: Bloomberg Finance LP. 09/2022

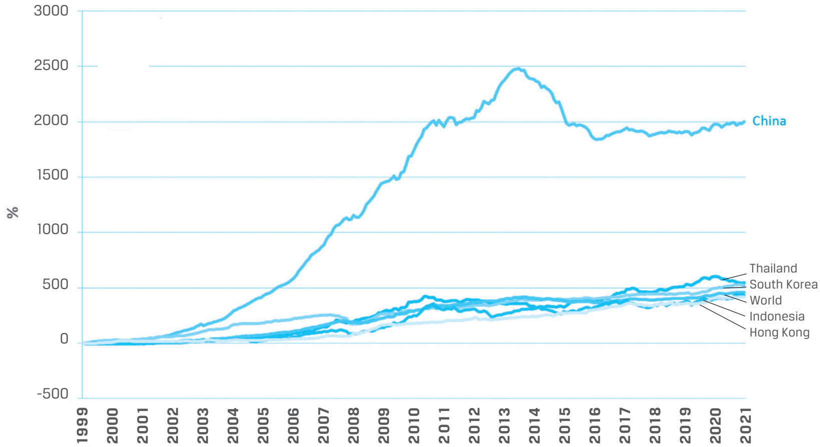

Figure 2.7.5: Change of Forex Reserve since 1999

Source: Bloomberg Finance LP. 09/2022; Note: 12/31/1999 = 0%

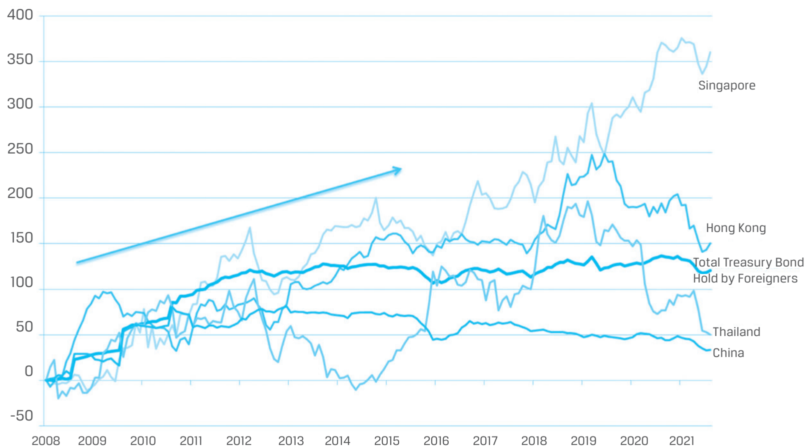

Figure 2.7.6: Change of U.S. treasury bond hold by foreigners since 2008

Source: Bloomberg Finance LP. 09/2022; Note: 12/31/2008 = 0%

When the emerging markets are swelled with credits from the influx of capital, the level of leverage increases remarkably. However, when the "tide" recedes, interest rates will rise together with the U.S. dollar. It is noteworthy that the year-on-year change in credits to non-financial institutions in emerging markets is closely related to the change in the U.S. dollar. That is, when credits in emerging markets rise, funds flow from the United States to emerging markets, keeping the U.S. dollar stable. However, when the U.S. holds back QE, the dollar begins to rise because of deleveraging in the emerging markets (Figure 2.7.7). Either way, the dollar appears to be unbreakable.

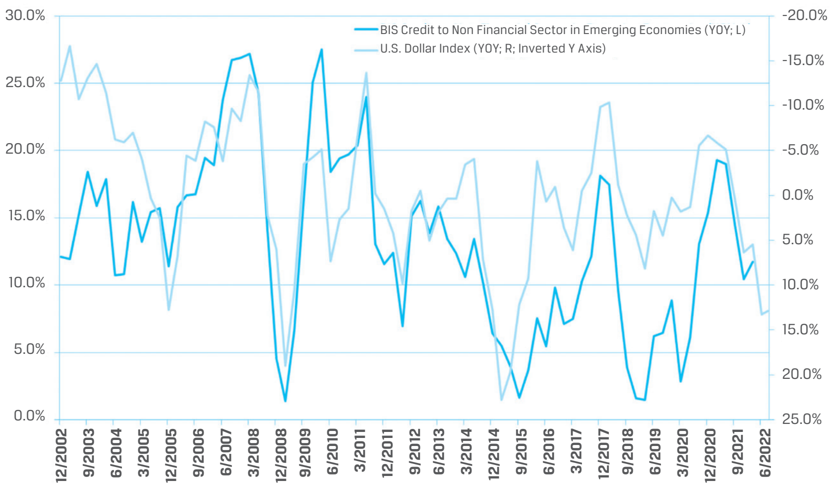

Figure 2.7.7: Credit growth and change in dollar index
Source: Bloomberg Finance LP. 09/2022

On the contrary, when emerging markets deleverage and repay their debts, they tend to be trapped by the strong U.S. dollar and the jacked-up interest rates at the same time. It is a double whammy for emerging markets. It explains also why, when the Fed enters the interest rates hike cycle and gradually tightens market liquidity, the pressure on emerging markets including Hong Kong is a force to be reckoned with.

