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# Center on Japanese Economy and Business

日本経済経営研究所

# Coping with Crisis: Financial Policy in the U.S. and Japan

November 10, 2009

Panelists

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# Coping with Crisis: Financial Policy in the U.S. and Japan

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The Center on Japanese Economy and Business (CJEB) and the Program for Economic Research organized a conference titled "Coping with Crisis: Financial Policy in the U.S. and Japan." More than 280 people attended this inaugural event of CJEB's new program, "New Financial Architecture: Japan & the U.S.," on November 10, 2009, at Columbia Business School.

Heizo Takenaka, Japan's former Minister of Internal Affairs and Communications and former Minister of State for Privatization of the Postal Services, recounted his key role coping with the Japanese banking crisis of the 1990s. Patrick Bolton, Barbara and David Zalaznick Professor of Business at Columbia Business School, examined the current U.S. financial crisis through the prism of Japan's experience. University of Tokyo Professor Takatoshi Ito reviewed lessons from Japan's crisis for the U.S. situation. Merit Janow, a professor at Columbia University's School of International and Public Affairs, offered her viewpoint based on her experience as chair of the NASDAQ Exchange. This report is a summary of their presentations.

## HEIZO TAKENAKA

I was in the Japanese government from 2001 to 2006, under former Prime Minister Junichiro Koizumi, during which we reformed the banking sector and worked on privatizing Japan Post.

In the second half of the '80s, Japan had a bubble economy. The Nikkei average grew almost six times in value. After the bubble burst in 1989, the '90s became a lost decade. The growth rate of Japan was only 1 percent, compared with 4 to 5 percent the previous decade.

The Japanese government mismanaged its macroeconomic policy. A balance sheet adjustment was needed. But the government only increased public works expenditures and failed to do a supply-side adjustment. This caused a serious financial crisis. Yamaichi Securities, the second-largest security company, went bankrupt in 1997, and Hokkaido Takushoku Bank, one of nine city banks at that time, also went bankrupt. In reaction, the Diet approved a law in 1998 to use public money as capital injections for troubled banks. In 1999, a total of 7.53 trillion yen—1.5 percent of GDP—was injected into major banks. But this was not enough. The crisis did not subside until 2003, four years later.

### Three Lessons from the Crisis

First, capital injections alone will not solve the problem. If bad assets are still being conceived, the crisis will continue. Only after precise and strict asset appraisals at financial institutions should the necessary capital be injected. In Japan, this did not happen until 2002 when the financial revitalization program was introduced. After being strictly examined, Resona Bank received a capital injection in 2003. The situation began to improve.

Second, government intervention can go too far. When the government gives excessive protection to some, this can worsen the crisis of confidence. In this context, the world trend toward reversing mark-to-market accounting is troubling. In 2003, when Japan's election coincided with its financial crisis, many politicians and industrial groups called for the suspension of mark-to-market accounting. But Mr. Koizumi strongly rejected this view. If he had agreed, bad-loan disposal and the economic recovery would have taken even longer.

Third, both lenders and borrowers must be considered. The disposal of nonperforming loans in the banking sector and the reduction of excess debt in damaged businesses are two sides of the same coin. We established the Industrial Revitalization Corporation of Japan, whose role was to help the balance-sheet adjustment of debtors, in the form of managed bankruptcy, in order to consider the needs of both lenders and borrowers.

### Predictions for Japan's Economy

In the first quarter of this year, the growth rate was minus 12 percent on an annual basis. But in the second quarter, the rate was plus 2.3 percent, and economists predict the third quarter will be 2 to 3 percent.

However, the current recovery depends on the fact that the Chinese economy is again growing very rapidly, and the fact that the Japanese government is funding the fiscal expansion. This cannot be sustained given the size of the fiscal deficit. So the recovery will be W-shaped.

The new Democratic Party of Japan government is to be commended for its open-sky policies—such as its antibureaucratic policy making and its promotion of the decentralization of power to local governments. However, its weakness is in macroeconomic policy. The fiscal deficit must be reduced. But it must also stimulate aggregate demand. To do both is difficult.

