

Praise for  
*The Asian Financial Crisis*  
1995–98

A combination of applied and highly practical economics that through reality bridges the gap between policy theory and actual implications and results, but more it is also a travelogue and a diary.

— Richard Chenevix-Trench, Former CIO of Sloane Robinson

Russell Napier's book offers an authoritative and highly erudite account of one of the most consequential events that reshaped the modern world. As a market participant and a keen observer, Russell offers a seat at the table for anyone who wishes to understand the challenges facing today's policymakers and how the Asia Pacific crisis birthed the age of debt. It is an indispensable guide.

— Viktor Shvets, Global Strategist and Author of *The Great Rupture: Three Empires, Four Turning Points and the Future of Humanity*

A detailed retrospective on the development and evolution of the Asia Crisis drawn from the contemporaneous notes of a keen observer of economic and financial history... interesting food for thought for investors and policymakers alike.

— Terrence Checki, Former Executive Vice President and Head of Emerging Markets and International Affairs, Federal Reserve Bank of New York

The Asian crisis was a remarkable learning experience for everyone in finance. This blow by blow account is an important reminder of what we learned and the hard way we learned it.

— **Lord Davies of Abersoch, Ex Standard Chartered plc and previously Minister for Trade and Small Business**

The Asian financial crises marked the dawn of a new strain of highly virulent crisis that would, in time, come to afflict every advanced economy in the world. This lucid book offers a forensic and compelling account of its source, contours and consequences.

— **Andy Haldane, Chief Economist at the Bank of England**

A remarkable record of the highs and lows of Asia's boom and bust in the late 1990s – you feel you are watching the Asian financial crisis unfold before your eyes. This is this an invaluable compendium of what really happened, as seen by a participant in the drama.

— **John Greenwood, Chief Economist Invesco Ltd.**

THE  
**ASIAN  
FINANCIAL  
CRISIS**  
1995-98



**THE  
ASIAN  
FINANCIAL  
CRISIS  
1995–98**

**BIRTH OF THE  
AGE OF DEBT**

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First published in 2021.

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Hardback ISBN: 978-0-85719-914-0

eBook ISBN: 978-0-85719-915-7

British Library Cataloguing in Publication Data

A CIP catalogue record for this book can be obtained from the British Library.

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Harriman  
House

*For my colleagues at CLSA from 1995 to 1998*

*“Forsan et haec olim meminisse iuvabit.”*

*“A joy it will be one day, perhaps, to remember even this.”*

The Aeneid



# CONTENTS

|   |     |
|---|-----|
| About the author  | xi  |
| Introduction and acknowledgements                       | 1   |
| Part One: Learning the hard way<br>- a beginner's guide | 7   |
| Part Two: The road to devaluation                       | 33  |
| Part Three: Devaluation and crisis                      | 169 |
| Part Four: The bottom                                   | 303 |
| Part Five: The beginning not the end                    | 357 |
| Index   | 269 |



# ABOUT THE AUTHOR

Professor Russell Napier has been an adviser on asset allocation to global investment institutions for over 25 years. He is author of *Anatomy of The Bear: Lessons From Wall Street's Four Great Bottoms* and *Keeper of the Library of Mistakes*, a business and financial history library based in Edinburgh. He has founded and runs a course called 'A Practical History of Financial Markets' and also an online marketplace (ERIC) for the sale of high-quality investment research to institutions. Russell is Chairman of the Mid Wynd International Investment Trust.



# INTRODUCTION AND ACKNOWLEDGEMENTS

This is another book about mistakes.

In my last book – *Anatomy of The Bear: Lessons From Wall Street's Four Great Bottoms* – I chronicled, by analysing opinions expressed in the pages of the *Wall Street Journal*, why intelligent investors were so keen to sell equities when they subsequently produced excellent long-term returns. While financial history in general and the history of investment in particular focuses on the individuals and institutions that get things right, the story of those who get things wrong is often ignored. While spectacular failure often makes it into a footnote, conventional failure is the background noise that barely reaches beyond a gentle hum in the pages of financial history. I hope that in *Anatomy of The Bear* I showed how common errors, when equities were cheap in 1921, 1932, 1949 and 1982, provided excellent signals that it was time to invest.

In this book I assess contemporaneous opinion both at the top of the bull markets in Asian equities from 1995 to 1996 and also, following a vicious bear market from 1996 to 1998, such opinion at the bottom of the bear markets in September 1998. On this occasion I rely not on the pages of the *Wall Street Journal* to assess such opinion, but on my own writing as an Asian equity strategist working in Hong Kong throughout that period. Many of the mistakes in this book are my own mistakes. You will find my own contemporaneous opinions from 1995 to 1998 throughout this book in boxed sections. What you will read in these sections is not the history of the Asian economic miracle nor the Asian financial crisis. You will read what financial market practitioners thought would happen in Asia, but didn't. That is a very different story from financial history, but it's the most important story for investors assessing why financial assets can become so misvalued. The opportunity for investors to profit was in determining the prevailing errors of

analysis in Asian financial markets in 1995 and 1996. They were very different errors that signalled the bottom of the equity bear markets in September 1998.

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 incentivise such behaviour. 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 incentivised 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 US 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 organisation 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.

There are many people I need to thank for aiding in the creation of this book. This book would not exist without Abbie Perkins. In her original role as head of production at Credit Lyonnais Securities Asia (CLSA), she edited the original analysis that now appears in this book in the boxed sections. Despite having suffered through the editing process from 1995 to 1998, she volunteered to do it a second time and edited the first draft of this book. That the original work met with such approval was largely due to Abbie's ability to translate my rambling prose into English. I hope I have learned from her over the years and this book was somewhat less of an editing challenge. I would like to thank Abbie for her work, patience, perseverance, guidance and friendship over many years. Abbie and Peter Perkins were just two of the friends we met in Hong Kong who sustained us through a period of too much work, too much travel and too much chaos. In the maelstrom of 1995 to 1998 it was also the friendship of Ronnie and Julie Lim, Michelle Ring and Brendan Brady, Joan Kiernan and the formerly PJ King, Mark McFarland, Chris Lown, Sam Darwin, Jodie Gibbens and Emma Slade that brought us some much-needed sanity. It was also my good fortune to meet in Hong Kong a man

from Paisley in Scotland called Donald Nimmo. Donny is a remarkable man who I am honoured still to call a friend. However bad things are they always seem lighter in his company and he distributes his wisdom in often blunt but always witty doses. I hope some of that wisdom and humour has rubbed off over the years and may even be reflected in this book.

I was fortunate enough to work with many colleagues at CLSA who were both excellent company and provided a rapid education of how things worked at the sharp end of capital markets. Mike McCoy's name will appear on various occasions in this book and I often today find myself looking at an investment situation and trying to find the 'McCoy' angle. The head of CLSA in London, Jonathan Compton, is the smartest investment maverick I have met. A trained barrister freed from the laws of evidence, he produced more unique investment ideas in an afternoon, usually after a glass or two of claret, than most of us can produce in a lifetime. Not all these turned out to be good investment ideas, but many were and being subjected to them is perhaps the greatest educational experience of my career. I also learned a lot from Dr Jim Walker, chief economist at CLSA, long before I had joined the firm. I learned even more in the journey through the boom and bust that was to come. CLSA lost its co-founder and inspiration, Gary Coull, at far too young an age. I keep on my desk a framed admonition from him which I refer to almost every day: "You have to read this and ask yourself: what's new, different, interesting? Where's the angle? If you can't tell me that, throw it away." Throw it away he often did and the authors always benefited from the disposal.

