# The Global Financial Crisis: The EU and Japan

Session 3, The EU and the Global Economic Governance
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## Topics

1. The Japanese crisis of the 1990s
   --- why, how and what
   Japanese policies to counter the solvency and liquidity crises
2. The global crisis of today
   --- comparing the two crises and policy responses
3. Some prospects

# The Japanese crisis (1)

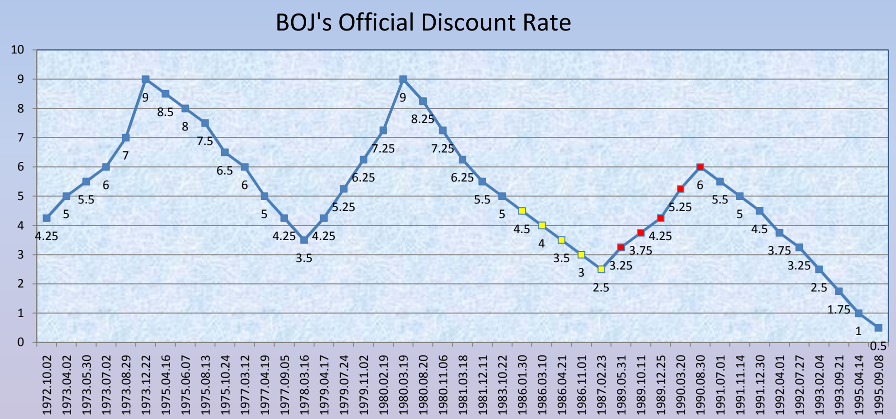
Three factors:

1. Expansionary Monetary Policy following the Plaza accord (August 1985, promise to expand domestic demand and reduce current account surplus)
2. Myth that real estate and stock prices 'never fall'
3. Deregulation in the financial sector



# The Japanese crisis (2)

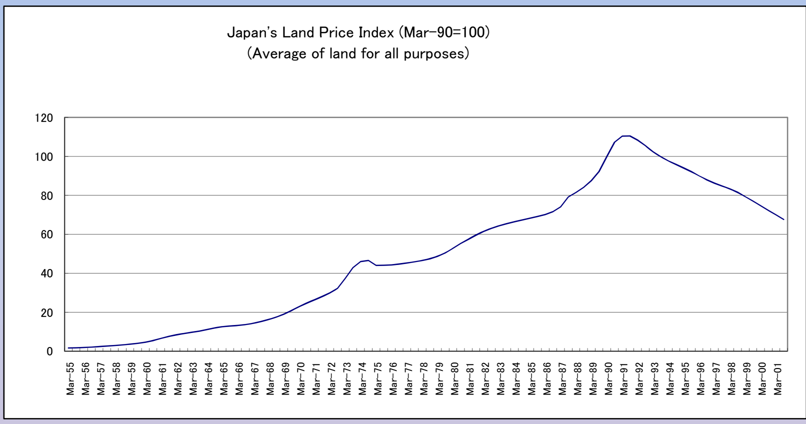
1. Expansionary Monetary Policy




Source: Bank of Japan

# The Japanese crisis (3)

2. Myth 1: Real estate prices 'never fall'

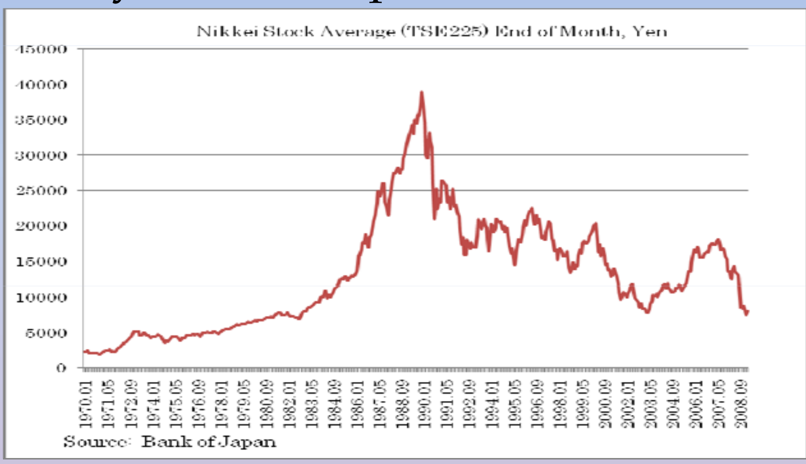



Source: Japan Real Estate Institute



# The Japanese crisis (4)

2. Myth 2: Stock prices 'never fall'



## The Japanese crisis (5)

3. Financial market deregulation

Due to increases in the 1970s in:

