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The Ongoing Economic Crisis- Series 3

The mistakes of US authorities in dealing with the financial crisis *(First published in March 2012)*

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World economic crisis, Financial institutions, Fiscal austerity

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The next problem involves the process of bailing out financial institutions. US authorities bailed out banks by injecting public money in order to defend the financial system. In light of our experience in Japan, there are two problems with regard to the modality of the bailout in the United States.

1/ First, it has not cleared doubts about the health of the balance sheets of financial institutions. The following measures are essential for clearing concerns in light of our experience:

(i) The balance sheets of all major financial institutions must be examined by an official authority, using mark-to-market accounting, and the results must be made public;

(ii) The amount of public funds necessary to completely dispose of non-performing loans in each institution must be identified;

(iii) Each institution must dispose of all non-performing loans, making it clear that no non-performing loans are left on balance sheets to market investors.

This is well proven by the fact that public money in the amount of 1.8 trillion yen injected on March 1998 without the authorities' prior examination of institutional balance sheets failed to wipe out market concerns about Japanese financial institutions, while another injection in the amount of 7.5 trillion yen on March 1999, only after authorities, applying mark-to-market accounting, examined institutional balance sheets, was successful. The first injection was done across-the-board using the same amounts, while the second was not across-the-board and used different amounts. It was also made clear who actually bore the burden of the loss caused by non-performing loans. In the case of Japan, the total amount of disposed debt reached 100 trillion yen, of which only 10 trillion yen was borne by the public; the rest was absorbed into the annual profits of private financial institutions. I have emphasized this point since presenting it at Harvard Business School in the spring of 2008.

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2/ In the United States, the mark-to-market accounting rule was frozen until the fall of 2010 as a result of pressure by the US Congress over AICPA (American Institute of Certified Public Accountants). The method of examining balance sheets of major financial institutions is not stringent, unlike in Japan where loan loss reserves are computed against individual transactions. It is called a "Stress Test", which is built around computations based on macroeconomic forecasting. Moreover, according to banking staff who were in charge of this test, the bare results of the test horrified authorities, who then allowed the final results to be adjusted. It will be difficult for the market to regain confidence in the balance sheets of major financial institutions in the United States. The injection of public money following the stress test fell short of assuring investors that the amount injected was enough to dispose of non-performing loans at these major financial institutions.

3/ Furthermore, the stress test applied more stringent loan loss reserves to securitized products at the center of the problem than those built up by individual financial institutions. Reserve levels are not sufficient in light of our experience in Japan. Discount rates on non-performing loans in Japan, most of which used real estate as collateral, reached upwards of 90%. Discount rates on securitized products which do not have such collateral must be higher. Actual discount rates upon which the amount of loan loss reserves is calculated are far lower, far short of the level that would restore the market's confidence in the health of financial institutions. Such a low level of loan loss reserves being what they are on the asset side, practices on the liability side are simply horrifying. Securitized products posted on the liability side - that is, those created by one institution and sold to another - have been deeply discounted on the grounds that, as there is no market for such products, they can buy them back at a high discount, resulting in a substantial reduction of liabilities. Substantial bonuses have been paid out of the net profit created by such treatment. I would like to reiterate that it will be difficult to wipe out uncertainties about the health of financial institutions without an ample injection of public money based on a diligent examination of balance sheets by authorities and then making them public.

4/ The second problem lies in the fact that public money was injected without investigating the responsibility of bank management and authorities. As you can easily recall, all board members of liquidated or partially nationalized financial institutions during the Japanese financial crisis in 1997 and 1998, such as Sanyo Securities, Yamaichi Securities, Long-Term Credit Bank and Nippon Credit Bank, were arrested and prosecuted, except those of Sanyo Securities. Several staff of supervisory authorities, including the Ministry of Finance and the Bank of Japan, were also arrested and found guilty. Some of them committed suicide. Executives of Long-Term Credit Bank and Nippon Credit Bank were found innocent by the Supreme Court more than ten years later. It is arguable whether such prosecutions were appropriate. In this way, however, the responsibility of bank executives and