Contrary to popular belief, the Fed continued with a near-zero interest policy for a long period after the GFC. The policy has distorted the dollar interest rate and has heated asset prices in an irrational manner. Currently, we are living with asset bubbles in credits, stock market, properties, bonds, etc. and the financial markets are much more vulnerable and unstable than people are aware of.

This Time Is Different...

Will this time be different? Credit bubbles are the mother of all crises. When the tide recedes and when the previous seemingly free inflow of capitals slows down or even comes to a halt, the burst of credit bubbles can be catastrophic, given the more than a decade of unscrupulous lending. Can the Fed push QE5 and save the day? How big is the collapse this time? Nobody knows for certain but any educated guess would put the size of the next financial wave as nothing less than the one before in 2008 if not bigger in multiples! A new term has to be coined to match the scale of it because financial crisis doesn't do it justice anymore. Financial Armageddon may just appropriately describe the extent of the next global crisis.

Last but not least, two more thoughts worth sharing. First, how did the GFC change my view of my endeavors?

Newton's third law—for every action, there is a reaction—is not only applicable to physics. The first signs of inflation in 2022 are hints that the magic potion is watered down, and the rounds after rounds of QE rescues are losing their efficacy. Stepping into 2022, extremely high inflation due to the problems with supply chains and high energy prices force the Fed (and other central banks in many countries) to reverse its longstanding QE policies. QE has changed the landscape of the global financial market by rattling investors' psyche. Weak economic data and forecasts, for example, would otherwise be interpreted as negative sentiments for stock market performance, but since anticipation for the Fed's intervention is high, the news is now seen by many as not necessarily bad or seen even as good news. Any analysis by any economist, well known or not, done without regard to the QE situation as the key determining factor is simply not meaningful nor realistic.

An old Wall Street mantra, "don't fight the Fed," has taken a revival since the GFC. The phrase succinctly describes the cure-all panacea of bill-printing kneejerk reaction by the Fed and central banks to "bandage" wherever happens to "bleed." As a matter of fact, the cumulative effects from the incessant bailing out of QE is so startling since 2008 that the analytical outcomes are sometimes rendered erratic or derailed under traditional analytical market interpretation.

Secondly, it's only logical to ask just how much longer will Hong Kong stick to the status quo of its financial structure in relation to the U.S. dollar that puts Hong Kong in a passive and vulnerable position as aforementioned. Is the hinge to USD something to be kept alive for the HKD, or something to be ended for our economy to take back control over our financial well-being and reclaim our autonomy once and for all?!

Notes

1 IMF, Global Financial Stability Report, October 2008.

2.8
A Pandemic Tale of Two Cities

— Jeffrey Ng and
Kevin Ow Yong,
CFA

Introduction

The outbreak of the Pandemic-led Crisis in 2020 severely hampered international trade and investment activities. Although both Hong Kong and Singapore are major financial hubs, they navigated and addressed the challenges of the COVID-19 pandemic and the global slowdown differently. CFA Society Hong Kong and CFA Society Singapore have two of the largest charterholder membership bases in Asia. Over 4,000 CFA charterholders are in the Singapore Society, while the Hong Kong Society has 1.5 times more charterholders, with over 6,000 members.

Recently, the fund management and banking industries have witnessed an exodus of top financial talent out of Hong Kong. For example, according to the European Union Office to Hong Kong and Macao, around 10% of EU citizens living in Hong Kong have left the city in the past year, and growing numbers of employees, including bankers, have asked to be relocated.[1]

Figures from the Census and Statistics Department show that the city has also seen a net total of close to 120,000 residents leaving Hong Kong this year.[2] This number of departures was nearly 1.3 times higher than that from mid-2020 to mid-2021, when around 89,000 residents left Hong Kong for elsewhere.