- government bond issuance
- cross-border financial transactions

in the 1980s,

ceilings on deposit interest rates were liberalised/removed

large firms could raise funds in the capital market by issuing bonds



## The Japanese crisis (6)

→ business environment for Japanese banks changed

from: protection and regulation under the ‘convoy system’

to: increased competition in terms of both deposit-taking and lending

→ expand real estate-related business

## The Japanese crisis (7)

This expansion into real-estate related lending by Japanese banks coincided with:

- Japan's CA surplus reaching 3.6% of GDP
- Japan's promise at the Plaza to decrease this by boosting domestic demand
- 100% appreciation of the yen after Plaza
- Deregulation = 'hard way out', Monetary expansion ='easy way out'

→ BOJ lowered the ODR 5 times between Jan 1986 and Feb 1987

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## The Japanese crisis (8)

Economic expansion began in Dec 1986, yet,

- Discount Rate was left at 2.5% for 2 years and 3 months
- Minister of Finance Miyazawa announced in May 1987 a 6 trillion yen economic package
- Money supply growth reached 10% per annum by 1987

→ the BUBBLE

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## The Japanese crisis (9)

- BOJ raised ODR in May 1989 to 3.25% and 5 times after that, to 6% by 1st July 1991
- MOF announced a 'notification' in Dec 1989 urging Securities Houses to refrain from compensating their corporate clients for stock-market losses
- MOF put cap on real estate related lending (from April 1990 to January 1992)

→ the bubble BURST

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## Policies to counter the Solvency Crisis (1)

November 1997

Failure of

Sanyo Securities

Hokkaido-Takushoku Bank

Yamaichi Securities

→ severe credit crunch, Japan premium

→loss of confidence in Japanese accounting and auditing system

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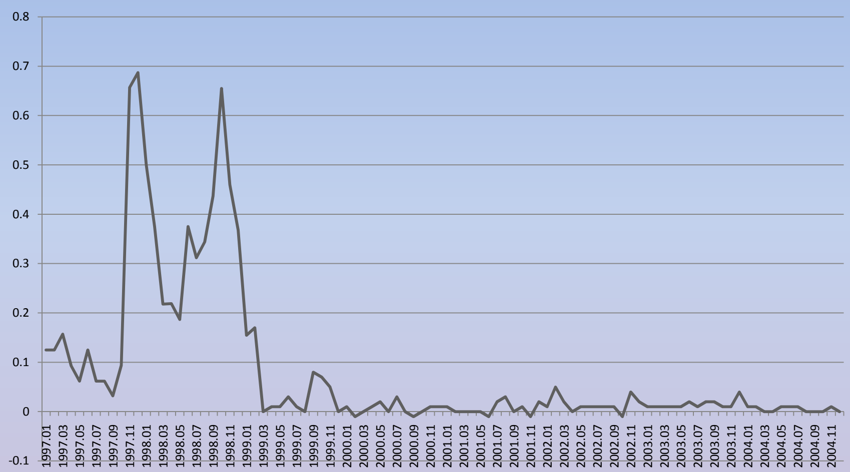
# Japan Premium




Source: Bank of Japan

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## Policies to counter the Solvency Crisis (2)

By end 1997

**Emergency Economic Package**

13 thousand billion yen

for capital injection to solvent banks

17 thousand billion yen

for protection of depositors in failed banks

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## Policies to counter the Solvency Crisis (3)

**BUT** the package **did not work**;

March 1998

**ONLY 1.8 thousand billion yen was injected into 21 large banks** WITHOUT complete examination or comprehensive cleanup of bank balance sheets

October 1998

Long Term Credit Bank goes into public receivership

December of 1998

Nippon Credit Bank goes into public receivership



## Policies to counter the Solvency Crisis (4)

Just before LTCB went into receivership in 1998,
60 thousand billion yen (12% of GDP) was made available

New: **Financial Revitalisation Act**

18 thousand billion yen for resolution of failing banks

New: **Bank Recapitalisation Act**

25 thousand billion yen for capital injection into solvent banks

Old: **Deposit Insurance Corporation**

17 thousand billion yen for protection of depositors

## Policies to counter the Solvency Crisis (5)

**Financial Revitalisation Act of 1998**

- Basically for 'insolvent' institutions
- FRA also covers privatization procedure (introducing efficient new management, injecting capital, disposing bad loans)
- Public funds are used to protect depositors and replenish damaged capital base.