Part of my job during the crisis was to liaise with CLSA's numerous regional offices across Asia. This could be fraught with difficulties as in most organisations the centre is often accused, often correctly, of being 'out of touch' with the regions. Despite the tensions inherent in any such relationship I found great friendship and guidance from Amar Gill, then in Malaysia; from Mark Faulkner, Doug Clayton and Daniel Tabbush in Thailand; from Vincent Houghton, Jason Donville and Ian McCallum in Indonesia; Donald Skinner and Nel Friets in Singapore; and Brian Parker in Hong Kong. In those few mad years from 1995 to 1998 I travelled the world meeting institutional investors usually in the company of CLSA's institutional sales team. What should have been tedious and exhausting travels were made entertaining and invigorating when in the company of people like Nicolas Leouzon, Damian Dwerryhouse, Hideki Nozawa, George Hansom, Tim McKenna, Rob Eberley, Martin Cornett, Bill O'Rahilly, Sumio Kato, Nao Kamiya, Andrew Riddick, Evelyn Moore, Jay Plourde, Tara McNamra, Nick Hornby amongst many others. Throughout

all of this CLSA had a head of research, Edmund Bradley, who forced the company to produce high quality research on time. This may sound simple but it was not easy or our competitors would also have managed it. It is even clearer today that the company added significant value to its clients during this tumultuous period and a significant portion of the credit for that must go to Edmund.

While this book covers the period from 1995 to 1998, much of the analysis of the period has benefited from what I have learned since about financial markets. In pursuit of greater understanding I founded 'A Practical History of Financial Markets' course in 2004 and it is still going strong. Over many years I have benefited from the wisdom of my fellow teachers – Herman Brodie, Edward Chancellor, Jamie Dannhauser, Jon Compton, John Greenwood, Gordon Pepper, Derry Pickford, Andrew Smithers, Peter Warburton and Stephen Wright. The search for greater understanding continued with the foundation of The Library of Mistakes in 2014 and I would like to thank everyone who has contributed to its foundation and its continued success.

I was delighted that Harriman House was supportive of a follow-up book to *Anatomy of The Bear*. I would like to thank Craig Pearce for his support and particularly Kay Hawkins, whose editing has made this book much more intelligible and I think much more readable.

I would like to conclude by thanking my family. The Napier family is now split between Scotland, Northern Ireland and New York but this does not take away from what it is. To my mother and two brothers, I owe everything for their love and support over many years. Though my Dad is not around anymore he is with us all every day in many different ways and his strong, simple but wise advice is always present. Writing books is an anti-social activity even if done in a period of social distancing. This means being away from family life for an extended period and thus any book is always the result of a burden shared. To Sheila, Rory and Dylan for all their help and support my thanks and love. Without family, what's the point anyway?

Russell Napier,  
Scotland, 2021



# PART ONE

## Learning the hard way - a beginner's guide

**Tuesday, 9 September 1997**

Harry – Hello. Hello. It's Harry here.

FM – Ah, Harry who?

Harry – Harry from PT XYZ, we met in Jakarta last year.

FM – Oh yes. Hi Harry.

Harry – We need some money.

FM – Sorry?

Harry – We need some money.

FM – Dollars or rupiah?

Harry – Any money, any money, we need some money.

FM – What maturity?

Harry – Any maturity, any maturity, we need some money.

FM – I'm sorry Harry we don't [line from Indonesia goes dead].

**Phone conversation on Tuesday, 9 September 1997 between a fixed interest fund manager at HSBC Hong Kong and the chief financial officer of an Indonesian corporate**

Harry and his company stood on the edge of bankruptcy less than two months after they had benefited from one of the biggest economic booms in history. Having spent years turning down cheap foreign finance, Harry was now begging for it, but not a penny was to be found.

Harry of course was not his real name and neither was PT XYZ a real company. This transcript I produced for institutional investors in September 1997 did not reveal those details for fear of heaping more problems upon Harry and risks upon the fund manager who received the call. By September

1997, Asia was full of Harrys and they didn't just operate out of the finance departments of Asian companies. On 8 October 1997, a very similar call was placed, but this time from the Ministry of Finance of the government of Indonesia and it was to the International Monetary Fund (IMF). This country of almost 200 million people had run out of money.

It was not the only country in Asia that was suddenly on the verge of bankruptcy. A financial feast had turned to famine in just a few months.

## **There's no money left**

The consequences of running out of money transcended finance and economics. By May 1998 in Indonesia, over 1,000 people had been killed in riots and President Suharto's 31-year tenure was over.

It was no ordinary recession that brought such chaos to Asia. In the Asian financial crisis the decline in gross domestic product (GDP) per capita, measured in US dollar terms, was of a huge magnitude: Indonesia -56%, South Korea -34%, Malaysia -30% and Thailand -27%. Investors who sold billions of US dollars and other currencies to buy Indonesian equities lost 90% of the value of their investment, in US dollar terms, in little over a year. Losses in other regional stock markets may not have been as bad, but they were still eye-watering declines in the US dollar value of investments: Hong Kong -58%, Malaysia -87%, the Philippines -78%, Singapore -59%, South Korea -71%, Taiwan -36% and Thailand -89%.

Savers had invested to benefit from the famed Asian economic miracle. They got the notorious Asian financial crisis. This is the story of that crisis, but not a history of it. It is told primarily through the writings of someone who was there at the time and who was trying to assess the economic and financial outlook both before and then through the chaos. It is a story of what it is like, as an investor, to live through one of the largest ever financial crises without the benefit of knowing where and when it will end.

In learning the investment lessons from that crisis, the mistakes in forecasting the future you will find in this story are probably more important than the successes. They are my mistakes - your author.

## The so-called Asian economic miracle turned crisis

I was enfranchised to make these mistakes as I was, at the age of 30, hired to advise global equity investors on where and where not to invest in Asia. As the Asian Equity Strategist for one of Asia's largest stockbroking companies, I lived through and chronicled this economic miracle that became a crisis.

I landed in Hong Kong in May 1995 to join the wild party in financial markets that was a key part of the so-called Asian economic miracle, but by the time I left in September 1998, much of the region was on financial life support provided by the IMF and the crisis looked like it could trigger a global depression. In just over two years, what was widely admired and praised as an economic miracle had turned into what is now widely known as the Asian financial crisis. Portfolio investors and commercial bankers lost hundreds of billions of US dollars in little more than a year.

The collapse threatened the solvency of the global financial system, bankrupted Russia and brought devaluation and economic chaos to Brazil. It also did something that was to prove even more destructive, as it created, in its aftermath, the conditions that were to fuel one of the biggest debt booms in global history – a debt boom that in 2021 continues on its destructive course.

It all began in the rear end of a koala. For three and a half years I chronicled the end of a boom and then the storm of the Asian financial crisis from the 33rd floor of what was then called the Lippo Centre in Admiralty, Hong Kong.

The two-towered building had been built by Australian entrepreneur Alan Bond. The Bond Centre, as it was originally called, was completed in 1988 when Alan Bond was at the zenith of his success. Bond was a proud Australian, though born in England, and he had the two towers designed in the shape of trees, each complete with a series of climbing koalas. My office was in the rear end of one of those koalas hanging out over Admiralty with a view across Hong Kong harbour to Tsim Sha Tsui. On a clear day, of which there were increasingly few, you could see the hills of the New Territories. China was not visible but, because of the pollution, you could often smell it.

