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The Ongoing Economic Crisis- Series 1

Comments on the EU Comprehensive Strategy to address Debt and the Financial Crisis (Oct. 2011) *(First published in January 2012)*

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World economic crisis, EU debt crisis, Financial institutions

About the institutes

1/ According to the media, the "concrete" measures of the comprehensive strategy are as follows:

(1) The ESFS, which now has the capacity to lend up to 440 billion euros (about 46 trillion JPY) as a safety net, will be expanded to a level of 1 trillion euros (about 105 trillion JPY).

(2) Creditor banks accept a 50% write-off of their credits to the Greek government.

(3) Net capital of banks will be increased by 106 billion euros (11.13 trillion JPY).

2/ The problem is that the proposal does not specify the framework of this strategy, particularly how the ESFS will be expanded. Further, it does not explain the difference between 105 trillion JPY and 46 trillion JPY, nor:

1) Who will undertake this burden

2) What is the modality of the scheme

Accordingly, it is unclear whether this expansion is realistic. In particular, judging from the demarche at the time of the G20 to solicit contributions from advanced countries outside the EU and BRIC, it is likely that EU member countries do not intend to pledge additional contributions to the ESFS. Against this backdrop, it is difficult to dispute the claim that EU member countries might be trying to free-ride.

3/ At a session of the IMF Board after the strategy was announced, many questions were raised about the above-mentioned points. The European chairs did not offer any concrete answers. IMF management was desperate to maintain control of the session. Although Ms. Lagarde, Managing Director of the IMF, has

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been touring BRIC countries to solicit their commitments, it would be impossible for these countries to even begin internal discussions on the subject without the following details:

(1) Do EU member countries intend to make additional commitments to the ESFS? What is the burden-sharing among EU member counties? What is the burden-sharing between EU member countries and others?

(2) What is the modality of the contribution? Would it be contributions to the ESFS fund, loans to the fund, or purchase of bonds to be issued by the fund?

(3) What kind of repayment assurance is there in the case of loans or bond investments? Would a collective guarantee by EU member countries be preconditioned? How would the interests of creditors be assured in case of default?

(4) What modalities are there regarding the use of fund resources? More specifically, would resources only be used to address the liquidity problem; or, if necessary, would they be used to address the issue of a nation's solvency?

(5) What is the decision-making mechanism of the fund? How would the rights of contributors or creditors who participate in the decision-making process of the fund be assured?

(6) Last but not least, what kinds of concessions are EU member countries prepared to make in response to the contributions by other countries with regard to the governance issue of international organizations such as the IMF?

4/ Meanwhile, burden-sharing among the EU and the IMF of IMF assistance to European countries after the Lehman shock was as follows:

Iceland (non-EU member) ⇒ only IMF (2.1 billion USD）
Latvia ⇒ 3:1 (5.1 billion euros : 1.7 billion euros)
Greece ⇒ 8:3 (80 billion euros : 30 billion euros)
Ireland ⇒ 2:1 (45 billion euros : 22.5 billion euros)
Portugal ⇒ 2:1 (52 billion euros : 26 billion euros)

If the scope is broadened to include any historical cases of IMF assistance, such as the Asian crisis in 1997-98 in South Korea, Thailand, and Indonesia, the crisis in Russia in 1998, and the crisis in Brazil in 1998, most financial assistance was extended by countries in the region to the IMF. In all cases, tough conditions were imposed by the IMF to guarantee repayment. The EU, as a political and economic community, goes beyond independent countries in the region. Hence, the ongoing crisis among EU member countries should be addressed, in principle, by the EU itself. The initiative by the EU to try to solicit contributions from countries outside the region also marks a major departure from the past cases described above.

5/ Furthermore, major European countries' sentiment to refuse tough conditions attached to IMF assistance due mainly to pride is a source of dispute among BRIC and non-EU countries, typified by the Italian government's decision to decline an offer of assistance by the IMF. The IMF has various resources in addition to the general resource account (GRA), such as the New Arrangement to Borrow (NAB), which was expanded in 2010 to around 60 billion USD under my chairmanship. Assistance from these resources requires conditions. It is being examined whether it would be possible to buy government bonds from European countries without conditions through a new trust account which will be established from contributions of member countries. Such an idea, though, would hardly be psychologically acceptable as it represents inequitable treatment of Asian countries such as South Korea, Thailand and Indonesia, Latin American countries, and Russia, which all accepted and followed tough conditions when they received assistance from the IMF. In the case of South Korea, for instance, candidates for president sat an oral interview with the IMF mission to ensure they would be firmly committed to such conditions should they become president. In addition, the purchase - without conditions - of government bonds from such countries as Italy or Spain as a guarantee of the IMF fund runs a high risk as to whether these governments might default on the bonds. Such purchases can be compared to investing in debentures issued by a private company or making additional loans which may be insolvent, without going through the process of Chapter 1.

