

# Summary of the Inaugural Symposium on “How Quickly Can We Recover from the Global Financial Crisis?”

By US-Japan Research Institute

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The US-Japan Research Institute (“USJI”) is a joint establishment by five leading Japanese universities with focus on matters of urgent and emerging concern to the United States and Japan.

The inaugural symposium, entitled “How Quickly can we Recover from the Global Financial Crisis?”, was held on Tuesday, September 22, 2009

Professor Takatoshi Ito of the University of Tokyo and Dr. Edwin Truman of the Peterson Institute for International Economics delivered keynote speeches, followed by panel discussion with experts from both countries, and took questions from the audience.

Professor Ito started his speech with a review of current global financial crisis of 2008-09. He pointed out that the heart of the crisis was US securitized subprime mortgage bubble and burst.

Then he analyzed the mechanism of institutional failures that led to the bubble and burst, including the moral hazard among originators (mortgage banks), investment banks using wrong assumptions and models in creating Collateralized Debt Obligations, CDOs (re-securitized “senior” “mezzanine” “equity”) from a large quantity of subprime mortgages; and CDO squared; credit rating agencies having conflict of interest in rating CDOs; opaque accounting of Special Investment Vehicles, SIVs, that is not consolidated with parent bank balance sheet: Liquidity support for SIVs made investment bank insolvent; retail investors (US, European smaller banks, hedge funds, pension funds, and other institutions) lost heavily, withdrew money quickly – causing a fund run.

He also explained the mechanism of the problem of concentration of Credit Default Swap (CDS) that made it necessary to nationalize AIG.

Professor Ito summed up regulatory failure, as SEC could not detect any vulnerabilities of investment banks. . After Lehman’s failure, risk premium heightened everywhere, and the financial markets globally became close to a melt down.

He shared his views on the US housing bubble in comparison to Japanese experience. The Japanese banking crisis of 1997-98/2002-03 was caused by non-performing loans

problem due to housing bubble burst, complicated by “evergreening” and opaque accounting (hiding losses). It all started from smaller institutions (housing loan institutions) to the very largest: in the end, too-big-to-fail perception had to be broken to prevent further moral hazard. He gave praises to then Minister of Financial Services Takenaka for the policy switch. He also talked about the regulatory failure, saying the government did not decisively deal with it while the problem was small.

Professor Ito said, the current crisis started with the failure of US investment banks. The crisis spread to Fannie Mae and Freddie Mac, MMF, insurance company (AIG), big 3 auto companies, (and perhaps more).

Professor Ito concluded that similarities in both financial meltdowns are housing Bubble and burst.

Professor Ito later compared the crisis management in both countries. Both denied emerging problems in the beginning before foreclosure happened. Both countries acted too little and too late. But US government took much quicker and stronger actions in dealing with the crisis in relatively shorter period of time than Japan.

The professor from the University of Tokyo worried about the US housing prices, as they may fall further despite slight rise since April 2009.

The Japanese financial institutions did not suffer from the global crisis as much as US and European counterparts, as direct losses were very small (if any), but valuation losses from equity holding was substantial.

The Japanese economy suffered a major blow in terms of falling exports, with heavy dependence on exports for economic growth. Another impact is on stock price declines that had profound negative effects on consumption and banking sector.

However, people are beginning to talk about recovery, with positive growth rates in 2009 Q2, partly benefited from the stimulus packages (green subsidies)

There are other signs of bottoming out: FRB, BoJ, ECB are cautiously optimistic in sending the message that the worst is over; IMF, which has been behind the curve, may stop downward revision soon.

But, recovery may be slow because there is no apparent engine of growth; government support may run out of steam; unorthodox monetary policy may be withdrawn soon; fiscal stimulus package may not last long due to deficits concern; both monetary and fiscal authorities may rush to “exit”; international coordination will be difficult.

Professor Ito warned audience of the risk ahead. US Housing prices may not stabilize soon, commercial mortgage may deteriorate, and high unemployment may persist, causing consumption to be subdued for long, and credit card loans default may rise.

What’s more, bank capital shortage may continue, because TARP/PPIP may not work after all; oil and commodity prices may rise prematurely.

Then, the well-known professor worried about a double-dip recession in the US. As for Japan, the economy may not bounce back, for large corporations are cautious in investment; long-term problem of declining population may deter investment; Japanese companies are fine due to globalization, but the Japanese economy is not.

Professor Ito pointed out that there is one bright spot in emerging market economies: China, India, and resource based economies will perhaps perform better.

Following Professor Takatoshi Ito is Dr. Edwin Truman, senior fellow from the Peterson Institute for International Economics.

Dr. Truman gave a simple answer to the symposium title: the economy would recover more quickly from the global financial crisis than anyone would have thought possible a year ago or six months ago. Actions taken have stopped the free fall of the global economy and financial system. He said “we are in the recovery phase from the financial crisis.” He did question the nature of the recovery, and its subsequent expansion.

Dr. Truman looked back at the crisis from the angle of sound macroeconomic policymaking and analysis. There is no shared diagnosis of the origins of this crisis. But he shared his own perspectives on the origins of the crisis.