The rear of this particular koala had its own warning about the perils of assuming that enterprise funded with excessive debt is an enterprise built upon firm foundations. Alan Bond went spectacularly bankrupt just a few years after the Bond Centre was completed. This was not the only casualty associated with the Bond Centre. After Bond's demise, the building became the Lippo Centre and the Lippo Group of Indonesia was almost mortally wounded in the Asian financial crisis.

Of the two towers of the building, one was named the Peregrine Tower after the stockbroking company that was to be one of the more high-profile casualties of the Asian financial crisis. Local Feng Shui experts suggested that it was the shape of the glass koala that brought such bad luck to those that were associated with this building. Perhaps they were right, but during the time I occupied the rear of the koala, there was little good luck to be had anywhere in Asia.

My job in Hong Kong was to write papers advising professional investors on which of the many Asian equity markets to invest in and which to avoid. *The View from the Rear of the Koala* would have been a striking title for these writings, but perhaps too outrageous even for my famously irreverent employer, CLSA.

Instead, I settled on something much more prosaic for these musings with two words from a song called ‘Northern Muse’ written by Van Morrison. The writings you will find reproduced here, mainly written in the low light of an early Hong Kong morning, are as they hit the press from 1995 to 1998, published under the banner of *The Solid Ground*. From the outset, I saw the irony in that title as there is no such thing as anything solid in forecasting the future – financial future or otherwise. That is both the curse of those who try to forecast and also the appeal of the pursuit to the enquiring mind.

Fortunately, the job of an investor or their adviser is not to accurately forecast the future, but to forecast it more accurately than the consensus. These writings attempted that task without of course knowing anything about the future.

## **Mistakes and misconceptions in the fog of war**

Historians know what happened next and this informs, often wrongly, their interpretation of events and decisions at the time. Misconceptions and mistakes are analysed without any understanding of how reasonable they seemed to those wrapped in their own fog of war. What follows here is a story of those mistakes made in the fog of war and of the major, then prevalent, misconceptions and their role in creating one of the world’s worst financial crises.

The content published here was written from 1995 to 1998 and cannot be described as history because it was written in an attempt to forecast the future. Now that we know that future, we can assess what advice, whether right or wrong, proved of value to those trying to secure positive real returns from their investments in the teeth of one of the world’s greatest financial

crises. Your author believes that it will be advice that will be helpful for investors still involved in the battle for investment survival.

It was perhaps John Kenneth Galbraith who best described why memories, even perhaps if they are someone else's, are “utilitarian” and can protect us all, at least somewhat, from the “luminous insanity” that sometimes pervades markets:

The story of the boom and crash of 1929 is worth telling for its own sake. Great drama joined in those months with a luminous insanity. But there is the more sombre purpose. As protection against financial illusion or insanity, memory is far better than law. When memory of the 1929 disaster failed, law and regulation no longer sufficed. For protecting people from the cupidity of others and their own, history is highly utilitarian.

**John Kenneth Galbraith, *The Great Crash 1929*, Preface to the 1975 edition**

## **No extrapolation allowed**

As an over-confident 30-year-old arriving in Hong Kong in 1995, the first thing I did on entering my office was to print out and pin on a board behind my desk the phrase “No extrapolation allowed”. This was aimed at reminding myself that I couldn't hope to get paid for mere extrapolation, something I discovered is actually only partly true, but it was also aimed at warning colleagues that I was not interested in any analysis that consisted of deploying a ruler and a pencil and drawing a line between two points.

There was an awful lot of such analysis about in 1995 in the middle of the Asian economic miracle and it is something that becomes incredibly prevalent in bull markets. One can indeed get paid for it and, if in the right place at the right time, can get paid very well for it too. That was a path I could have chosen and while it can be lucrative, it can lead to a short career for you and your clients.

Beside the exhortation against extrapolation, I pinned a Deuchars IPA beer mat – a fine Edinburgh beer – behind my desk to remind me that the worst that could happen was that I would end up back in Edinburgh drinking much better beer than was then available in Hong Kong. That didn't seem like such a big downside, and thus perfectly equipped with a determination to avoid extrapolation as a form of analysis, a beer mat and an attitude to career risk perhaps bordering on the reckless, I set out to analyse the Asian economic miracle. I even had a Chinese name, courtesy of my secretary, that meant ‘precious stone of scholarly determination’. A name to live up to.

## Understanding the fundamentals

To understand the perspective and analysis in this book, you will need to understand a little, just enough, about how credit and money are created and destroyed. It was a failure to understand this and instead a focus on what most investors call ‘the fundamentals’ that led so many people to lose so much money in the Asian financial crisis. These fundamentals are all derived from analysis of the operations, likely profitability and balance sheets of individual companies.

The reasoning goes that a company’s share price will primarily reflect these fundamentals and that other factors for consideration, such as macro factors related to money and credit, just get in the way of forecasting what really drives equity prices over the long term. That focus predominantly on these fundamentals can be helpful and sometimes is indeed the best approach to estimating returns from equities.

The longer the holding period of your investments, the more important the fundamentals are. There are circumstances, however, usually when a money and credit boom are underway, where even for long-term investors there is a great danger in focusing too much on the fundamentals.

The stock market index that best measures the capital performance of Asian ex Japan equities peaked in January 1994 and did not sustainably exceed that level until the summer of 2010. At its low in March 2020 that capital index was just 12% above the level it first reached in January 1994.

In most of Asia by 1995, the fundamentals were the product of a money and credit boom and they were to deteriorate rapidly when that money and credit boom ended. When the true fundamentals were finally established investors were nursing huge losses. The seemingly positive fundamentals were driven by the excessive growth in money and credit that were the products of huge capital inflows impacting upon managed exchange rate regimes.

These factors were determining the fundamentals that investors were focused on. There was little realisation that cause and effect ran from money and credit to the fundamentals when the tide of capital flowed into Asia. That realisation came only on the ebb of the tide.

How the Asian central banks and then the commercial banks acted to transmute capital inflows into local currency money and credit was the key to understanding the fickle foundations of the Asian economic miracle. I had learned the basic mechanisms of money and credit creation analysing the US banking system as a fund manager in Edinburgh. Watching the 1990–91 US banking crisis unfold and how monetary policy settings impacted or failed to

impact bank credit growth and thus money growth, was a great way to learn quickly. No form of analysis will always provide the right answer or even the better answers that we need to profit in purchasing financial assets the prices of which are always discounting the future.

In the conditions in Asia pertaining at that time, however, an understanding of money and credit was the key skill required to understand the investment outlook. In the Asian economic miracle, a hyper-charged credit cycle was underway and there was little in financial history to suggest that it could be sustained. That those credit cycles relied increasingly on short-term capital inflows to sustain them suggested that the time was near when the unsustainable would indeed be unsustainable. How to assess when the unsustainable credit cycle is about to end, at least in managed exchange rate regimes, is what most of the contemporaneous writing you will find here is about.

## **A bit about financial history**

An understanding of financial history is also a key tool in understanding how credit cycles peak and the consequences of that peak and then decline. With degrees in law and no formal qualifications in economics, business or finance, I had found that I could learn a lot about financial markets from reading financial history.

It struck me as curious then, and still does today, that so few professional investors know how financial markets have behaved in the past when faced with some of the stimuli they expect them to be impacted by in the future. I'm not sure that it is an approach to understanding cause and effect that would be tolerated in other professions, but it is a very pervasive approach in investment.