Another issue is how the DPJ has three distinct groups. One is very innovative, including graduates of The Matsushita Institute of Government and Management. Mr. Seiji Maehara, Minister of Land, Infrastructure, Transport and Tourism, is a leading figure in this category.

The second are the former bureaucrats who have experience with policy making. Finance Minister Hirohisa Fujii and Koji Matsui, the deputy chief cabinet secretary, are leading figures in this category.

The third are people who represent special vested interest groups, such as labor unions. This can result in contradictory policies. For instance, the DPJ wants to strengthen the economy through deregulation. But they are also going to renationalize the Japanese postal system.

The DPJ ensure that its micro and macro policies are consistent through a "control tower." Since 2001 the Council of Economic and Fiscal Policy, which I headed, played this role. But it was abolished and the newly created National Strategy Bureau will fill the role, although it is regrettable that it is not yet functioning.

Also, politicians tend to create populist policies rather than true economic reform. For the time being, the Japanese economy will show signs of recovery because the DPJ government will continue its expansionary fiscal policy. But this is not well-designed macroeconomic management. It's a populist approach given next year's elections and the lack of a working control tower.

## PATRICK BOLTON

The current U.S. crisis is similar to Japan in the '90s in this way: A bubble in the real estate market was fueled by lax monetary policy and facilitated by deregulation. Then the real estate bubble burst and bled into other asset markets.

The twist in the U.S. is the development of shadow banking—the growth of securitization and repurchase (repo) markets that facilitated the growth of subprime mortgages.

How can we address regulatory issues regarding shadow banking? We must consider issues of incentives for originators and servicers of mortgages; the question of whether loans should be allowed to be off the balance sheet of the bank; the problem of credit rating agencies; the role of credit default swaps; capital requirements; and so on. The problems that we face in the U.S. are common to all developed financial markets, whether it's in Europe or Japan.

### The Issue of Securitization

We saw a tremendous growth in the issuance of asset-backed securities over the past decade, and then it all came to a halt in 2007. The markets have not revived. We don't want to return to pre-bubble heights, but we do want to rely on securitization again.

On the plus side, securitization diversifies risk by creating diversified asset pools. It also offers distribution to long-term investors. There's a big demand for fixed-income securities, whether by U.S. pension funds or the world at large. We need to tap into that demand.

If done right, securitization is very good for asset liability matching and risk management. But another stated benefit of securitization, conserving on capital, is not a good reason for securitization. You're relying on short-term deposit financing to fund your mortgages. But your mortgages are long-term, fixed-interest assets. So that's a huge asset/liability mismatch. You're very vulnerable to interest rate risk. How do you reduce that risk? You sell off these long-term assets immediately, and then you hold on to the proceeds from that sale. You invest it. Now you have well-matched assets and liabilities. That's what should have happened.

What happened instead was an increase in leverage, magnifying the maturity mismatch. What is puzzling about the maturity mismatch in the shadow banking sector is that this is done outside of the banking regulatory sector, outside the subsidy afforded by deposit insurance.

### One Solution Is Covered Bonds

There isn't that much to be gained by doing securitization of bank balance sheets. There is an alternative called covered bonds.

These are not used widely in U.S. banks, but they are widely used in Europe and have a lot of advantages. You can do securitization just the way you do it off balance sheet in the U.S., but it remains on the balance sheet. The big advantage is that you have recourse in bank equity, in case one of those covered bonds runs into trouble. You align incentives and that's an important advantage.

## The Role of Rating Agencies

A new bill proposed in the Financial Services Committee of the House of Representatives is encouraging. It is a step in the right direction to solve the problem of conflicts of interest at rating agencies and prevent debt issuers from "shopping" for the best rating.

Unlike in other sectors, if we have more competition in the form of more rating agencies, it makes things worse. New entrants will try to compete for market share by being excessively friendly to issuers. I suggest a parallel with what the Sarbanes-Oxley Act did with auditing firms, which was to boost competition by mandating a rotation: You're not allowed to always go back to the same rating agency.

As far as Nationally Recognized Statistical Rating Organization accreditation is concerned, this is important in current regulations. Rating agencies play a fundamental role in modern financial markets. What we need is to boost that role and not undermine it.