supervisors was tested through the judicial process. In contrast, the responsibility of those people has never been tested in the United States. It is worthwhile to keep in mind the magnitude of the political influence of financial institutions, in particular that of Wall Street. In the case of Japan, criticism mounted, thus reducing their political influence, following scandals over the behavior of financial institutions and supervisory authorities, the liquidation of major institutions, and the prosecution of key people. In the case of the United States, the all major financial institutions avoided liquidation except Lehman Brothers, kept intact through a bailout and their political clout. This situation made it difficult not only to launch fundamental reforms of the financial system, but to fully investigate the real cause of the financial crisis. In particular it has made it extremely difficult to investigate the responsibility of executives of major banks. Bailing out major banks without prosecuting their executives fostered disbelief in the political process; voters do not know where to direct their anger over how tax revenue paid by honest taxpayers can be justifiably used to bail out major banks, whose executives brought about the ongoing financial crisis, received excessive bonus, and escaped prosecution without being brought to account. As a result, top executives of major banks in the United States have not learned any lessons from the Lehman crisis. It is frightening to think that such executives are likely to make the same mistakes again.

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Fiscal austerity was a mistake

In the last letter it was noted that Western governments failed to restore the confidence of investors in financial institutions by injecting public money into these institutions without rigidly examining their balance sheets and bailing them out without completely disposing of non-performing loans. It was also noted that taxpayer frustration mounted as the people responsible for the financial crisis were never brought to account. Furthermore, bailing out financial institutions--investment banks, in particular--brought about the following serious issues, which will be critical to the recovery of the world economy.

As was witnessed in Japan, during the economic crisis the private sector grew concerned about risk-taking and investment. It is the government sector which has to take risks and make investments or increase its expenditures to prop up the domestic economy. Reduced risk-taking in the private sector leads to stagnant funds and circulation of money in the financial sector. Such

resources have to be pumped into the government sector by way of tax increases and/or issuance of government bonds and should be used for government spending in such things as public works, thereby facilitating the circulation of money. Central banks tried to stimulate the economy by reducing the interest rate and with "quantitative easing." However, as has clearly been shown in ten years of experience in Japan, private enterprises do not take risk investments without a clear prospect for business recovery in the future. In this way, even if the central bank were to supply a huge amount of cheap money, it would only lead to excess liquidity and would not contribute to economic recovery without "real demand" for financial resources.

As was seen in Japan during the economic crisis after the financial bubble collapsed, two of the four sectors which make up GNP--the household sector and corporate sector--suffered from an overhang of over-borrowing from the bubble period, requiring them to squeeze their balance sheets due to loan repayment. Left alone, this would result in the contraction of the national economy due to negative growth in both the household and corporate sectors. The government sector has to increase expenditures to prop up the domestic economy through fiscal stimulus such as public works, thereby avoiding negative GNP growth. It was based on this idea that, in response to the call by the managing director of IMF, major world countries, including Japan, embarked on a policy of large-scale fiscal stimulus in 2009, thus avoiding a sharp fall in GNP and a repetition of the Great Depression from the 1930s. It was estimated that a two-percent increase in fiscal stimulus vis-à-vis the GNP of each major country would pull up global GNP by two percent. In 2009 this policy worked well indeed.

However, countries discontinued such a policy in 2010 because it appeared that the US economy had temporarily recovered. I warned then that the recovery was only temporary because of the factors explained below and emphasized that, in order to bring the economy back into a normal cycle, it would be essential to continue fiscal stimuli like those of 2009, but nobody listened.

1) It is customary in the United States that small and medium companies recover first, followed by big industries. The economic recovery in 2010 took place only among big industries.

2) An examination of big industries showed that the performance of investment banks had picked up. This was attributable, however, to "creative corporate accounting," which slashed the amount of securitized products on the liability side, as reported in the last letter.

3) There was a one-time business boom for investment banks thanks to the requirement to increase core assets enforced by the Basel 3 regulation advocated by authorities in the US and the UK.

As many had worried would happen, the world economy again stalled in 2010.

The responsibility of investment banks

The following best characterizes the state of the global economy since early 2010:

1) In order to enhance the economy, central banks have supplied excess liquidity to the market, which has not been successful in stimulating the economy due to a lack of real demand.

2) Accordingly, there is a huge amount of excess liquidity in the market. On the other hand Western investment banks--British and American, in particular--remain insolvent. While superficially they look fine thanks to bailouts, the relaxing of accounting rules, and obscure stress tests, it will be critical for these investment banks to break free of insolvency through high short-term returns if they want to survive.

