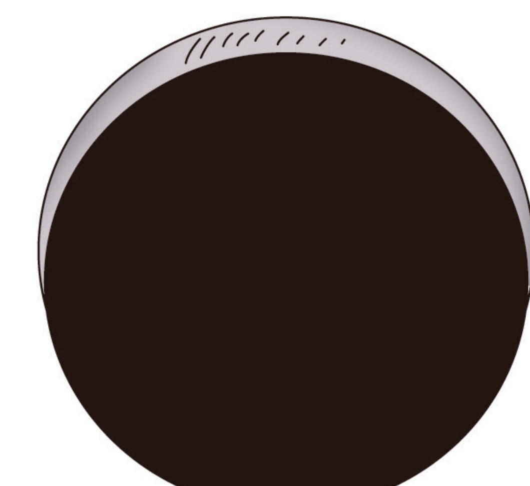
THE STRAITS TIMES.
SINGAPORE PRESS HOLDINGS,
NEWS CENTRE, 1000 Toa Payoh North, Podium Level 2, 318994

SPH Chief Executive Officer **Alan Chan Heng Loon**
Editor-In-Chief (English & Malay Newspapers Division) **Patrick Daniel**
Senior Executive Vice-President (Marketing) **Leslie Fong**
Senior Executive Vice-President (Newspaper Services & Chinese Newspapers) **Robin Hu**

Editor **Han Fook Kwang**
Deputy Editor **Alan John**
Associate Editors **Bertha Henson, Zuraidah Ibrahim**
News Editors **Carl Skadian, Dominic Nathan**
Night Editor **S. Yogendran**
Life! Editor **Helen Chia**
Picture Editor **Michael Sargent**
Straitstimes.com Editor **Joanne Lee**
Digital Media Editor **Felix Soh**
Supervising Editor **Sumiko Tan**
Political Editor **Chua Lee Hoong**
Review Editor **Janadas Devan**
Money Editor **Ignatius Low**
Art Editor **Angelina Choy**
Sports Editor **Mathew Pereira**
Forum Editor **Yap Koon Hong**

ECONOMIC WATCH

Why no one seemed to see the crisis coming



ROCA

By Tan Suee Chieh

"WHY did no one see it coming?" the Queen of England asked when she visited the London School of Economics in December last year.

The truth of the matter is some people did, but they had neither the influence and power, nor the context, to effect a change of direction. Economists saw it coming as early as 2003-2004, and the voices became louder in 2006-2007, when the squall broke.

Mr Martin Wolf (Financial Times), Mr Nouriel Roubini (New York University), Mr William White and Mr Raghuram Rajan (Bank of International Settlement), and Mr Kenneth Rogoff (Harvard) were the early naysayers. Mr Ed Gramlich (the Federal Reserve governor) warned of the sub-prime danger as early as 2000, and proposed that regulations should be tightened.

Mr Harry Markopoulos, the celebrated whistle-blower, complained to the Securities Exchange Commission as early as 2005 on Bernard Madoff's Ponzi scheme, but was largely ignored.

There are a number of ways we can analyse this problem. One is economic and the other social and psychological.

At the economic and political levels, there are always many rival schools of thought on most issues. We can think of the Brazilian debt crisis, the fears the West had of Japan's mighty export machine in the 1980s, the federal budget imbalance of the Reagan years, the persistent imbalance of the trade and federal deficits of the United States in the Bush years and the rightness or otherwise of the Long-Term Capital Management rescue in 1998.

Firstly, before this crisis broke, many were deluded by the soundness and resilience of the financial system on which the economy rests. While there are problems, we will ride through them as we have always done. Federal Reserve chairman Ben Bernanke said in 2005, at his confirmation hearings, that "the depth, liquidity, the flexibility of the financial markets have increased greatly".

Many saw the validity of comments made on the housing bubble, the persistent deficit of the US current account, and the spread of derivatives, singly and in totality; but to win the debate conclusively on timing, scale and consequences is another matter. Everyone knew the American housing market and the deficit were unsustainable, and that unwinding would be disorderly. But none knew the timing or the intensity of the events that would follow. The reckoning could erupt any time in 2008, 2011 or 2015.

Think of the Japanese stock market rise to Nikkei level 33,000 in the 1980s; it was anomalous and not sustainable. But if you were an Asian market fund manager, it would be unwise to be out of it, because anomalies can last a long time – and it did. So you benchmark, and that is following the crowd.