In the 31st edition of the Global Financial Centres Index, produced by the China Development Institute in Shenzhen and the London think tank Z/Yen Partners, and published on 24 March 2022, Singapore was ranked sixth among global financial centers and Hong Kong third.[3] Although Hong Kong has consistently been Asia ex-Japan's top financial hub for many years, it ranked fourth in the most recent (32nd) edition of the semi-annual Global Financial Centres Index, published on 22 September 2022. In contrast, Singapore improved its ranking to the third most important city for global finance (after New York and London).[4]

We believe that both cities continue to demonstrate tremendous financial strength and resilience. Both Hong Kong and Singapore underwent very impressive economic transformations over the last 30 years. Both also face similar challenges in terms of an increasing cost of living, an ageing population and low productivity. We believe that both financial hubs have numerous potential avenues for growth in the years ahead.

The Economic Growth of Hong Kong and Singapore

The growth of China's economy over the last 30 years has been a driving force behind Hong Kong's rise as a leading global financial center. More than a thousand Chinese companies are listed on Hong Kong's stock exchange. Hong Kong came first in IPO fundraising for four of the last seven years. It is also the largest offshore renminbi (RMB) hub, and it plays a major role in RMB internationalization and the expansion of offshore RMB businesses.

At least two factors play into Hong Kong's international success. The first is its pro-business environment, which includes a low tax regime, efficient financial regulatory framework, and one of the most economically free markets in the world. The second is its increasingly close economic relationship with mainland China. We believe that both these factors will be fundamental in maintaining Hong Kong's competitiveness as an international financial center.

Like Hong Kong, Singapore has evolved into a developed economy over the last 30 years. It is now a global financial and transportation hub, and the preferred location for the regional or global headquarters of many multinational corporations. Singapore's financial sector performed strongly throughout the COVID-19 pandemic and registered robust growth in the banking, insurance, asset management, and payment services sectors. Singapore has also grown steadily as a leading fund management hub. In terms of wealth management, Singapore's family business ecosystem helps wealthy Asian families professionalize their wealth management as wealth transfers from one generation to the next.

Singapore's competitive edge lies in the Asian growth story. As long as Asia continues to grow, Singapore's financial center is well positioned to do the same. The Asian Development Bank estimates that strong exports and domestic demand will drive Asia's growth to more than 5% per annum in the coming years. Both infrastructure investment and project finance are expected to continue double-digit growth. Overall, Singapore's economy remains on track to grow by 3-5% in 2022, barring a worsening external environment.

Challenges Faced by Hong Kong and Singapore During the Pandemic

The COVID-19 pandemic introduced several external shocks to Hong Kong's economy. First, it halted all economic activity globally, with the tourism, hotels, aviation, catering, and retail industries being the hardest hit. In addition, deglobalization led to a worsening of China-U.S. trade frictions, which had a huge impact on Hong Kong's exports and re-exports.

Hong Kong is driven by external demand and therefore is highly susceptible to global economic fluctuations. The perception that Hong Kong is converging towards China could lead investors to classify the territory as higher risk. In the worst-case scenario, there could be a Hong Kong discount instead of a premium. The economic downturn and changes to Hong Kong's domestic and external environments also pose new challenges to its development.

The Hong Kong government announced two rounds (HKD 30 billion and HKD 137.5 billion) of Epidemic Prevention and Anti-epidemic Fund measures, in addition to the HKD 120 billion in relief measures announced in the fiscal budget in early 2020.[5] The total amount allocated was HKD 287.5 billion, which included HKD 80 billion for the Employment Protection plan and HKD 10,000 in cash to permanent residents of Hong Kong aged 18 and above. The government also announced support for the industries most affected by the pandemic, such as passenger transport, tourism, construction, aviation, and catering. A third HKD 24 billion round of the Anti-epidemic Fund was subsequently announced on 15 September 2020, and a fourth round (HKD 6.4 billion) was approved by the Legislative Council on 21 December 2020.

The Singapore government also announced similar aid packages.[6] On 18 February 2020, the government launched an SGD 4 billion Stabilization and Support Package (known as the Unity Budget). Thereafter, the government announced a second stimulus package (the Resilience Budget), which amounted to SGD 48.4 billion. Similar to the Hong Kong aid package, the Resilience Budget included measures to help sectors that were directly affected by the COVID-19 pandemic, such as aviation, tourism, food services, and land transport. The government then announced a third stimulus package worth SGD 5.1 billion (known as the Solidarity Budget) followed by a fourth package worth SGD 33 billion (the Fortitude Budget) on 26 May 2020.[7] In total, Singapore spent nearly SGD 100 billion to help businesses and households withstand the economic impact of the COVID-19 pandemic. The spending added SGD 74.3 billion to Singapore's budget deficit, approximately 15.4% of its GDP. It is the largest ever shortfall for a country known for its fiscal prudence.