Another issue in the shadow banking system is the role of derivatives, credit default swaps, and repos. Under current bankruptcy laws in the U.S. and in many other countries, credit default swaps and repos are exempt from an automatic stay in Chapter 11. This provides an important subsidy to those derivatives. But what we need are subsidies for long-term financing, not for extremely short-term financing such as repos.

## TAKATOSHI ITO

All banking crises have a very similar pattern: A bubble bursts, the government denies there's a problem, or says it's small. By the time the government says there is a problem, it's usually too late. It has spread to many sectors of the economy and smaller institutions start to fail.

From 1992 to 1995 in Japan the problems were still small. If the government had radically reformed then, there would have been no decade-long crisis. Similarly, in the U.S., there were signs of stress in August 2007. But again there were no radical reforms.

The problem grows, more institutions begin to fail, and the government throws money at the failing institutions. But this is chasing the problem from behind. Then the explosion happens. In Japan this happened in November 1997 and in the U.S. in September 2008. Then the government finally responds to the systemic crisis in a big way.

## Japan's Response to the Financial Crisis

First, Japan injected capital, as Mr. Takenaka discussed. Second, it created the FSA, the Financial Services Agency, an integrated regulator, which means banking securities and insurance are all in one organization. It is somewhat independent from the government—it is part of the government but it is understood it will act independently.

Third, the government allowed the FSA to nationalize institutions. If the FSA decided that a financial institution was undercapitalized—not yet insolvent but very undercapitalized—then the FSA was endowed with the power to take over the institution, to nationalize it, wipe out shareholders, appoint new managers, and make reforms.

Two banks were nationalized in 1992: Long-Term Credit Bank and National Credit Bank. These were big events—to take over internationally active, complex banks, to unwind all the transactions without fail. They cleaned up the banks and did IPOs sold by auction later. If the story ended there, it would have been a much happier ending. But the crisis came back three years later. Why? Because there was an accounting softness that allowed the undercapitalization to continue.

In 2002 Prime Minister Koizumi heard criticism that the FSA was not working well. We economists complained that a particular accounting provision hid undercapitalization. Mr. Takenaka and his predecessor debated, and Mr. Takenaka won, so he got the job of FSA minister. One of the first things he said was that no bank is too big to fail. This caused a furor among bankers.

It took eight months but the banks began to seriously reform. Japan nationalized two banks in 2003 (Resona and Ashikaga). This was the end of the Japanese banking crisis. So from a very small problem, it took 10 years.

## The U.S. Response

Is the U.S. in 1998 or 2002? I thought the U.S. was responding well up to October and November of last year, in the aftermath of the bankruptcy of Lehman Brothers and the creation of the Troubled Asset Relief Program (TARP). But I've been disappointed since then. At a time when financial markets were at the cliff's edge looking into the abyss—when the opportunity for radical reform was ripe—the U.S. Treasury failed to act.

There is no integrated regulator. There is no nationalization, or what we call in the U.S. a resolution mechanism, which is basically a temporary nationalization mechanism passed by Congress. TARP is still drifting—it is not working to separate the bad assets from the good assets. Maybe, unlike Mr. Takenaka, the head of the U.S. Treasury is too nice a guy, too soft to push financial institutions to do big reforms.

The U.S. needs a single integrated regulator that can regularly perform all the stress tests until the crisis is over and has the authority to temporarily nationalize an institution. Nationalizing an institution can be done while still allowing it to do business in short-term liabilities. You keep paying overnight loans and one-week loans and so on. This is very important to uphold the system in place. Nationalization is the only mechanism that offers stability while also removing the moral hazard problem.

Six months between the collapse of Bear Stearns and Lehman was wasted without creating the power to nationalize. But it's a scandal that, after 15 months, you still don't have this integrated regulator and the resolution mechanism. Japan did much better in this regard.

One added complication is that we need international coordination on a resolution mechanism. After Lehman failed, three countries—the U.S., the U.K., and Japan—applied their own, different bankruptcy laws. It would be difficult to unwind a simple swaps agreement without an internationally coordinated framework.

Unless we have it and unless we have a person like Mr. Takenaka threatening the financial institutions, financial institutions will not behave. All the wrong incentives Professor Bolton mentioned will continue, and in other forms. We may experience, in the future, a similar kind of crisis.