Many investors were at sea when, boom, the only thing most had known in Asia turned to bust. There was plenty of guidance as to what would probably happen, but it was all hidden in history books and not economic textbooks. Few thought those history books could be a guide to the 'modern' investor, but they were to prove to be one of the best guides we had.

As the years progressed, I came to rely more upon financial history as a guide to the financial future and in 2004 established a course in financial history for professional investors, 'A Practical History of Financial Markets', at the Edinburgh Business School in Scotland. Although this book covers the period from 1995 to 1998, you will find many references to periods in financial history before then that I believe proved useful in assessing the financial future. This book now serves as another guide on how to spot an over-exuberant credit cycle, how to work out when it is ending, and what to do when it does.

Investment is not a physical science, but a pursuit to establish price by human beings who bring key psychological biases to the endeavour. The importance of those biases waxes and wanes, but at some although not all times, they become overwhelmingly important. The history of those periods, when these psychological biases overwhelm the rational mind, are essential reading for any investor and the story of the boom and bust in Asia, from 1995 to 1998, is one of those periods.

The lessons from such periods remain largely untaught in the finance faculties of our leading universities. They are not periods in which the behaviour of investors fits readily into the academic models that have much greater validity in periods when more rational, if not irrational, behaviour prevails. As this book is composed of daily writings from the period when an illusion ended, it is also a guide as to what happens when illusions end and the search for a new certainty begins.

Much of this book, written between 1995 and 1998, is uncontaminated by hindsight bias. Along with these views from the investment trenches you will also find new commentary that I have now added written with the benefit of hindsight. That commentary seeks to distil the key lessons for investors from the crisis era from a long and hopefully somewhat detached distance. This is then not a history of the Asian financial crisis per se, but a story of what it was like to guess “what was at the other side of the hill”, much as the Duke of Wellington explained to be “all the business of life”:

All the business of war, and indeed all the business of life, is to endeavour to find out what you don't know by what you do; that's what I called “guessing what was at the other side of the hill”.

Historians, looking backwards as their profession dictates, always know what is “at the other side of the hill” and thus their analysis of the state of mind of participants at the time is often naturally ill informed. This benefit of hindsight is particularly dangerous when writing the history of financial markets. Markets are discounting mechanisms and are always pricing in the future. This is particularly so in financial markets where so much of the value of an investment is based upon an uncertain future. The purchaser of a chair, for instance, does not expect an uncertain return from that chair, and it is very likely to still be providing all the expected functions of a chair long after its purchaser has ceased to be. When the future for the chair is so predictable, most of its value and hence price can be established in assessing all the things we know about it before purchase and those features almost certainly will not change.

In financial markets where corporate earnings and dividends change, where interest coupons are paid or not paid, where inflation rises and falls, and where exchange rates oscillate, however, the opinions on all those ever-changing variables are encapsulated in prices sometimes changing by the second. The prices of financial assets are replete with opinions about the future, and historians looking from “the other side of the hill” often miss the key determinants of price for those guessing what they don’t know based on what they do know.

For the financial market historian, there is thus great value in the study of the contemporaneous opinion of those pricing financial assets. Like the Iron Duke, they sought “to endeavour to find out what you don’t know by what you do”, and in that pursuit they regularly failed. The common failures in such pursuits are worthy of study and this book attempts to study such failure – in this case largely my own!

## The benefit of hindsight

In my first book *Anatomy of the Bear: Lessons from Wall Street's Four Great Bottoms*, I plumbed the *Wall Street Journal* in an attempt to establish what the combatants in the battle for investment survival foresaw in real time. It was in their common errors, often paraded as wisdom in the *Wall Street Journal*, that *Anatomy of the Bear* sought answers to the question as to how one might invest at the bottom of a US equity bear market.

This book seeks to do something similar but this time relying upon my own contemporaneous opinion regarding the future. While hindsight bias must slip into any edited version of contemporaneous opinion, this book is an attempt to show forecasting ‘warts and all’ rather than being covered with the heavy makeup of hindsight.

As I think *Anatomy of the Bear* showed, it is in the mistakes commonly made that prices are diverted from their true value and thus opportunities created for long-term investors. This book thus lays out my own mistakes and, of course, I could not resist, includes some successes. The aim is to improve in the “endeavour to find out what you don’t know by what you do” while acknowledging that investors will never know what is at the other side of the hill. Wellington seemed to get better at guessing what was at the other side of the hill the more he tried. Wellington’s troops paid a high price when he got it wrong and investors pay with their pocketbooks or the pocketbooks of their clients for mistakes made in real time with real money. The aim of this book is to allow the reader to learn from mistakes made in the heat of investment battle without ever having to waste any of their financial ammunition.

## Boom and bust

I had already wasted a bit of financial ammunition when I arrived in Hong Kong. In what had been a short career, less than five years when I landed at Kai Tak airport, I had already seen the incredible impact that a money and credit boom had had in lifting the price of shares to astronomical valuations in Japan and then dashing them.

In Japan, fundamental investing had been of limited use in calculating just how high equity prices could rise, when they might stop rising and how quickly they might then decline. Similarly, in Taiwan, a stock market then closed to direct foreign participation, equity valuations had risen to astronomical levels by 1989, only to then crash spectacularly. In both cases a boom in money and credit seemed to have played a key role, heavily influenced by an attempt to manipulate exchange rates.

Such booms and busts were considered infrequent and the exceptions to the norm that, even if they could be understood, were safely ignored by an investor seeking to select equities to own for the long run. We have now had what most people would consider the ‘long run’ and in 2020 the capital indices of both Taiwan and Japan were still below their 1989 highs. Even investors for the ‘long run’ need to pay attention to the scale of the credit boom underway when they decide to invest.

As the 25 years from 1995 were to show, levels of both credit and money growth played key roles in creating unstable systems that resulted in gross damage to the savings of those whose wealth was tied up in financial markets. While exceptional investors rode out all the stock market collapses invested in the shares of companies they had correctly identified as representing good value, most investors had neither the genius, nor the luck, nor the fortitude to benefit from such an approach. For these investors, the macro factors regularly whipsawed their investment returns and in that volatility they often sold low and bought high.

## Macro factors and financial market pricing

For all but the exceptional investor, some consideration of macro factors proved to be essential in assessing the future returns from financial assets. In the Asian financial crisis one learned quickly which macro factors counted and which didn’t. Too late for many, the focus shifted from the ‘miracle’ of high economic growth to the instability of how it had been financed.

Having witnessed the stock market bubbles inflate and burst in Japan and Taiwan, I was predisposed to believe that there was more to assessing the outlook for asset returns than the so-called fundamentals scrutinised by micro investors. One day in a bookshop in the City of London, I stumbled upon a book that purported to be able to explain, at least in part, the relationship between macro factors and financial market pricing. It was called *Money, Credit and Asset Prices*. It summed up the lifetime's work of Gordon Pepper and had just been published.

Gordon Pepper, whom I was subsequently lucky enough to persuade to become a teacher on 'A Practical History of Financial Markets' course, had been the 'guru of the gilt-edged' market through the 70s and 80s. As an analyst of gilts, British government debt, he had also developed an uncanny knack of forecasting the direction of the UK stock market. It turned out his research for the stockbroking firm W. Greenwell & Co. had been avidly read by Margaret Thatcher and she was to turn to him for policy advice in later years.