## Policies to counter the Solvency Crisis (6)

**Bank Recapitalisation Act of 1998**

- For 'solvent' institutions
- Public funds injections to restore credibility

**Deposit Insurance Corporation** (est. 1971)

Limit of coverage increased twice from 1 million to 10 million yen by 1986,

DIC obtained new power to assist mergers of failed institutions and sound institutions

## Policies to counter the Solvency Crisis (7)

The DIC fund had never been used until 1992

DIC was allowed in 1996 to fully protect depositors beyond the normal 10 million yen as temporary measure until March 2001

In May 2000, the **Deposit Insurance Law (DIL)** was further amended to prepare a permanent resolution scheme for failing banks

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## Policies to counter the Solvency Crisis (8)

Under **FRA**, LTCB and Nippon Credit Bank were nationalized in October and December of 1998.

Under **BRA**, 7.5 thousand billion yen of capital was injected into 15 major banks at the end of March 1999.

By late 1998, Japan premium began to subside

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## Policies to counter the Solvency Crisis (9)

End September 2002:

Economic and Financial Policy Minister Takenaka designated Minister of Financial Services

Within a month, Takenaka directs FSA to

- revise its methods of checking the classification of bad loans by banks
- treat all banks uniformly
- hold auditors legally liable for the corporate results that they authorized

→ further large write-offs of non-performing loans and actual liquidations

**cf. Feldman (2008)**



## Policies to counter the Solvency Crisis (10)

Under **DIL**, Resona bank (formerly Daiwa and Asahi banks) was rescued in May 2003, by injection of public money (1.96 trillion yen of capital through the DIC)

→ 'now the government will save shareholders, not just depositors'

→ the Tokyo stock market rallied

**cf. Fukao (2007)**

## Policies to counter the Solvency Crisis (11)

As of 31st March 2008,

the Japanese government has recovered **8.8 thousand billion yen** out of

the **12.3 thousand billion** yen injected into private sector banks

between 1998 and 2003



## Policies to counter the Solvency Crisis (12)

The government started selling off the banks' Preferred stock (no voting rights, but given priority over common stock in payment of dividends and upon liquidation) purchased with the public money in February of 2000

The government made **1.3 thousand billion yen** worth of profits, due to the rise in stock prices (as of March 2008)

## Liquidity Crisis and Monetary Policy (1)

The Bank of Japan's monetary policy

1. Official Discount Rate
2. Overnight Unsecured Call Rate
   Zero Interest Rate Policy
3. Quantitative Easing, then back to Overnight Unsecured Call Rate



## Liquidity Crisis and Monetary Policy (2)

**1. Official Discount Rate**

This was the rate at which private banks borrowed directly from BOJ

In the era of regulation, deposit rates moved with ODR

After 1994 when deregulation completed, deposit rates no longer followed ODR → no longer a direct policy tool

## Liquidity Crisis and Monetary Policy (3)

**2. Overnight unsecured call rate**

This is the rate at which banks borrow short term from each other

BOJ uses ODR as ceiling for OUCR which it controls by changing money supply

**Zero Interest Rate Policy**

Between Feb 1999-Aug 2000 the BOJ aimed at keeping this close to zero

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## Liquidity Crisis and Monetary Policy (4)

The economy worsened after the ZIRP was dropped in August 2000

March 2001

ZIRP was introduced again

**Quantitative Easing** began and continued until March 2006

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## Liquidity Crisis and Monetary Policy (5)

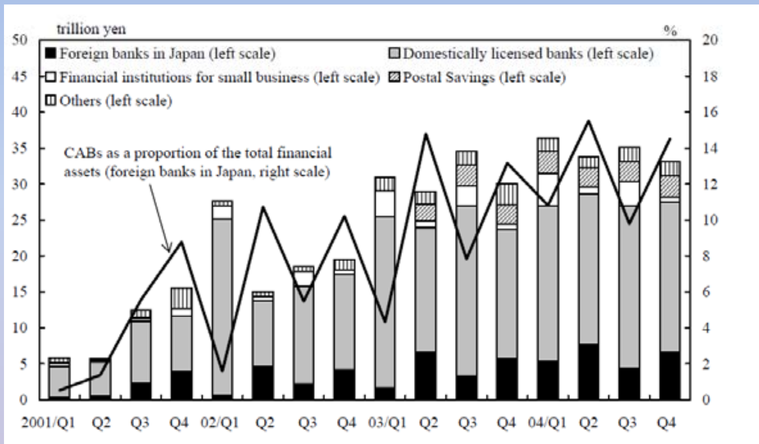
### 3. Quantitative Easing

Under this policy, the BOJ uses the 'current account balances' which private banks keep (with no interest) at the BOJ as the main policy target

BOJ has raised the target level several times, to levels far above the level of required reserves



## Current Account Balances at BOJ




Source: Bank of Japan, "Flow of Funds Accounts."