## MERIT JANOW

We have seen a lot of consensus around the idea of strengthening some powers of the Federal Reserve and the Securities and Exchange Commission and the movement of CDs and other over-the-counter market-type instruments onto exchanges. I see that as a constructive step. But there has been a lot of concern in Congress about putting too much power into the Fed. There are arguments about a lack of accountability and discomfort with the Fed as a super-regulator and now, much more discussion about some council of systemic regulators.

While it may be objectively obvious or useful to think of an integrated regulator in the U.S., I think we want Congress to play a rather limited role. We have to think about what role politics will play.

There are many positive features of Japan's FSA as a model for an integrated regulator in the U.S. It represents for the first time in Japan an agency with broad powers and with people who come from both the private sector, with securities market experience, and the Justice Ministry. It has both an enforcement feature and a supervisory feature, working together.

One dimension, though, that is not so obviously strong is with respect to their actual supervision of financial markets. In my role as chair of the NASDAQ Exchange, I get a lot of highly detailed data on how markets are operating. A lot of that supervision is embedded in technology itself and complex patterns applied to the oversight of U.S. equity markets. Japan has not yet invested in that, and it's an expensive undertaking, requiring manpower and technology invested in that kind of regulatory oversight of principal markets.

## QUESTIONS AND ANSWERS

Question: Can you compare how the U.S. has handled its current crisis to Japan's experience?

Mr. Takenaka: The Japanese and American cases are completely different. We had a very typical banking crisis. Since banks are very strictly regulated by legal framework, it was relatively easy to supervise the banks. The U.S. crisis is a money market crisis with assets held by many players. The problem is much more complicated. But both cases show how it is completely impossible for politicians to understand finance. It is highly technical and the failure to understand the issues, and quickly, creates a crisis in confidence. The U.S. did act more quickly than Japan, in one or two years instead of 12.

Another difference is that the regulatory frameworks of the two countries differ greatly. We need to adopt best practices from among all countries, including Europe.

One other issue is that of personnel. The people making decisions in the U.S. have a lot of experience in the markets, such as Treasury Secretary Henry Paulson, who was former chair of Goldman Sachs. In Japan, that's not the case and needs to change.

Question: The public sector debt is $8.5 trillion, at its historically highest level ever and 160 percent of GDP. How much of the public debt is owned by foreign investors?

Mr. Takenaka: Yes, it is a serious problem. The debt-to-GDP ratio exceeds 170 percent. When I was the minister for economic and fiscal policy, I introduced the concept of primary balance, assuming the nominal growth rate and nominal interest rate are almost the same in the long run. In this case, if we restore the primary balance, the debt-to-GDP ratio will decline and we can recover. But because of fiscal expansion started by Prime Minister Taro Aso's administration, and the fact that the DPJ administration doesn't understand macroeconomic management, this ratio is expected to grow.

Under such circumstances, the DPJ has almost decided to renationalize the privatized Japan Post. Was this to finance the public debt? No, this is not the direct reason, I think. This initiative was from Minister Shizuka Kamei, who cannot understand that kind of macro issue. It's a bid to get votes during the next election.

Question: Regarding the issue of resolution mechanisms, does a large size necessarily make an institution risky in itself?

Professor Bolton: I think the big concern with the current White House plan—which is to create a special category of institutions that are too big to fail, treat them separately, put them to a higher standard, impose higher capital requirements, and so on—is no matter how tough you are with those institutions, the market will perceive them to be completely safe. They will treat them like Fannie Mae and Freddie Mac, and we know what happened with those.

I actually side with what former Fed Chairman Paul Volcker has been saying: Find a way of breaking up these very large institutions, so that no institution is too big to fail. That's easier said than done, though.

Mr. Takenaka: I believe size and risk are related. The impact of bankruptcy of big institutions is huge. It is important to control the influential financial institutions—if it's banks or security companies or investment banks, etc.—to control these influential institutions as one category.

Question: In both crises, there were signs of a gathering storm. Was the problem that regulators didn't have the right tools to address the problem, or was the problem more that the regulators did not have the incentive or the will to even recognize the problem?