3) Some countries suffer from budget deficits caused by their own fiscal stimulus plans. There are particular concerns about the financial prudence of the European countries that have reported current-account deficits.

Against this backdrop, European countries with a poor financial balance have become targets of market attack mainly through short sales and credit default swaps. Greece was the first such country to come under attack. A rapid decline in confidence in Greek government bonds made it difficult for Greece to refinance bonds that came due. Greece requested assistance from the IMF in the spring of 2010. Although I will delve into the reasons behind Greece's problems on another occasion, that government bonds have become subject to attack by investment banks has led to fatal issues working against the recovery of the European economy. As explained above, the government sector has to create real demand by taking risks and increasing expenditures to prop up the domestic economy. The Greek situation has made this difficult. European countries under attack by the market have no option other than fiscal austerity. Such a policy has created a vicious cycle between the real and financial sectors, which also occurred in Japan in the late 1990s and substantially lengthened the economic contraction of Europe.

(Note)

The vicious cycle between the real and financial sectors refers to the following. First, facing the need to dispose of nonperforming loans, banks try to reduce assets to 12 times capital or less in order to avoid a shortfall of assets. This deleverages bank credit. Such behavior on the part of banks makes it difficult to provide funds to borrower industries, such as manufacturing, resulting in an economic slowdown in the nonfinancial sector. This, in turn, invites deterioration in business conditions and contributes to an increase in corporate bankruptcy and a decline in asset prices. As a result, banks have to further increase loan loss reserves due to the deteriorated financial health of borrowers as well as the decline in collateral value of financial institutions. This causes a further decline in financial institutions' capital and further deleveraging.

Future challenges

Based on an IMF analysis conducted when assistance was extended to Greece, I made a pessimistic projection in 2010 that the European economy would recover no earlier than 2018. Unfortunately recent economic conditions dictate that even my projection might have been too optimistic. It is highly likely that the European contraction will exceed Japan's much-publicized "lost decade."

The only way to rectify the situation in Europe is, to reiterate what I explained above, first to restore confidence in government bonds and the financial system, and then to recover real demand through fiscal stimulus. In order to restore confidence, it will first be necessary to conduct reliable examinations of all major financial institutions based upon mark-to-market accounting to make their financial health completely transparent. Then the government, through a transparent process acceptable to taxpayers, must inject an amount of public money large enough to restore confidence. Next, to restore confidence in government bonds it will be essential to expand the safety net to a level sufficient to wipe out market concerns about the European Union. For this, ESFS should be increased from 0.5 trillion to 2 trillion euros, which will not be achievable with the conventional tax resources of member countries. Accordingly, authorities must explore a new approach to increase the fixed-term deposit insurance rate, which is the approach taken in Japan; adopting a financial transaction tax, as proposed by Germany; or a combination of both.

This tax could very well have a fatal impact on investment banks. Introducing such a tax could be justified considering that it is their attacks on government bonds which have fueled the financial uncertainty in Europe that led to global economic contraction, and that they--who are most responsible for the economic crisis--seem to lack any sense of accountability for their role, while

their extraordinary payrolls have made them the object of resentment among ordinary people. In fact, the people advocating this tax insist that a new tax would be preferable to increasing deposit insurance since it would placate frustrated taxpayers.

Another option, of course, is the so-called "diabetic" solution. Under this scenario, the European Central Bank basically absorbs the government bonds of countries such as Spain and Italy. This would entail concentrating financial risk in the ECB. Although the day may come when confidence is lost in the ECB itself, requiring an injection of equity from member countries, this process would take a considerable amount of time, time we would bide while waiting for the market to recover. There is also the hope that biding our time in this way would get investment banks to lay down their arms in their attacks, which will be crucial for Europe to extricate itself from the real debt situation. This rests on the presumption that human greed can be reasonably controlled. In this regard there is also the terribly dramatic risk that the scale of additional equity which would need to be injected into the ECB may not be attainable from European countries alone. It goes without saying that among EU states Germany will bear a disproportionately large burden of any such capital injections.

For some time moving forward, we will have to keep a close eye on the relationship between the rate of progression of diabetes and the speed of economic recovery, while paying particularly close attention to developments in the financial transaction tax and the deposit insurance rates.