Source: Bank of Japan

## Liquidity Crisis and Monetary Policy (6)

When the BOJ introduced the QE policy, it promised to keep it 'until the annual inflation rate of CPI stabilised above zero'

Since March 2006, when the BOJ judged this condition had been met and quit QE, the BOJ has been targeting the Overnight Unsecured Call Rate again

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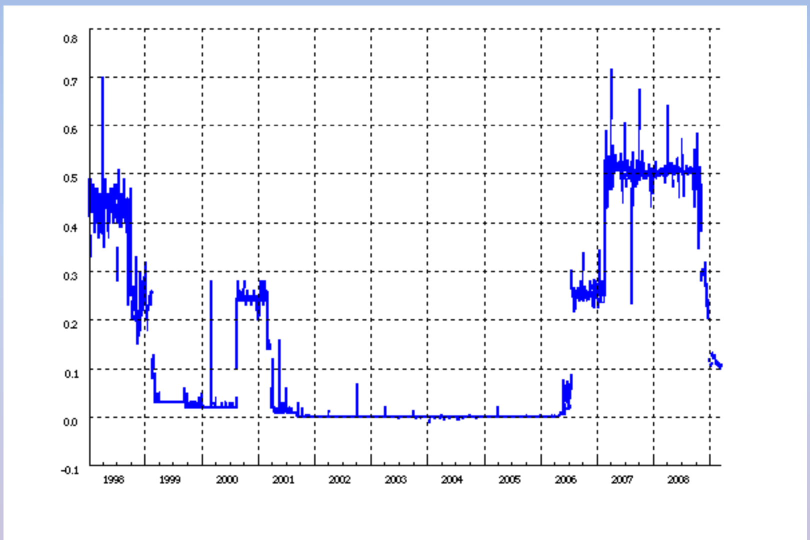
## Overnight Unsecured Call Rate




Source: Bank of Japan

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## The Global Crisis today (1)

Three factors:

1. Microeconomic and Macroeconomic policy mismanagement
2. Financial imbalances
3. Global imbalances



## The Global Crisis today (2)

**Microeconomic policy mismanagement**

- Regulations that encouraged off-balance-sheet transactions
- Endorsement/encouragement of new instruments such as CDOs and securitisation (misguided belief that they made markets fundamentally more stable via risk diversification)
- Mispricing of risk

## The Global Crisis today (3)

**Macroeconomic policy mismanagement**

Policy tool: monetary policy

Policy goal:

price stability AND market stability

The 'Greenspan put':

Emphasis on price stability, will deal with the bubble after it develops/bursts

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## The Global Crisis today (4)

**Financial imbalances**

- Increased leverage especially in the USA
- Financial sector debt to GDP ratio up from 20% to 200% in the last 30 years
- Household debt to GDP doubled to 100% in 20 years
- Private sector debt to GDP ratio has more than doubled to 300% in 25 years

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## The Global Crisis today (5)

**Global imbalances**

- CA deficit/net foreign borrowing on the part of developed countries such as the USA
- CA surplus/net foreign lending on the part of Japan, China and poorer countries
- Behind this: explosion in household spending and borrowing, backed up by the housing boom in the USA and in the UK

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## What do the two crises have in common? (1)

1. Overconfidence in the stability and success of the financial model in use
2. Crisis originating in the financial sector spreading to the rest of economy as financial intermediation froze
3. Downfall of the 'number 1' model, disbelief, denial, disgrace
4. Haphazard policy reaction as policymakers scramble for the correct policy