6/ It is therefore conceivable that most countries believe it would be more desirable to extend loans or invest in the IMF rather than doing something similar for the ESFS. If any contribution by Japan should become necessary, additional support directly to the IMF would be the only possible way, considering that it would go towards assisting all member countries (not only EU member countries) and that attached conditions would assure repayment. It should also be noted that extending credit to the IMF is the safest investment, because it is inconceivable that the IMF, which is basically the central bank of all countries, would not be able to repay the investment.

7/ Against this backdrop, expanding the ESFS to upwards of 1 trillion euros would be difficult unless European member countries could make additional contributions. Whether such additional contributions are feasible would depend on negotiations inside the EU. If it turns out to be unfeasible, the safety net for a potential economic crisis would remain flawed even if the resource base of the IMF were bolstered in terms of burden-sharing between the IMF and the EU. The fate of the world economy depends on the decision of European countries to stem the ongoing vicious cycle of its economy through renewed efforts to improve their fiscal condition. If such efforts prove unsuccessful, the world will have to expect a second economic shock larger than the one which followed the Lehman shock.

The Ongoing Economic Crisis- Series 2

What went wrong? Why did the world economic crisis occur after the Lehman Shock? *(First published in March 2012)*

1/ Why did the world economic crisis occur after the Lehman Shock? Little has been discussed on this point in detail, probably reflecting Western media's bias towards Wall Street. The complete abolishment of the Glass-Steagall Act in February 1999 was the main structural cause of the financial bubble in the United States and Europe from 2002 to 2007. It was abolished under the leadership of Treasury Secretary Lawrence Summers during the process of liberalizing financial markets in the late 20th century. The act was enacted in 1933 in order to divide the business of banking and securities in light of the tragic experiences of the Great Depression. Surplus liquidity created by an extended period of lax monetary policy in the first decade of the 21st century under the auspices of the Federal Reserve and Chairman Greenspan fueled a so-called money game by investment banks, which was inconsistent with the laws of real demand. Such policy and administration by the Fed and Treasury were the main causes of the bubble. However, I would like to leave a more detailed discussion of this point for another occasion and focus instead on the problems related to the failure of Leman Brothers in September 2008, which is what triggered the world economic crisis. I would now like to discuss two major mistakes made by U.S. and European financial authorities with regard to (i) how Lehman Brothers was liquidated and (ii) how the bailout of financial institutions was worked out. I will start with the liquidation of Lehman Brothers.

2/ Financial institutions in the United States have been suffering from non-performing subprime loans since the fall of Bear Sterns in March 2008. According to IMF staff who were seconded to the Federal Reserve Board for six months in March 2008, all staff at the Fed were so busy as to give up all weekend holidays. Under this backdrop, the memoir of Mr. Paulson ("On The Brink") published in 2010 gives a detailed explanation of what happened on the eve of the liquidation of Lehman Brothers on September 15, 2008. Initially, Lehman was negotiating with Bank of America about a possible buyout of Lehman by BOA. On Friday, September 12th negotiations fell apart and

BOA decided to buy Merrill Lynch. Then the Barclays Group, which was the largest shareholder of Lehman and would suffer the largest loss if Lehman were to fail, joined the negotiation table. Barclays too had prepared for this by entrusting due diligence of the Lehman Group to a neutral third-party. Accordingly, when the issue was brought to the table, the parties concerned had expected that the buyout would be agreed to and made public on the weekend. That weekend Barclays branch office executives stood by at their offices around the world. However, they received no word from London headquarters until late Sunday. Finally, on the night of Sunday, September 14 they were informed by the Financial Supervisory Authority of the British Government that the FSA would not allow Barclays an exception from the rule by allowing them to waive the listing requirement for a shareholder vote. As such, Barclays had to get the approval of shareholders by holding an extraordinary shareholders' meeting within twenty-four hours. Considering the fact that it was physically impossible to convene such a meeting, this was in effect disapproval of the deal by British authorities. As this information was delivered to the United States government, Treasury Secretary Paulson and president of the Federal Reserve Bank of New York Timothy Geithner went pale and phoned the British FSA to ask them to waive the listing requirements for a shareholder vote so that Barclays could go ahead and buy Lehman. They received only a dry answer to the effect that only the Chancellor of the Exchequer had the authority to do that. Paulson writes in his book that when he talked over the phone with Alistair Darling, then Chancellor of the Exchequer, he made it clear without a hint of apology in his voice that there was no way Barclays would buy Lehman.
（「Henry M. Paulson, Jr. On the Brink」 Page 272, Nikkei Publishing Inc. Translated by Yuko Aruga）