In his view, macroeconomic policies in the United States and the rest of the fully developed world were jointly responsible for the crisis along with regulatory and supervisory policies. In the US, fiscal policy contributed to a decline in saving rate, and monetary policy was too easy for too long. In Japan, the mix of monetary and fiscal policies distorted the global economy and financial system; monetary policy was too easy for too long. Many other countries also had very easy monetary policies in recent years, including Asian countries, energy and commodity exporters, a number of Euro area countries, as well as UK and Switzerland.

The credit boom did not just fuel a housing boom in the United States, but also housing booms in many other countries. In addition, credit boom fueled increases in the prices of equities and many other manifestations of financial excess.

Dr Truman then analyzed the lack of financial-sector supervision and regulation that also played a role in causing the crisis. Benign conditions led to lax lending and credit standards. In principle, financial-sector supervision could have helped to curb the excess, but it did not do so in the US or in many other countries around the world.

The rise of what is now known as the shadow financial system had been going on for decades in many countries: money market mutual funds, special purpose investment vehicles, hedge funds, private equity firms, etc. In many cases, these entities were highly leveraged and/or used short-term funding to finance longer-term investments. The global financial system became overleveraged, particularly but not exclusively the US financial system. When confidence finally and fully drained from the system a year ago, funding dried up, and structures collapsed.

The senior fellow at the Peterson Institute for International Economics said that new forms of financial engineering were part of the story, but innovations have been a

feature of domestic and international finance for decades. Financial engineering helped to distort incentives facing financial institutions and contributed to the market dynamics once the crisis got underway, but it was not “the cause” of the crisis.

In the end, Dr. Truman said that the lack of comprehensive supervision of about 50 large private financial institutions with operations around the world contributed to the crisis, and the failures of these institutions.

He emphasized two major causes of the global financial crisis of 2007-09 were failures in macroeconomic policies and in financial supervision and regulation.

Dr Truman distinguished current crisis from the previous ones by three features.

First, the proximate origins of the crisis were in the United States to a greater degree than with most other crises of the postwar period. The US macroeconomic policies and financial regulatory policies are to blame for the crisis. The actions of US financial institutions were central to the unwinding of financial positions that began in the summer of 2007. Activity in the US economy peaked in the fourth quarter of 2007. For the rest of the world, all this meant that the US economic and financial engine eventually went into reverse.

Second, globalization has linked all financial systems and economies, but the extent of that linkage was poorly understood prior to the crisis. As a result, comprehensive global solutions were slow to emerge.

Third, it is not unusual for a crisis to begin in the financial sector, spread to the real economy, cycle back to further weaken the financial sector, and thereby further weaken the real economy. If the proximate cause of the financial crisis was the US housing boom, housing is a feature of the real economy and also a non-traded activity or service though not in its financing. Subprime mortgage were a manifestation of financial excess or worse, but they were not the principle cause of the housing boom, which was easy credit and low interest rate.

Diagnosis of the economic and financial situation was even more complicated in the rest of the world. During much of 2008, economic growth appeared to be holding up in general, and inflation, particularly in commodity prices, was still rising.

What is rare is a significant economic downturn without a severe financial crisis that affects a broad set of asset prices, credit markets, and financial institutions. Policymakers were slow to learn that they were dealing with dual severe crises on a global scale.

Dr Truman then reminded audience of the Japanese financial crisis in the 1990s, and compared of the global recession and financial crisis of the early 1980s crisis and current one.

In the second part of his speech, Dr. Truman talked about the exit strategies and the global expansion.

He pointed out that the discussion of exit strategies should cover three broad categories of government policies: monetary policies (conventional and unconventional), fiscal policies (automatic stabilizers and discretionary), and structural policies mostly applied to the financial system and its institutions but also involving non-financial institutions such as major manufacturing firms.

The discussion of exit strategies tends to conflate three issues: timing, amount and scope. Beyond the question of whether talking about exit strategies is really about whether more stimulus should be applied is the question of what we mean by exit or reducing stimulus and support.

With respect to structural policies, the overriding question for many countries will be the extent to which government maintain their increased involvement in the financial system and other aspects of the economy. On this question, the circumstances of countries will differ in their ex ante, as well as ex post, philosophies about direct government involvement in the economy.

Fiscal policy is more complicated. One reason is that fiscal policy responses to the crisis were differentiated across countries based upon institutional differences and policy preferences.

With the prospects for global recovery improved, these differences in the size, timing, and composition of fiscal policies may not matter much in the aggregate, but there are cross-border spillovers. The most important spillovers involve not so much the nature of the recovery, but the nature of the expansion.

Monetary policy is similarly complex. Dr. Truman worries about the timing of central bank actions with respect to conventional monetary policy, in other words raising nominal interest rates.

Few countries face the threat of inflation. However, the larger concerns are two. First, the anti-inflation incentive not to adopt a policy of competitive non-appreciation has been weakened. Second, the lesson he drew from the crisis is that monetary policies around the world were too easy for too long earlier this decade, feeding the global credit boom and promoting lax lending and credit standards. In the context of the coordination of monetary and fiscal policies within countries and across countries, the larger concern is that the political authorities who are also the fiscal authorities will pressure central banks to be too easy for too long in the name of sustaining the recovery and holding down the interest costs of government debt. This was his interpretation of what happened in Japan earlier this decade.

The US economy and the Japanese economy are the two largest national economies. The consequences of policy mistakes are commensurately large not only for their own economies but for the global economy.

After the keynote speeches, panel discussion was held. Experts from both countries commented on the financial crisis and shared their views with the audience, and answered questions from the participants.