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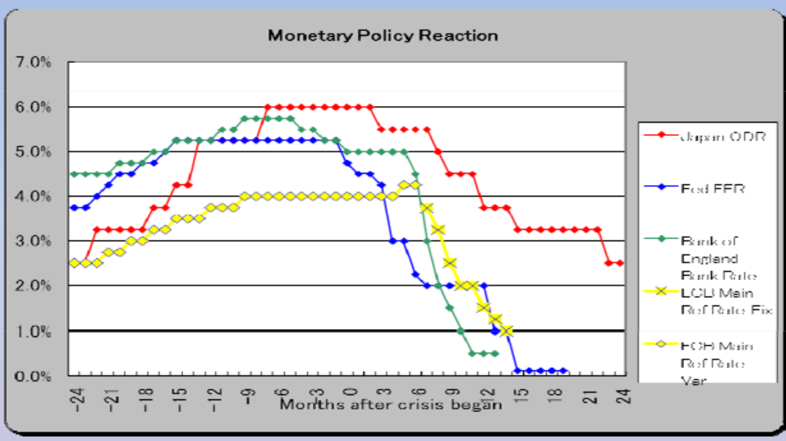
## Difficulties of taking action at EU level

1. EU is not equal to the single currency area
2. Member State actions must be consistent with EU legislation
3. Cannot fund EU/Eurozone level rescues/packages using taxpayer money
4. Globally active institutions are international in good times and national in bad times

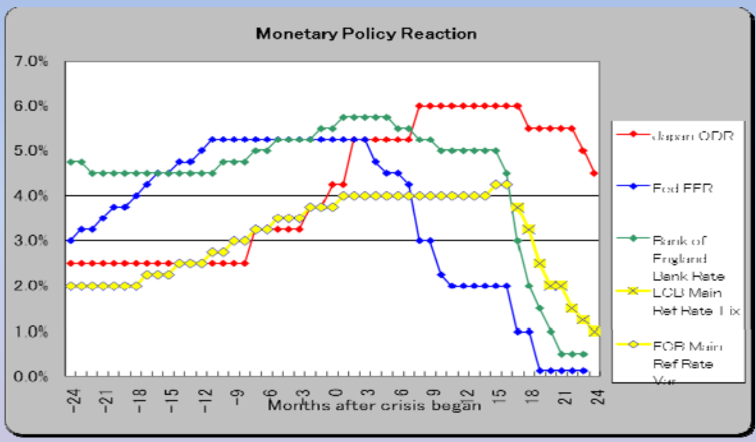


## Monetary Policy
## After the fall in real GDP growth




Sources: BOJ, Fed, Bank of England, ECB
Start of crisis: dates of fall in real GDP growth, BOJ=1st April 1991, BofE and ECB=1st April 2008, Fed= 1st October 2007

# Monetary Policy After the fall in markets




Sources: BOJ, Fed, Bank of England, ECB
Start of crisis: BOJ=1st Jan 1990 (date of fall in 225 Nikkei index), BofE, ECB and Fed=25th June 2007 (date of Fall in Mortgage backed security ABX index)

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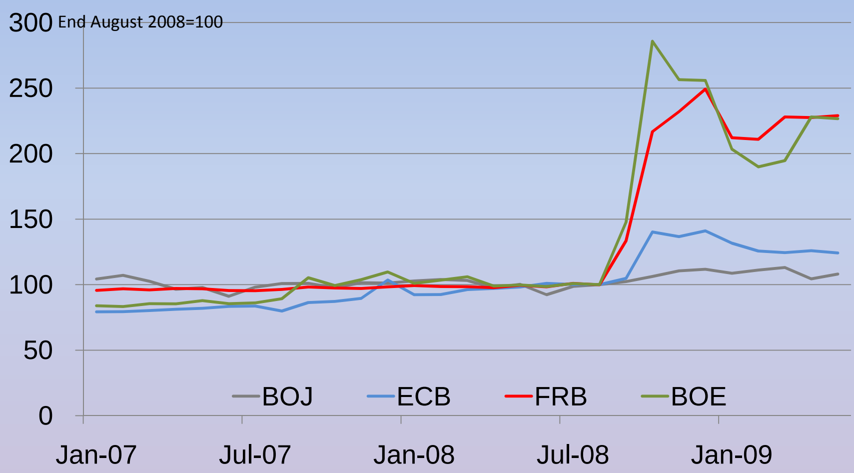
# Central Bank Balance Sheets during the current crisis




Source: Nomura Securities

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## Euro-area public interventions in the banking sector

