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Wacana Pembangunan/*Discourses on Development*

Insights from the Current Global Financial Crisis

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INTRODUCTION

The best test of a theory is its actual performance in the real world, i.e. its practice. To quote Kurt Lewin, "There is nothing more practical than a good theory" The Wall Street has enjoyed the reputation as the bastion of lightly regulated financial industry. It is thus not surprising that as a result of the ongoing financial crisis, the USA is losing its economic clout and its intellectual authority in economic matters (Beddoes 2008). The crisis represents an occasion for social scientists to do some hard rethinking. It re-affirms the relevance of development studies. It also shows the wisdom displayed by the editors of this journal in taking the initiative two years ago to open a forum for development studies.

This paper is a very modest contribution to the debate, by looking at some salient features of the ongoing financial crisis.

As I observe elsewhere, economic development should be seen as part of societal development (Heng 2008). Economic development takes place within a historical context, within a concrete physical environment and societal conditions. Economic development can damage and even destroy the natural environment or our physical resources, e.g. a lush forest turned into a wasteland or semi-desert. Similarly, it can also damage or destroy societal resources, e.g. rampant corruption displacing public spirit among civil servants and politicians.

TRUST AS INVALUABLE RESOURCE IN BANKING AND FINANCE

Viewed historically, financial system evolved out of banking which in turn evolved out of money changing to support the commercial activities of traders. Early banks functioned as custodians of their clients' money. As long as the depositors could trust the banks, most of their money was laying idle there. The smart bankers soon realised that by holding some reserves against deposits, they could lend out the rest against some collateral or invest in promising business ventures.

By acting as financial intermediary, banks make money and promote economic growth through the efficient use of capital. But to do so, depositors must trust banks with their money. Trust is an example of societal resource which takes time and effort to nurture. Trust is the most valuable asset in banks and financial firms. It is not easy to build up but it can be easily destroyed. Greed and financial excesses have destroyed public confidence in American investment banks, arguably one of the pearls of American financial industry. Taking advantage of the weaknesses of the financial system, speculators have been seeking short term super profits, causing chaos and financial melt-downs, and sinking a few world class financial firms while rendering deadly blows to thousands of other banks. It has been estimated that the banking and financial sectors will need to end up retrenching a million or so employees. For an excellent account of the subprime debacle (Lim 2008).

REGULATION – ITS NECESSITY AND LIMITS

Financial system is a socio-economic system embedded in a bigger matrix of legal, economic and political institutions. It is part of the whole complex of free market economy with different interests where the manufacturing interests converge as well as diverge with financial interests. That is why the US administration refers to the need to reconcile the interests of Main Street and that of Wall Street. Even within the financial system, there are conflicts between the commercial banks and investment banks. As a result of the tussle among the various interest groups, the past decades have seen a trend towards deregulation of the financial sector (Dymski & Pollin 1994). This has provided opportunities for financial firms to indulge in speculative financial activities which do not add value to their clients (Drucker 1999). They have come out with all kinds of fancy financial products with huge leverage. Given that such products are designed by people with training in advanced mathematics, the so-called rocket scientists, how can the public judge the products, given the lightly regulated environment? Well, there are the rating agencies like Standard and Poor's; it is part of their business to render financial products more transparent. They are supposed to supply financial market with intelligence that is authoritative, objective and credible. However, these rating firms earn their fees from the financial firms that develop the products, which should raise questions about their independence and reliability of their rating reports. The ongoing crisis is likely to prompt calls to tighten regulation and to reduce the violent impact of derivatives and other fancy financial instruments. Even the pro-market *The Economist* (Sept 18 2008) has this to say:

> Regulation is necessary, and much must now be done to improve the laws of finance. But it must be the right regulation: an end to America's fragmented system of oversight; more transparency; capital requirements that lean against booms and flex with busts; supervision of giants, like AIG, that are too big and too interconnected to fail; accounting that values risks better and that everyone accepts; clearing houses and exchanges to make derivatives safer and less opaque.