Both financial hubs remain in sound shape overall, in part due to these fiscal measures. However, both now face significant near-term challenges, including disruption caused by new technologies, the changing structure of international competition, and a growing trend toward economic nationalism. On the domestic front, both cities again face similar issues, such as an ageing population and a slowdown in population growth, rising costs, and low productivity growth.

The Way Forward

We believe that China's financial opening-up will continue to create long-term opportunities for the development of Hong Kong as an international financial center. Hong Kong offers many advantages in the offshore RMB business. It has the world's first offshore RMB clearing system, the world's largest RMB capital pool, an active RMB trading market, and a diversified RMB product system. As RMB internationalization advances, we foresee the offshore RMB market gradually expanding from Hong Kong to Southeast Asia to form a network of offshore centers across Asia, the Americas, and Europe.

The continuous improvement in the Guangdong-Hong Kong-Macao Greater Bay Area's financial services and economic capabilities will also add momentum to economic growth in the region. The Greater Bay Area is an important engine of growth for China and for the whole world. We are optimistic that the Greater Bay Area will give Hong Kong more opportunities to enhance its role in the financial sector.

Singapore's most promising area of growth is sustainable finance in support of Asia's transition to a low-carbon economy. It is estimated that USD 2 trillion will be needed in infrastructure investment over the next decade to enable Southeast Asia's transition toward sustainability. To that end, Singapore plans to build a comprehensive ecosystem for green and transition financing. To turn Singapore into a green finance hub, the Singapore government announced its Green Plan 2030 as well as the Monetary Authority of Singapore's Green Finance Action Plan.[8] According to the Climate Bonds Initiative, the total green debt volume in Singapore exceeds SGD 20 billion and the country now accounts for over half of total ESG bond issuance in Southeast Asia.

Both cities have demonstrated that in the future, competition for key financial sector talent will be a critical factor in fostering the development of the Greater Bay Area and in launching green financing bonds. In that regard, the Singapore government's decision to live with COVID-19 has given the city-state a head start in attracting foreign talent as it no longer requires quarantining or other isolation requirements. More recently, the Singapore government also announced a new work visa (The Overseas Networks & Expertise Pass).[9] There is no quota imposed on this work visa; it is meant for talented people in any sector who earns a monthly salary of SGD 30,000 and above, or who have "outstanding achievements" in the areas of science and technology, arts and culture, research and academia, or sports.

Similarly, the Hong Kong government announced that the city will allow non-residents to enter the city from 1 May 2022. This opening-up ends two years of stringent border controls put in place at the start of the COVID-19 pandemic and it raises hopes that one of the world's strictest COVID-19 quarantine policies will be relaxed. More recently, the Hong Kong government has announced its decision to remove the COVID-19 hotel quarantine policy for all arrivals from 26 September 2022. For many residents and businesses in the financial hub as well as for the Hong Kong CFA community as large, this decision is viewed as a very positive development that will help bolster Hong Kong's competitiveness and standing as a global financial center. We believe that the further easing of border controls will help both cities foster greater economic growth so that they can transition successfully into the post-pandemic period.

Notes

1 https://www.bloomberg.com/news/articles/2022-02-25/harsh-covid-rules-prompt-10-of-eu-citizens-to-exit-hong-kong

2 https://www.scmp.com/news/hong-kong/society/article/3188536/113200-residents-leave-hong-kong-12-months-contributing-16.

3 The Global Financial Centres Index is based on a global online survey of more than 10,000 professionals. These professionals evaluated 119 cities on 151 factors across five broad areas of competitiveness, including the business environment, human capital and reputation. The full report is available here: https://www.longfinance.net/programmes/financial-centre-futures/global-financial-centres-index/

4 In explaining the ranking changes, the report stated that, "continuing travel restrictions in places like Hong Kong and Tokyo affect their ability to conduct normal levels of business." This is because Hong Kong has followed a "zero Covid" policy for more than two years. since the beginning of the pandemic. The policy had at times required visitors to spend as much as 21 days in a hotel or quarantine facility upon arrival.

5 https://www.coronavirus.gov.hk/eng/anti-epidemic-fund.html.

6 https://covidguide.life.gov.sg/covid/resiliencebudget.

7 https://www.gov.sg/article/a-summary-of-the-fortitude-budget-2020.

8 https://www.greenplan.gov.sg/.

9 Details of the work visa can be found here: https://www.mom.gov.sg/passes-and-permits/overseas-networks-expertise-pass.

This is the end of the ebook.