Table 3: Euro-area public interventions in the banking sector
(in % of GDP, Jun 2008 to Apr 2009) (1)

| | Capital injections | | Guarantees on bank liabilities | | Relief of impaired asset | | Liquidity and bank funding support | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|
| | approved | effective | approved | effective | approved | effective | approved | effective | approved | effective |
| Austria | 5.0 | 1.7 | 25.7 | 5.1 | 0.4 | 0.4 | 1.6 | 1.5 | 32.8 | 8.7 |
| Belgium | 4.2 | 5.7 | 70.8 | 16.3 | 4.2 | 4.2 | NA | NR | 79.2 | 26.2 |
| Cyprus | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Germany | 4.2 | 1.6 | 18.6 | 7.1 | 0.4 | 0.4 | 0.0 | 0.0 | 23.2 | 9.1 |
| Greece | 2.0 | 1.5 | 6.1 | 1.2 | 0.0 | 0.0 | 3.3 | 1.8 | 11.4 | 4.6 |
| Spain | 0.0 | 0.0 | 9.3 | 3.2 | 0.0 | 0.0 | 2.8 | 1.8 | 12.1 | 5.0 |
| Finland | 0.0 | 0.0 | 27.7 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 27.7 | 0.0 |
| France | 1.2 | 0.8 | 16.6 | 4.5 | 0.2 | 0.2 | 0.0 | 0.0 | 18.1 | 5.6 |
| Ireland | 5.1 | 4.2 | 225.2 | 225.2 | 0.0 | 0.0 | 0.0 | 0.0 | 230.3 | 229.4 |
| Italy | 1.3 | 0.0 | NA | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 1.3 | 0.0 |
| Luxemburg | 6.9 | 7.9 | 12.4 | NR | 0.0 | 0.0 | 0.0 | 0.0 | 19.3 | 7.9 |
| Malta | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Netherlands | 13.9 | 13.9 | 34.3 | 7.7 | 3.9 | 3.9 | 0.0 | 7.5 | 52.2 | 33.1 |
| Portugal | 2.4 | 0.0 | 10.0 | 3.3 | 0.0 | 0.0 | 0.0 | 0.0 | 12.5 | 3.3 |
| Slovenia | 0.0 | 0.4 | 32.8 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 32.8 | 0.4 |
| Slovakia | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Euro area | 3.0 | 1.9 | 20.5 | 8.7 | 0.6 | 0.6 | 0.5 | 0.8 | 24.6 | 12.0 |
| Memo EU-27 | 2.9 | 1.8 | 24.6 | 8.1 | 0.4 | 0.4 | 2.5 | 2.6 | 30.5 | 13.0 |

(1) NA - Not available indicates that the amount is not available in the State aid decision. NR - Not reported indicates that the amount was not reported by the Member State in its reply to the EFC questionnaire.
*Source:* Commission services.

http://ec.europa.eu/economy_finance/publications/publication15487_en.pdf

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## What do the two crises have in common? (2)

Fundamental, inevitable nature of financial markets:

i. Fear and greed
ii. Moral hazard
iii. Information asymmetry
iv. Low cost of transactions, high speed of adjustment
v. Inconsistent triangle

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## What do the two crises have in common? (3)

We cannot remove any of these fundamental characteristics of financial markets, the best we can do is to affect some of them by policy

In addition, memories are short

→ crisis originating in financial markets will happen again

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## How should we react? (1)

In the short-run:

Financial intermediation must recover

- Banks' balance sheets must improve and confidence must return
- Monetary policy to include 'unconventional measures', introduction of another policy tool
- As Japan's experience shows,
  none of this is easily done

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## How should we react? (2)

Questions in the longer run:

To what extent can saving-investment balances be changed by policy?

How should risk be priced?

How can we construct global and local regulatory structures that discourage destabilising behaviour?



## How should we react? (3)

Questions in the longer run:

What is the role of a bank?

Money's two important roles:

- medium of exchange
- store of value

Is it impossible to optimise both at the same time?

## How should we react? (4)

- This crisis is revealing the importance of markets, not the uselessness of markets
- Nobody, not the government, not the private sector, can function without the credible price of their transactions --- today: price signals are no longer credible, because markets are not functioning properly
- Just as we need to contain the spread of protectionism, we need to make sure intervention and regulation remain such that they do not distort market signals.

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## How should we react? (5)

- At the same time, the problem with today's world is that phenomena that collectively come under 'market failure' are increasing in importance.
- We must be careful not to deny the usefulness of markets and market signals, but we also need to recognise the shortcomings of market-determined solutions.

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