I remember very well the day I read *Money, Credit and Asset Prices*. What occurred to me instantly was that this analysis, all taken from the UK and the United States, would be particularly useful when applied to jurisdictions where exchange rate management policies were in place, as they then were across Asia.

Solving equations had never been my forte, but it was obvious, even to me, that such solutions were much easier to solve when one started with one known variable. Asia's managed exchange rates provided the known variable in the equation for anyone trying to solve the equation of money, credit and asset prices. This was an approach to analysing the investment outlook for Asia that was not widely used and certainly not given much credence by investors enamoured of the higher economic growth rates of Asia.

That such higher economic growth rates would produce high returns on equity investments was a mantra that was often repeated and rarely questioned. I had already witnessed just how in practice the operation of a managed exchange rate helped with forecasting future asset price levels.

## **Hong Kong and the currency board system**

In Hong Kong, from 1990–91, inflation and interest rates had gone in different directions and that was a divergence that was not supposed to happen according to the limited number of economic textbooks I had read in studying for the Society of Investment Analysts exams. The decline in interest rates in Hong Kong, while inflation and economic growth had risen,

led to a major rise in the price of local equities as people shifted away from the fixed-interest investments and deposits that offered such poor real returns.

Equity investors in Hong Kong were benefiting from the positives for corporate earnings and dividends resulting from higher economic growth while also benefiting from the lower interest rates used to discount future earnings. That combination of higher earnings and a lower discount rate led to higher net present value calculations for future earnings and thus higher share prices.

This surprising divergence in inflation and interest rates was the direct result of the currency board system, a particular form of exchange rate management system that operated in Hong Kong and effectively imported US interest rates to the British colony regardless of the local level of inflation. The colony was importing interest rates set according to levels of growth and inflation expected in the United States, but in an economic system experiencing growth and inflation at the higher levels being generated through its economic links to China.

The economic textbooks had been fairly silent on such divergences as they focused primarily on how money and credit flowed and influenced economic activity in flexible exchange rate regimes. That interest rates and inflation could diverge so markedly, with clear impacts for asset prices, was something I had thus already seen in action. That they would diverge in a more painful direction was not just likely, but inevitable – but when?

## **A ‘miracle’ in Asia or the mispricing of financial assets?**

While Hong Kong had the strictest form of managed exchange rate in Asia – the currency board system – some form of currency management was in force across the whole region. Through their choice of managed exchange rates, the Asian authorities had put in place the one known variable that would significantly increase the chances of using the *Money, Credit and Asset Prices* form of analysis to produce better quality forecasts of financial market prices. The more interest rates were likely to be out of sync with underlying economic conditions, the greater the prospect of asset price volatility and, thus, investment opportunity.

This was not a form of analysis that was widely applied at the time in Asia as investors were convinced that what was driving Asia was literally a *miracle* that had something to do with what was in the air, in what was believed to be a unique brew of culture, entrepreneurship and policy settings that all but guaranteed higher economic growth and, it was argued, higher returns from investment in equities.

That there is no connection between levels of economic growth and returns from equities is a key conclusion from financial history, but it was the dominant belief among investors in Asia in the mid-1990s. Between that perception and the reality of how managed exchange rates could deliver but also end credit booms lay the mispricing that was to prove so destructive of the wealth and livelihoods of millions.

The mispricing of financial assets in Asia was also driven by a dominant cultural misconception. A key precept behind the Asian economic miracle was a belief that it was founded on something called Asian values. What the Asian financial crisis revealed was that the Asian values foreign investors believed underpinned the Asian economic miracle were very different from the Asian values perceived by Asians themselves. The foreigner looked to Asia as a region of hard working, hard saving peoples imbued with what the Westerner might call family values. In some ways the Western investor saw in Asians, particularly the Chinese diaspora that dominated business across much of the region, a form of the puritan spirit that they supposed had played such a key role in the success of capitalism, at least according to Max Weber's famous exposition in *The Protestant Ethic and the Spirit of Capitalism*. The combination of these same virtues identified by Weber were supposed to be the secret to high levels of savings and capital formation and a political backing for pro-growth economic policy settings all against the background of political stability.

That foreign investors had come to define Asian values so specifically in relation to the region's economic success proved dangerous. To many Asians, Asian values were about placing communal rights above the rights of the individual, and this was hardly in tune with the foundations of capitalism that foreign investors understood and ultimately represented. Much of the capital structure of the region and also economic policy settings reflected this very different set of Asian values and it was often manifested as links between business and politicians that were very far from what developed world investors were used to. The values that foreign investors saw in Asia might have been prevalent among the population of Chinese descent, but such people were often minorities within complex and fragile social structures held together by policies that conflicted with what Weber would have described as capitalism.

The foreign investor paid up for Asian values without actually understanding what those values were and how those values conflicted with their role as providers of capital. When the miracle became a crisis, they rapidly relabelled Asian values as *crony capitalism* and instead of an asset, they priced this form of Asian value as a liability. That the values foreign

investors thought were aligned with capitalism were so opposed to it was to become very apparent when the IMF rode into Asia with its prescriptions for change. Those prescriptions were seen by many, most notably Mahathir Mohammad, the prime minister of Malaysia, as in direct conflict with Asian values. According to the non-Asian policy makers driving the IMF intervention in Asia, foreign investors needed the destruction of crony capitalism if capital outflows were to cease, exchange rates to stabilise and interest rates to decline. These were the same investors who only months before had very willingly poured capital into that same system. Just how that clash of two sets of values played out in the crisis and has played a key role in establishing the age of debt, is also the story of this book.

## The investment crowd

When I arrived in Asia, a crowd had formed. A crowd is very different from a set of individuals:

A crowd quite often seems to overflow from some well-guarded space into the squares and streets of a town where it can move about freely, exposed to everything and attracting everyone. But more important than this external event is the corresponding inner movement: the dissatisfaction with the limitation of the number of participants, the sudden will to attract, the passionate determination to reach all men.

Elias Canetti, *Crowds and Power*, 1960

By 1995 the investment crowd in Asia had long ago burst into the squares and streets. In 1993, passing through screening at the airport in Kuala Lumpur, the security agent had seen that I was carrying a pile of investment research. He told me that he would make my progress through security particularly difficult unless I gave him a stock tip.

The crowd had the passionate determination to reach all men, and women, and by 1995, it seemed to have succeeded. In Malaysia, the crowd had embraced secondary market trading in burial plots as one of the roads to riches. It seemed that all men had been reached – dead or alive. To live among such a crowd but to avoid its “passionate determination to reach all men” is not easy, but it helps to arrive from outside and fairly late.

I was fortunate enough to arrive in Hong Kong as an outsider *after* having witnessed the “inner movement” of the crowd from the safer distance of Edinburgh and London. Crowds do not welcome outsiders who resist the

inner movement, as I soon discovered. Like any young person seeking to learn quickly, I sought out the advice of the older 'Asian hands' who might really know what was going on. These insiders, whom I was sure knew more about what was going on in Asia than I did, were well informed, but they were also intoxicated with success and the mutual affirmations of others. They too were part of the crowd. It is a lesson that has remained with me that it is always essential to get the opinions of an outsider on any investment proposition.