3/ The expression of "without a hint of apology" reveals well how Mr. Paulson felt. The basic position of the British authorities is understandable, however, taking into account the possibility that British taxpayers might have had to bear the burden of Lehman's loss if Barclays, which is much smaller than Lehman, failed after acquiring Lehman. I do not mean to say that disapproving the deal was a problem. The real problem lied in the following. When Yamaichi Securities closed in November 1997, which I was in charge of as the director of the Ministry of Finance, the Japanese government allowed the liquidation of Yamaichi only after all cross-border transactions had been unwound over the weekend of November 22-24. The main purpose of this was to not let the closure of Yamaichi affect overseas financial institutions and drag Japan into the epicenter of a world depression. The workload to do this was extraordinarily huge, but it was accomplished through cooperation between the Bank of Japan, Ministry of Finance, private financial institutions and foreign governments. This worked to contain the shock from the closure of Yamaichi within Japan and, as the world economy continued to grow, the Japanese economy has also recovered since 2003. On the other hand, this was not the case for the liquidation of Lehman Brothers. Lehman went bankrupt on Monday, September 15 without unwinding its huge volume of cross-border transactions. This had an extraordinarily contagious effect on the world financial system, starting with the London branch of AIG, and triggered a world depression comparable to the Great Depression before the Second World War. What U.S. and British authorities (Treasury Secretary Paulson and the president of the Federal Reserve Bank of New York Tim Geithner on the U.S. side and Chancellor of the Exchequer Alistair Darling and Prime Minister Gordon Brown on the British side) could have done was cooperate and, by suggesting to the market that negotiations between Lehman and Barclays were still ongoing, to save another week of time which would have enabled authorities to unwind all cross-border transactions. Liquidating Lehman only after all foreign transactions had been unwound could have averted a worldwide crisis.

4/ Understandably enough, if Lehman Brothers had been liquidated only after all cross-border transactions had been unwound, the United States government would have had to spend a huge amount of taxpayer money in order to bail out Lehman Brothers, protect the U.S. financial system, and put a halt to any contagious effects on other financial institutions. If this had happened, the government would have needed to offer a comprehensive explanation to persuade taxpayers why such a colossal amount of public and tax money had to be spent. It is highly likely that this would also have required an investigation into the responsibility of management and supervisory authorities. Such an investigation has never been conducted in the United States and the United Kingdom in the three and a half years since Lehman Brothers went under. In contrast, ten years ago in Japan, the responsibility of executives involved with failed financial institutions such as Yamaichi, LTCB and NCB was thoroughly investigated, while most of these executives were arrested and prosecuted. We have long pointed out the need for such investigations to our counterparties in the governments of the United States and the United Kingdom but our voice has yet to be heard. Taxpayers in both countries were deeply frustrated by the lack of an investigation. In addition, most executives of financial institutions on Wall Street and in London received tremendous bonuses and retirement compensation. The widespread woes of taxpayers were not properly reported in the media, which might have been overly biased towards Wall Street. Japanese correspondents, instead, reported many such woes from all over the United States when they visited local cities. The main reason why the Democrats lost in the mid-term election was not because of health care reform but due to the failure of the government to address complaints from taxpayers.

5/ It is my firm belief based on the above experiences that the most effective measure for protecting the financial system is to reach an international agreement to the effect that when the liquidation of a financial institution with a certain size of international transactions cannot be avoided, authorities must unwind all cross-border transactions before the liquidation takes effect.

Such an agreement would allow the financial system to avoid a worldwide financial crisis whenever a financial institution is liquidated. This would naturally lead the country in which the financial institution is located to liquidate the institution at the cost of its taxpayers. Countries such as the United Kingdom and Switzerland, so-called financial nations that accommodate an excessively large financial sector compared to the size of their national economies, would no doubt dislike such an agreement. Any regulation of the financial sector, including the Basel Accords, tend only to create a vicious circle of regulatory loopholes and are not effective in avoiding financial crisis. To make money, bankers always try to find loopholes in existing laws. Accordingly, the most important and fundamental attitude of supervisory authorities should be to always maintain the utmost diligence in fulfilling its duties of daily administration based on the premise that there is no perfect form of regulation. The above-mentioned rule requiring authorities to unwind all cross-border transactions before the unavoidable liquidation of a financial institution with a certain volume of international transactions takes effect would likely encourage supervisory authorities to undertake day-to-day supervision with extreme diligence because any rule that would require the use of taxpayer money in one's own country would put enormous pressure on them to demand full accountability for the nation's taxpayers.