Think of the so-called inevitability of communism, or Dr Henry Kissinger's domino theory, and the eventual fall of Berlin following Soviet leader Mikhail Gorbachev's glasnost and perestroika. These were anomalous situations, like the unsustainability of the Soviet Union. They lasted for a very long time.

Think of the strength of the US dollar – even today. On any fundamental ground, one has to be short on it.

So in Wall Street and Washington or indeed in the world's capitals, not many could see the looming crisis in stark, do-or-die terms. The thinking was that: Indeed, there were problems; but we could always work them out. That was until the weekend of Sept 12 last year (Lehman Brothers collapsed and American International Group required rescue), when then US Treasury Secretary Hank Paulson and Mr Bernanke saw the abyss.

They began to make it up as they went along, because they were in uncharted territories. Until then, no one had the sense of ownership or the power to act.

And politically, it was not possible to rein in Wall Street, because it was too difficult, too controversial, too unpopular and too untimely. It required a crisis for populism to galvanise support, to enable politicians to act – because it is difficult and unpopular to spoil a good party.

At a socio-psychological level, we can see so many such examples, why purportedly intelligent human beings continue smoking even when evidence is compelling that it is disastrous to health. The turning comes when they are diagnosed with cancer. Then, they adhere to a non-smoking regime, after the shock and impact of discovery. We do what we like, not what is right.

So long as the music is playing, you've got to keep dancing. "We're still dancing," Mr Chuck Prince, Citigroup's former chairman and chief executive said in 2007. A few weeks later, he was out of a job. With these comments, he got to the heart of the banking crisis. Chuck Prince's metaphor is sociological and anthropological, not economic.

Very often, groups demonstrate peculiar sets of behaviour which are not commonly accepted by individuals. Examples of these are rampant, evident from street gangs to reclusive religious organisations. In this sense, Wall Street is no different.

In each of these cases, members of these groups rally between themselves based on certain beliefs and causes. In accepting these values, each individual is viewed from the eyes of his peer. So, whether it be street gangs or executive offices in Wall Street, it ends up that the peers will determine what bonuses get paid out and how fast one will go up the career track.

Not all the values absorbed by these groups lead to success. These values can be local and subjective. Any member who questions these values becomes an outcast.

Examples of this abound. The people who promoted dot.com stocks believed in them too and did not necessarily see themselves as liars. The same applies to those who sold structured products. They clung on to theories that perpetuated their self-interest.

The probing mind will make a convincing case that one of these explanations ought to be correct. The fact of the matter is that such explanations are often self-serving to one's interests or opinions. The decision to invade Iraq is a good case in point. The same argument applies to key executives at major financial institutions.

If Mr Prince had decided to pull Citigroup back from its increasingly frenzied trading and lax lending, he would have been deposed – by shareholders desperate for profit, non-executive directors steeped in conventional thinking and, above all, by subordinates hungry for bonuses.

There are many social psychology experiments which suggest we do not challenge the status quo or authority, and that we prefer to stand with the majority. These include the Stanley Milgram experiment in Yale University on how people bow to expert authority, and the Solomon Ash experiment on the length of lines, which demonstrated how we conform to popular opinion.

In real life, Ms Kitty Genovese was murdered in New York, in the early hours of March 13, 1964. Thirty- eight witnesses saw her being stabbed 64 times over 30 minutes in three episodes. No one called for help. There was diffusion of responsibility – the "bystander effect" – and social information suggests doing nothing is the appropriate thing to do.

The thinking is that, surely, if something were really badly wrong, someone else would have acted. As for oneself, one would go along with the group first.

That is what Mr Prince meant when he said that so long as the music plays, you have to dance.

Very often, we do what the group wants, not what is right.

Until the whole group gets into trouble and the reckoning comes. With a vengeance.

The writer is NTUC Income's chief executive. This article first appeared as part of a series of commentaries on Mr Tan's Facebook webpage.

***The truth of the matter is some people saw the financial crisis coming, but they had neither the** influence and power, nor the context, to effect a change of direction...The thinking is that, surely, if something were really badly wrong, someone else would have acted. As for oneself, one would go along with the group first...Very often, we do what the group wants, not what is right.*