Those whose job it is to follow a particular asset class can very easily form a crowd and crowds are full of feedback loops that create, for those in the crowd, a view of the future for asset prices that an outsider often finds divorced from fact or analysis. It is the easiest thing in the world to assume that it is the insiders who know more about the facts in any given situation. However, when a crowd has formed, the insiders are more likely to be caught up in the extrapolation from current conditions that is the easy and thus most acceptable form of analysis to those in the crowd. It really does not matter whether the insiders are corporate leaders, finance ministers or humble stockbroking analysts, they are likely to find their opinion contaminated once they are embraced by the "inner movement" of the crowd.

In my initial period in Hong Kong, I travelled widely across Asia to talk with the heads of research at the CLSA regional offices and often they were able to arrange meetings with senior central bankers and people in the finance ministry. The uniformity of opinion, regardless of the source, I found to be deeply concerning and often directly at odds with the data I was analysing in my office 33 floors up in the glass koala. While it was fun to scoot about Asia and spend time working and socialising with colleagues, it was also dangerous.

The crowd is an attractive place to be. There is company in the crowd, there is no dissonance and everyone agrees with you – what's not to like? I soon cut back on the travelling and tried to stick to the data in the belief that in the battle between appearance and reality it was safer, as a forecaster, to be closer to reality. That the reality was more evident in the data than on the ground was perhaps the best indicator that a crowd had formed.

## **The hidden reality**

Perception can trump reality for a long time in financial markets, so the key question was when the worsening in the external accounts would come, bringing the tightening of money and credit that would very likely result in lower equity prices. The new reality of the Asian economic miracle seemed

to me to already rest on some very shaky foundations and was thus unlikely to be sustainable for much longer.

The fundamental reason why it could not be sustained was because the region's current accounts were already in significant deficit and the ability to maintain stable exchange rates and produce high levels of economic growth thus relied upon ever larger capital inflows. While ever larger capital inflows were possible, the deterioration in the quality of those inflows, in the form of ever larger sums of short-term capital inflow and less long-term capital inflow, suggested that it was increasingly dangerous to bet on their continuation.

As the Asian economic miracle story took hold, a larger and larger proportion of the capital flowing to Asia was for the purchase of listed equities, the local currency bond markets being virtually non-existent in 1995. This inflow of capital for the purchase of liquid investments was very different from foreign direct investment (FDI) – investment that primarily ended up in bricks, mortar and machinery or in some other form of productive capacity. Money flowing in for the purchase of equities was, at least in theory, highly liquid and could leave as quickly as it arrived. FDI funds could flow in quickly, but as they then took the form of usually physical capital, their rapid exodus was highly unlikely.

The analysis in *Money, Credit and Asset Prices* suggested that should a country managing its exchange rate turn from external surplus to external deficit, then its monetary policy would tighten. What had been a flood of money and credit could turn to a drought and there would be very negative consequences for the price of the assets that had benefited from the flood. Indeed, the little financial history I knew at that stage, mainly focused on the consequences of the boom in petro-dollar lending through the 1970s, suggested that such a drought could be dire for the economy and bank solvency, and could easily escalate to trigger a vicious recession, or worse.

What I did not know at that stage, and I think nobody in the equity markets knew, was just how much of the capital inflow fuelling the asset price party was coming through US dollar borrowing by Asian corporations and investors. It was not to be until much later in the saga of the Asian financial crisis that I stumbled across the incredible data relating to the size of US dollar borrowing that would create such havoc when the Asian exchange rates finally devalued.

Not for the last time, equity investors were blissfully unaware of what was happening in the credit markets and the impact that was having, directly and indirectly, on the outlook for economic growth and financial stability. If I didn't know it already, the Asian financial crisis taught me that equity investors

need to be very aware of what is happening in credit markets and particularly foreign currency borrowing by the local private and government sector.

To this day, professional investors still operate largely in asset-class silos and crucial information that relates to the financial future does not flow between those silos. Over and over again it is the end client who pays the price for this specialisation that confines their fund manager to such dangerous intellectual ghettos where the outlook for capital is for limited opportunity and low life expectancy.

## China's new focus

There was in 1995 a very specific reason why I thought the time was near for an external account deterioration, a tightening of money and credit, and a decline in equity prices. Not long before I had arrived in Asia, an event had taken place that was to ultimately trigger the Asian economic crisis and also the birth of the age of debt.

On 1 January 1994, China unified its official and market exchange rate and effectively devalued the renminbi by 50% relative to the US dollar. By that stage about 80% of China's trade was already priced using the market rate, but the devaluation still had an important impact on both trade and capital flows. More importantly, this lower Chinese exchange rate arrived just as the country was shifting its huge resources in labour from agriculture to manufacturing.

Deng Xiaoping's so-called 'southern tour', from January to February 1992, had sent a very clear message to China's budding entrepreneurs that the mobilisation of capital and savings, even if mobilised in the pursuit of riches, was now legitimate. Millions of previously relatively unproductive farm workers poured into the cities to work in the new factories created by the ideologically enfranchised entrepreneurs.

For those competing with China in export markets, the devaluation of the renminbi really intensified the already growing competitive pressure from China. It was this 1994 renminbi devaluation combined with the mass mobilisation of resources in China that was to change the world, with the first very visible sign of that change appearing in Asia.

The structural shifts in China were accelerating just as the North American Free Trade Agreement (NAFTA) had come into effect in January 1994 and as Mexico had devalued its exchange rate in January 1995. For an analyst focused on the interplay between the external accounts and the managed exchange rate, this sudden surge in competitiveness in China and Mexico acted as a starting gun for a tightening of monetary conditions across Asia.

By May 1995, the deterioration in the current accounts of Asian countries was already underway and as China mobilised ever more resources for its export drive, the pressure was only likely to intensify. China's current account surplus of US\$1.5bn in 1995 had, by 1997, become a surplus of US\$37.0bn.

By December 1995 Mexican exports were growing by 20% year on year and the country's current account had returned almost to balance following a US\$30bn deficit in 1994. The worse the other Asian countries' current accounts became, the more they were reliant upon accelerating capital inflows to ensure their exchange rates remained stable, while their economies continued to grow at the high rates that investors had come to accept as normal. A lot was now bet on an acceleration of those capital inflows, but those flows were increasingly short term in nature.

## **The consequences of the flood of capital into Asia**

Capital was flooding in to take advantage of higher economic growth, but increasingly it was also the source of that growth. The flood of capital was so great that it not only funded the current account deficits but forced major intervention in the foreign exchange markets by the Asian authorities to prevent their exchange rates rising relative to the US dollar. This act of intervention led to an accumulation of more US dollar assets by the Asian central banks, but crucially in the process led to the creation of more domestic money to pay for those assets.

The money the central banks credited to the sellers of the foreign currency, in their exchange rate intervention, was in the form of newly created local currency commercial bank reserves. Asian commercial banks, flush with surging reserves, reacted by increasing the size of their loan books. In so expanding their loan books, the fractional reserve banking system created money in that act of alchemy that has been with us since the 17th century. The capital inflows to Asia, combined with the Asian central banks' intervention to prevent undue exchange rate appreciation, was thus feeding both a credit boom and a money boom.

In effect, the accumulated savings of generations of the developed world, now being assigned for investment in Asia, were being turned into money in Asia as this was the only way in which the local authorities could prevent their exchange rates from appreciating. A stock of money that had been accumulating for generations, known as savings, was being transformed into a flow of ever more Asian money. This enforced increase in the supply of credit and money

led to lower interest rates and thus the capital inflow itself was creating the money and credit boom that created seemingly robust 'fundamentals'.