Regulation done in the right way is part of the effort to build a sound and robust financial system. This is a big topic that is outside the scope of this paper. However, there is one point to note. The current international financial system is fragile (Allen 2007), as evidenced by its impotence in the face of attacks by speculators. A sound and robust financial system is a crucial element of the socio-economic infrastructure, acting as a bedrock to support global economy. Its central task is to promote trade, investment and economic growth, rather than serving as a platform for the speculators to indulge in financial excesses.

Though tighter regulation is certainly needed, there is a limit to what regulation can do. As mentioned earlier, the regulation must be right in the first place. Secondly, the regulators must be not fall prey to corruption, a common political disease in many Asian counties. Third, banks and financial firms are past masters in exploiting the blind spots and profiting from the loopholes. For example, they can hide their assets off their balance sheets, or buy insurance (such as that provided by American Insurance Group) which enables them to slide out of the capital requirements designed by the regulators. Both schemes were used by banks which were at the centre of the crisis.

INCREASING SOCIETAL RESOURCES

Regulation is part of institutional building, part of socio-economic-legal infrastructure, which plays critical role in social and economic development of a country. Institutional development is part of capacity building of a society, and its role in economic life is obviously important (North 1990). It is also part of state building which requires tremendous cultural, social and economic resources as well as wise political leadership. One may even say that this is one key factor which determine the position of a given country in this era of globalisation.

There is one feature that sets the US apart from other rich countries in the current crisis. It is the phenomenon of huge public debts combined with huge private debts. In addition to the subprime mortgage crisis, the USA has to face risks associated with credit card loans and student loans default. At a more fundamental level, these are manifestations of something beyond the traditional focus of economics. As pointed by a columnist of *The International Herald Tribune*, it has something to do with the American culture:

> The culture that said the most patriotic act was to shop. The culture that sent the best and the brightest to Wall Street to concoct toxic securities. The culture that said there was no need to balance individual rights and community needs. The culture that replaced thrift with thrills and hope with hype. The culture that said a country at war is not a country that needs to pull together in sacrifice (Cohen 2008).

The implication is obvious for every country: it is crucially important to build up and continuously strengthen socio-economic and legal institutions, to take good care of and increase the societal resources (e.g. culture, public spirit and social harmony). The task is all the more urgent when a country is exposed to the new benefits and perils of globalisation.

SOME CONCLUDING REMARKS

Significant societal events are often opportunities to engage the public in some reflective thinking. The exercise may not lead to some new insights. At the very least, it helps us revisit our follies and recover some forgotten but valuable insights.

First, it is worth repeating that banks and financial firms are different from other businesses. If one shoe factory commits foolish mistakes and goes bankrupt, other shoe factories will rejoice. If this occurs in the banking sector, the result is different. Failure of a bank can trigger a bank run on other banks. And if the failed bank is a big player, it can adversely affect the payment system, choking the smooth flow of money. By their very nature and the roles they play, banks and financial firms need to be guided by the principle of prudence. This fact is nothing new, but it is worth repeating now.

Second, there is no free lunch. To earn an honest living, banks must provide value-adding service to their clients. Banks will do well to take a cue from other businesses which are good in value-creating innovation. Long-term wise, there is no way for banks as a collective group to make money by speculating on the stock market. Financial speculation is but a polite term of treating the stock market as a casino. And as pointed out by Drucker (1999), "no matter now clever the gambler, the laws of probability guarantee that he will eventually lose all he gained, and then a good deal more."

Third, the banking industry, food industry, medicare industry, transport industry and many other businesses affect the welfare of the people in serious ways. While they provide services to society and earn profit in the process, it must also be added that they can only do so *with the consent of society*. This is the moral justification for regulation.

Finally, the current crisis allows us to look at some aspects of information economy. When times are good, the financial industry is perceived as a good example of the information economy. It deals with data processing, interpreting the information output to make moves to generate wealth. Now we have to sit back and reflect if such information intensive activities could be seen as value-creating as well as value-destroying.

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