

POST-CRISIS REFLECTION

# Ripe for an asset price bubble

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FOR THE STRAITS TIMES

**Q**UEUES can once again be seen at condo launches – a sight that may surprise many, given that the effects of the world financial crisis will last long after countries emerge from the recession.

Are the queues a sign of the start of a new asset price bubble? Will we learn from our mistakes? What can policymakers do to pre-empt future crises?

Sadly, the root cause of financial crises is in our genes. We are genetically coded to survive and to seek a better life for our offspring. In economic terms, this means consuming some resources now and accumulating the rest for a better future.

While the relentless pursuit of wealth may be individually rational, it can become collectively destructive. The role of a government is to put in place a system that can mitigate the destructiveness by constraining the actions of individuals and businesses.

Going back to the condo frenzy, I can understand why people would line up even after being burned by the market recently. Who would want to miss the boat? The price may soon be out of one's reach if one doesn't jump in now.

This line of thinking may create another unsustainable bubble. Of course, desire alone is not enough. There must be enough accumulated capital to set the bubble creation process in motion.

This leads me to my second point. The savings accumulated in Asia, plus the liquidity injected into the world economy by governments in response to the

financial crisis, are massive. The macro environment is, in my opinion, ripe for an asset price bubble. A recent indication of this is the tremendous price surge in China's stock and real estate markets. The surge was not accompanied by any noticeable rise in consumer price inflation.

If this financial crisis were a major earthquake, the ensuing asset price bubbles, like the looming one in China, may be preludes to aftershocks of unknown magnitude.

Unfortunately, policymakers are caught between a rock and a hard place. Any cooling measure runs the risk of spooking markets and reversing economic recovery. However, there are things that governments can do, such as setting clear and firm ground rules for investments.

We can learn much from the saga of the Lehman Minibonds and other credit-linked structured notes. When Lehman Brothers went bankrupt, the whole structured product enterprise collapsed with it. Tens of thousands of investors saw their life savings vanish. They demanded that governments come to their rescue.

The Monetary Authority of Singapore (MAS) laid down basic principles for handling this difficult matter. Among other measures, it investigated the selling practices of financial institutions and set up a fast-track process in the Financial Industry Dispute Resolution Centre to deal with complaints by investors.

This was a balanced and sensible approach to resolving the fiasco. After all, people invested in the structured notes because of various reasons, including informed risk-taking, greed and mis-

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leading sales practices. In many cases, it would be impossible to sift out the reasons. In this instance, the solution had to be a compassionate one based on individual circumstances. But I also hope that individuals will end up shouldering part of the responsibility.

The settlements on credit-linked structured notes announced in July in Hong Kong were generous, with all individual investors getting at least 60 per cent of their original investment back. While I am happy for the investors on a personal level, as an economist, I have to say that there is merit in a government not giving in to political pressures to lean on financial institutions.

Let's imagine a government caving in and forcing financial institutions to cover the losses incurred or using public funds to do so. Is this fair to those who did not make similar investments? Moreover, the financial institutions' losses will eventually be transferred to their customer bases.

More importantly, such actions will

send a signal that irresponsible investment will not lead to negative consequences so long as people can band together to exert political pressure on the government. This would encourage precisely the kind of herding behaviour that creates bubbles.

Returning to the situation here, 10 financial institutions investigated by the MAS were banned from selling structured products for periods ranging from six months to two years. They were also required to fix their internal processes for providing advisory services concerning investment products. This MAS action was applauded by many but it also stunned industry watchers.

I can see why. Financial institutions operate in a competitive market and are expected by their equity holders to generate handsome returns. If their competitors are involved in a lucrative business line, it would be hard for them not to join in.

However, this is yet another case of being individually rational but collectively destructive. Without external intervention, markets will almost certainly fail to stamp out bad selling practices. Although 10 financial institutions were penalised, their short-term pain will translate into long-term gains for the industry.

It would be naive to think that we will be able to avoid future financial crises. But we should be able to draw valuable lessons from the past. The knowledge accumulated over the years led to the swift worldwide response to the current crisis, thus averting a potentially calamitous depression.

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