I had seen such booms play a key role in pushing the price of Japanese and Taiwanese equities to what were by 1995 agreed to have been bubble valuations. Through this alchemy the capital inflows to Asia were creating their own positive fundamentals, but investors were not focused on this symbiotic relationship between their own capital inflows and the economic and asset price booms they were witnessing.

While financial textbooks teach that capital flows react to reflect the fundamentals, it was not a new idea that, in certain conditions, they could actually change the fundamentals. In *The Alchemy of Finance*, published in 1987, George Soros put forward his theory of reflexivity in which capital flows themselves could create the better fundamentals that would in turn attract even more capital flows to that particular asset.

In my opinion, it was just such reflexivity that was underway in Asia. With growing Asian current account deficits, it was only the capital inflows, increasingly dominated by the inflows for the purchase of listed equities, that were creating the easy credit and easy money that sustained high economic growth and a rising stock market. While Soros had focused upon reflexivity in relation to certain corporate asset classes, such as real estate investment trusts (REITs) and conglomerates, the reflexivity in Asia had seen capital inflows change the fundamentals of entire economies.

Of course, reflexivity works in both directions. If the capital inflow should slow, exchange rates would be under pressure, and the authorities would have to sell their foreign exchange reserves and contract the supply of local currency bank reserves to support the exchange rate. Interest rates would likely rise and asset prices likely fall. The managed exchange rate regimes made such a reaction very probable should capital inflows slow and should they reverse, then an economic slowdown would turn into something much worse.

What had been a virtuous circle for investors pouring short-term portfolio capital into Asia could quickly turn into a vicious circle should they stop. Soros's theory of reflexivity was not part of the standard education of those pouring capital into Asia. They and their clients were to pay a high price for instead believing the standard economic models that did not admit to the observable fact that, in some circumstances, the capital flows determine the key fundamentals. Investors equipped with the conventional models were about to fail conventionally.

## The change in capital flows

It was the structural changes in China and the launch of NAFTA, with its negative impact on Asian current accounts, that had made the forecast of a vicious liquidity cycle in Asia much more likely to be correct. Initially, the current account deterioration was mild and the capital inflows remained robust. Those who had focused on the negative impacts from the devaluation of the renminbi (RMB) and the Mexican peso were forced to backtrack on their opinions.

This was a mistake, but a mistake that was easy to make when you worked in a financial services industry keen to extol the virtues of the Asian economic miracle that could now in mid-1995, a year and a half after the event, endure even a Chinese exchange rate devaluation! The mechanism through which the RMB devaluation and the mass mobilisation of China's excess labour would eventually tighten credit and monetary conditions in Asia was working only slowly, and as a result most investors could not afford to recognise it and invest accordingly.

With the benefit of hindsight, the mechanism through which the RMB devaluation tightened monetary policy seems assured, but at the time, investors read the slow deterioration in Asian countries' external accounts as a sign that their competitiveness would not be unduly undermined. Even had Asia maintained its competitiveness relative to China, the fact was that current account deficits were already large; domestic growth was high, sustained by very easy money and credit; and any hiatus in capital inflows was very likely to lead to at least an economic slowdown.

So the argument for investors was somewhat circular. The positive fundamental of high economic growth was likely to remain if you thought China's devaluation would not eventually undermine Asian competitiveness, but for it to remain high, your capital had to keep flowing in at current or even greater levels. This is an uncomfortable reality to live with for an analyst or a fund manager. It is uncomfortable because nobody can know when those capital flows will abate.

The demolition of capital controls and the much higher liquidity in domestic equity markets meant that this short-term capital might not just stop coming but could even reverse! The liquidation of existing equity holdings and ensuing capital outflow could happen very quickly, but what would be the chimes at midnight that signalled the negative reflexivity associated with a change of capital flows had begun?

There was a major problem working for a stockbroking company and publishing analysis that suggested the flood of capital into Asia was creating

a very vulnerable financial system. That capital inflow was the main source of the company's profits! The employees of all stockbrokers, including my employer, were all benefiting greatly from the flood of portfolio capital through the financial services industry to access the Asian growth story.

## **Stop buying? It's a bull market! No way!**

Many people were getting rich through pay and bonuses, financed by commissions from the capital inflow, and also by investing in the booming stock markets themselves. This was a difficult environment to arrive into as a 30-year-old concerned that the party was fuelled by excessive credit and money growth and that that growth was likely to at least subside, if not end.

I was recommending that those foreign investors, who ultimately paid the salaries and bonuses and pushed the local stock markets ever higher, should stop. Whether that opinion was ultimately to be right or wrong, it was probably not going to be good for business, pay and bonuses in the short term. In a world where bonuses are large and awarded annually, the short term dominates the institutional dynamic. Most analysts whose remuneration is ultimately derived from brokerage commission thus tend to be positive most of the time.

Internally, it is much easier to be a bull; and while bulls in bull markets get paid, bears in bull markets get fired. If it's to be a bear market, then neither bulls nor bears get paid. The risk/reward of this model of remuneration strongly favours the adoption of bullish opinions. Bears get invited to fewer parties. It can be lonely and dangerous being a bear. In Asia in 1995 there were few bears.

In the crowd that forms in a bull market, myopia is increasingly evident. Part of my job as the Asian equity strategist was to attend the morning meeting every day at which the firm's best daily ideas would be singled out to then be 'broke'd' to professional investment managers across the world. In return for these best ideas, the clients of the firm were supposed to buy or sell Asian equities through CLSA and the firm would earn commission on those orders.

Of course, everyone in the room knew that foreign investors were much more likely to buy than sell Asian equities as the flood of capital intent on benefiting from Asia's high economic growth showed no signs of abating. There was much more money to be made by phoning institutional investors with buy ideas than sell ideas. To walk into a morning meeting every day, mainly comprised of salespeople, and suggest that they advise their clients to sell Asian equities was akin to telling individual salespeople and the company to turn away business. To say it was not favourably received would be a bit of an understatement.

Every salesperson could provide testimony from the smartest guys in the room, their clients, the professional fund management community, that this was in fact a great time to buy Asian equities. When the smartest guys in the room, many of them with decades more experience than the newly arrived strategist, were so positive, how could the firm be betting its future on an inexperienced analyst with such a pessimistic outlook?

People were quite literally throwing money at us, so why should we be telling them to stop? There is an institutional dynamic towards myopia in such situations still best summed up in the words of Sinclair Lewis: "It is difficult to get a man to understand something, when his salary depends upon his not understanding it!"

I found morning meetings to be a painful affair because I held a different opinion from most of the other participants. However, the main reason I found them painful was because I thought it was stupid to have to come up with our best ideas on a daily basis. As someone who had been a fund manager, it was ridiculous to believe that our clients wanted five or six new ideas every day to help them manage their portfolios. No professional fund manager in the world turned over their portfolio at the rates which such a plethora of daily advice was designed to accommodate, and CLSA was just one of the firms broking a flood of daily ideas to the fund management community.

I had many friends who were professional fund managers and there was universal agreement that the stockbroking community was churning out far too much opinion backed by far too little analysis. I did not think that it was a controversial opinion and as it came direct from the client base, the company was bound to listen. However, it was an opinion that held virtually no sway within the stockbroking community.

Stockbroking firms and investment banks are populated by, and often run by, very highly paid salespeople who know that the firm's success is based almost entirely upon their persuasive abilities on the telephone! To keep them in front of their clients every single day they needed something new to say every single day.