Professor Ito: In the case of the Japanese crisis, regulators would say that they didn't have the tools. I would say they didn't have the will to act. In 1992 to 1995, the regulators and the regulated were too cozy, and they didn't have the incentive to act. They just made a plan on the assumption that land prices would go back up in five years.

Professor Bolton: Regulators can only do so much, if they don't have the backing of the politicians behind them. That's been a recurrent problem in U.S. financial regulatory history. It's not the first time that we've had regulatory forbearance. We've had it during the savings and loans crisis. The regulators tried to close insolvent savings and loans but were stopped by Congressional committees supervising the regulatory agencies. We do need to pay attention to politics, special interests, and how the conflict among different special interests plays out.

I'm particularly concerned by new attempts in Congress to try and remove authority from the Fed, to try and encroach on its independence, trying to make sure that the new regulatory powers destined for the Fed will not be given to the Fed. It seems the financial lobby would rather have someone else besides the Fed in charge. One of the things that sets the Fed apart is it's more independent than other agencies. It doesn't have to rely on Congress for its funding, unlike other agencies.

Professor Janow: There are lessons from this period on gaps in coverage, in terms of too much segmentation of agencies and what they review. The culture of institutions is also important, as was mentioned. When Mr. Takenaka was saying Japan needs more people who are market-oriented, I think that could be equally said in the United States, when it comes to the SEC. There are too many lawyers in charge of financial oversight who are not close to markets.

I agree the Fed is the most independent agency. If there is to be a systemic regulator, I would want the Fed more in charge than anyone else. It would be the least politicized actor to undertake it.

## 日本の歴史的選挙：その理由と結果

2009 年 9 月 24 日

民主党による新政権誕生からおよそ一週間後の2009年9月24日、バージェス政治学教授であるジェラルド・カーティス氏は、国際関係・公共政策大学院（SIPA）にて会場を埋め尽くした175名の聴衆を前に、「日本の歴史的選挙：その理由と結果」をテーマに講演した。彼は、長期間与党だった自民党に対する民主党の国家的勝利の理由と、日本が民主党の新政権に何を期待できるかについて詳述した。

民主党は、人口減少問題の軽減を目的とした子ども手当と、高速道路無料化という、二つの主要課題を政権公約に掲げて選挙運動を行った。しかしカーティス教授は、民主党を勝利に導いたのはこれらの課題でも民主党自体でも、また鳩山由紀夫氏が首相となる可能性でもないと述べた。むしろそれは有権者の変革を強く望む声であり、また自民党に対する強い不満であった。

一方自民党側は、これまで奏功してきた「集票マシーン」の行き詰まりにより敗北した。自民党は国民、特に地方住民が求める課題に対する期待に沿うことができなかった。それは道路、橋、ダムを増やすことではなく、地方から都市部への流出を防ぐために医療・介護や職業訓練を増やすことであった。

この国民による改革の要望に伴い、新政権は、政府、与党、官僚制度が150年間にわたって行ってきたやり方を解体することに取り組んでいる。民主党は、行政における突出した強力な役割を官僚に与える代わりに、首相や選挙で選ばれた役人に権力を取り戻しつつある。

新政権はまた、子ども手当や高速道路料金の段階的無料化などの、選挙中に公約した7兆円規模の政策を立法化しようとしている。今のところ、この包括的経済政策は前政権のものとはかなり異なっており、経済再生を促すための消費刺激を目的に、国民の財布により多くのお金を直接行き渡らせるというものである。

外交政策においては、新政権は、日本同様比較的まだ新しい米国政権とともに協力することになるであろう。両国の指導者は、軍事以外のいくつかの分野において共通点を持っており、そのことが、厄介な軍事問題を含めた全般的連携の実現を促進するはずであると、カーティス教授は述べた。

鳩山首相がいかに成功するかは、氏がどれだけ不屈の姿勢で臨むか、どれだけ効果的に合意形成ができるか、またいずれ直面することは必至であり、そしてすでに直面しつつある、変革に反対する既得権益からの強力な圧力に、どれだけ抵抗できるかにかかっている。

翻訳：谷合満穂（コロンビア大学ビジネス・スクール2006年卒）
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