Much of the research selected each day to be highlighted to fund managers may have been of poor quality and likely to be wrong, but it did not matter that much. What was important was that the salesperson had a reason to phone their client at least once a day and perhaps more. It was even likely that the client would ignore all of this advice but still feel obliged to deal with the salesperson because of the 'service' being provided. Anyone who has never worked in a sales-driven organisation needs to watch *Glengarry*

*Glen Ross*, a Pulitzer-prize winning play by David Mamet, and also a film, that very accurately explains the psychology of selling and its consequences.

To say that such a culture was alien to me was very much an understatement, having gained my grounding in investment experience in a fund management partnership in Edinburgh that was very focused on the fiduciary relationship it had with its clients. However, every morning I had to go to the morning meeting where the expectation was that I would provide a new idea to be fed into the great sales machine that would generate commission. I could think of no greater oxymoron than 'daily strategy' and yet here I was expected to provide daily strategy. Creating daily opinions was bound to lead to failure, and indeed the company had already fired three Asian regional strategists in the previous year who had been forced to chase their tails pursuing such 'strategy'.

It took a while to realise that this time-honoured way of extracting broking commission was not going to change simply because, as an ex-fund manager, I was relaying the news that the clients did not want it. All of us face institutional imperatives and the institutional imperative for an organisation with a large sales team is to produce something for them to sell. Although that dynamic has mitigated somewhat over the past 25 years, it remains a dominant force in finance.

It is a topic I will return to throughout this book, but the excessive levels of turnover in holdings of financial assets is part of the industry-wide institutional dynamic that has done huge damage to the structure of the financial system and investment returns. In 1995 I found myself part of that institutional dynamic and struggling every day to focus my research, the CLSA sales teams and our clients on longer-term issues. The struggle to lengthen time horizons is largely futile in a bull market and the bull market was still raging when I arrived in Hong Kong in May 1995.

## **Hyper-liquidity and short termism**

A belief that there is always ample liquidity to reverse investment mistakes leads to poorer research, less consideration and ultimately poorer allocation of the scarce savings over which professional investors have stewardship. Having seen that dynamic from both the investment management perspective and the stockbroking perspective, I am convinced that it cannot change proactively. It will change probably under the burden of legislation, but it is highly unlikely that it will change through the choices of those who operate the system.

There are significant financial incentives to reward activity, and as Charlie Munger is wont to say: “Show me incentives and I’ll show you outcomes.” The wrong incentives played a major role in creating the huge capital inflows to Asia that fuelled the money, credit and asset price boom. Despite ever more legislation to regulate the financial system, the same wrong incentives remain largely in place today.

There are of course some notable and honourable exceptions to this prevalent short termism, but on the whole, the investment industry is based upon a fallacy that one can dance in and out of liquid securities and through this process enhance investment returns. It was the creation of ever more liquidity in ever more financial assets that enabled this drift to an investment time frame that is in fact the enemy of good investment returns.

This hyper-liquidity in financial assets was the key factor that destroyed financial stability in Asia in the 1990s and led to economic misery for millions. The problem for an analyst who could see the instability of the financial foundations was how to survive long enough to watch them crumble from within an institution built to benefit from that very hyper-liquidity.

## **A bear in a bull market**

That I survived as an analyst offering daily bearish opinion had much more to do with luck than anything else. It was my very good fortune to have accepted a job with a company that was run by people prepared to see the profit in holding a different opinion. The CLSA I joined was the Asian broking operation of a large French bank, but it was very much the creation of two former journalists, Gary Coull and Jim Walker.

The Canadian, Coull, and the Australian, Walker, very much saw themselves as outsiders in a world of insiders in British colonial Hong Kong and saw the opportunity for their firm partly based in the irreverence which they both enjoyed. As journalists, these wild colonial boys knew the value of a good story and knew that to compete with the establishment they would have to offer something very different from the consensus.

From its inception as Winfull Laing and Cruickshank in 1986, the two steered the company towards the iconoclastic analysis and opinion that would set the start-up apart in a world of old-school British stockbrokers and the increasingly dominant global financial behemoths. The head of sales in Hong Kong, Mike McCoy, was also a man who revelled in irreverence as another outsider, this time an American, in the British colony. Although he had to drive revenue through his team of highly paid salespeople, he also

enjoyed being different and was more likely to tolerate something somewhat less commercial if it was cocking a snook at establishment views.

Finally, the company had a chief economist who had already made his name as having strong and non-consensus views on just about everything. Dr Jim Walker – no relation to Jim Walker, the firm's co-founder – had already proved that one could have strong opinions and stick to them and be rewarded for that insight and candour. It was more than helpful that he had also concluded that the exchange rate intervention policies of Asia could not be sustained indefinitely.

Another crucial advantage was that CLSA's business was largely confined to earning brokerage commission on secondary market turnover and its capital markets division at that stage was not a key source of profits. Thus, unlike other stockbroking companies, the company was not dependent upon selling new issues to investors to profit from the Asian economic miracle.

Demand for such new issues tends to be particularly strong in a bull market and thus the incentive for analysts to offer bullish opinions when their employers are very dependent upon revenues from this source is very strong. That CLSA had not then got a seat at the capital markets table proved to be a boon for an analyst increasingly convinced that the Asian economic miracle would end with a bang and not a whimper.

CLSA had already seen that strong opinions sold and that it could conceivably profit even in a bear market given its revenues came from trading commissions. This allowed me to hold strong non-consensus opinions for much longer than would have been possible in just about any other stockbroking firm. Any analyst who is a bear in a bull market needs a lot of luck to still have a job when the game of musical chairs finally stops.

It was my luck to work for a company and with colleagues who were prepared to live with the negative business consequences of such opinions for longer than others. I strongly suspect that had I been working for any other stockbroking company, I would have been out of a job long before the Asian economic miracle finally became the Asian financial crisis. Even at a company such as CLSA it was far from clear that I would survive long enough to see what I thought was largely an illusion end.

## The greatest credit bubble the world has ever seen

This book seeks to show that there are important lessons for investors from the course of the Asian financial crisis. It also has a much larger aim, in that it seeks to show how that crisis led to the creation of a global financial architecture that produced the biggest debt boom in history.

It is a debt boom that has, by 2021, already led to spectacular economic busts, mass insolvency, crippling unemployment, the displacement of millions of people and radical political change. With world debt-to-GDP ratios at record highs even before the impact of the Covid-19 induced economic crisis, the negative direct economic, social and political consequences from this age of debt will likely plague the global outlook for at least another generation.

How the Asian financial crisis established the foundations for this new age of debt relates to the policy choices of the Asian authorities that were a direct consequence of the crisis. These policies had dramatic impacts on the developed world, leading to lower inflation and lower interest rates, and also to the clear lesson from the crisis that developed world monetary policy would, in certain circumstances, change to alleviate the distress of financial markets participants.

The result was that the price of borrowing declined and the availability of credit along with the appetite for risk rose. The ability of poorer quality credits to borrow increased. The ability to profit from using debt to buy assets increased. The risks of using debt declined. It was the perfect storm for the financialisation of the global economy that brought riches to the few and deep uncertainty to the many.

The Asian financial crisis taught many lessons to investors, peoples and policy makers who confused a credit bubble with an economic miracle. It is the greatest of ironies that it established the foundations for the greatest credit bubble the world has ever seen. What follows is the story of the crisis, told from the perspective of someone who tried to forecast its twists and turns, the lessons to be learned from it, but also the tragedy of its legacy.