Masaaki Shirakawa: Way out of economic and financial crisis – lessons and policy actions

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at Japan Society, New York, 23 April 2009.

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Introduction

Good afternoon, ladies and gentlemen. First of all, I would like to thank both Japan Society and the Institute of International Bankers for giving me the opportunity to appear before such distinguished guests. I also appreciate the warm introduction by Mr. Rhodes.

The global economy is suffering through the crisis of an exceptional scale. Many countries are struggling with the consequences of the global credit excess accumulated in the period of what we used to call "Great Moderation". How to extricate our economies out of this plight is a top priority for governments and central banks all over the world.

In these unusual circumstances, Japan's crisis episode almost a decade ago is drawing renewed attention. Japan went through a boom-and-bust cycle from the late 1980s to the beginning of this century. Throughout the 1990s, Japan's economy was caught in a prolonged stagnation. Japan also experienced a systemic financial crisis. Because of these, Japan's 1990s is often referred to as the "lost decade".

A "lost decade" is a memorable and captivating phrase, although not to my liking for the reasons I will discuss later. In fact, the background of Japan's economic slump during the 1990s was intensely debated in and outside Japan. In those discussions, Japan's "lost decade" was often considered as uniquely Japanese. But when it comes to falling economic activity and a weakening financial system, there are amazing similarities between Japan's experience in the 1990s and what the US has been through since the summer of 2007. And this leads some to argue that the US might be entering its own version of the "lost…not necessarily decade but something else".

With these in mind, I would like to structure my discussion into three parts. In the first part, I will talk about the similarities between Japan's previous crisis and the present US difficulties. However, it is not my intention to lecture you on what the US should do at this juncture. This is because no two crises are identical and because Japan itself is also mired in a severe economic downturn now. In the second part, I would like to revisit Japan's crisis experience from a broader perspective so that we can draw lessons in a multi-dimensional manner. In the final part, I will focus on the actions policymakers need to take in order to resolve the current crisis. To the extent relevant, I will touch on some aspects of crisis prevention as well.

Learning the past crisis lessons

To begin with, allow me to strike a personal note for a second. Back in May of 1990, the Bank of Japan created a new department responsible for financial stability and I was chosen as a division chief. Then Governor Mieno gave my boss and myself a mandate to spell out policy prescriptions so that the Bank of Japan can prepare itself for possible failures of financial institutions. At that time, Japan's economy was still in the booming mood. Although the stock market had peaked out already, property valuations still continued to rise. Looking back, I cannot help but think that the Governor was very prescient because it was a few years later that the initial signs of financial instability came to the surface.

To fulfill the fresh mandate given by the Governor, my boss and I went on a two-week tour to the US and Europe to learn how foreign central banks and supervisory authorities handled the past financial crises in their jurisdictions. Here in the US, we met a lot of experts at the

Federal Reserve Board, Federal Reserve Bank of New York, Federal Deposit Insurance Corporation (FDIC) and Resolution Trust Corporation (RTC), all of whom were generous enough to share their experiences and insights with us. We discussed the failure of Continental Illinois National Bank, the savings and loan crisis, and the demise of Drexel Burnham Lambert among others. On that basis, the Bank of Japan was able to develop in the early 1990s its own policy framework for possible financial contingencies in Japan. This framework evolved gradually to contain four pillars by the mid-1990s.

First, when banks are found to be capital-deficient, the authorities should encourage them to carry out restructuring and raise additional capital from private investors.

Second, when dealing with an insolvent bank, the authorities should explore a full range of measures, including assumptions by a stronger bank with financial assistance through the deposit insurance scheme, establishment of an asset management company to separate bad assets, and creation of a bridge institution to preserve the function of the failed bank.

Third, a central bank should act as a lender of last resort when banks are facing liquidity pressures with systemic implications.

Fourth, when banks find it difficult to raise capital in the market, the authorities should consider the possibility of injecting public funds. Such recapitalization with the state budget should come with a commitment by the management of the recipient bank to take due responsibilities and its existing shareholders to incur possible losses.

I believe these generic principles still hold true in today's environment. But in hindsight, I have to admit that they are only part of more comprehensive strategies for dealing with a full-blown financial crisis like the one we are witnessing. We need to ask ourselves why such comprehensive policies were not implemented in a timely manner.

Financial crises: similarities between Japan and the US

With these things in mind, I would next like to point out remarkable similarities between Japan's crisis experience from the 1990s to early this century and what the US has undergone in the past several years. These commonalities fall into five categories.

First, financial crises in both countries were preceded by high economic growth and low inflation for an extended period of time. Japan's economic ascent in the 1980s looked unstoppable. The continued strength in the US economy in the last decade was emblematic of the so-called Great Moderation.

In Japan's case, people strengthened confidence in the late 1980s after riding out the Oil Crises. Japan became the world largest creditor country by then with an increasing presence in the global economy. A sharp and sustained rise in land prices in those days was seen as a vindication of Japan's stronger economic fundamentals. At the end of 1989, Japan's stock market capitalization accounted for nearly half the world's total and the land values of the Tokyo metropolitan area alone were said to equal those of the entire US. What an irrational frenzy it was.

Second, both Japan and the US took time to recognize the collapse of the economic bubbles and to appreciate its substantive implications for the broader economy. In fact, Japan's equity prices peaked at the end of 1989 and the nation-wide land price index in September 1991. It was in July 1991 that the Bank of Japan started the easing cycle in its interest rate policy. Even at that time, though, many people cautioned that lower interest rates could lead to a resurgence of asset bubbles. In the US, residential investment growth turned negative in the first quarter of 2006 and the house prices peaked in May 2006. But it was in September 2007 that the Federal Reserve began to slash policy rates. Some attributed the irrational rise in international commodity prices then to the rate cuts by the Federal Reserve.

In the early stage of the bubble bursting, it took us quite a while to understand how serious its negative impact on the economy would be. We optimistically thought Japan's economy would pick up once cyclical corrections in business investment had run their course. This initial optimism was proved wrong by the subsequent deterioration in the downward spiral between the financial system and the real economy. The US is no exception in this regard. Policymakers often say "bubbles cannot be detected until they burst". But more accurately, we should say "bubbles cannot be readily identified even after they burst". The difficulty of identifying economic bubbles, both ex ante and ex post, has important implications for monetary policy. So I will come back to this topic later.

Third, liquidity strains have been a prime catalyst for many of the past financial crises. In Japan's case, the failure of a mid-sized securities house to honor its inter-bank obligations triggered severe dislocations in the money market, which spread instantaneously to the wider segment of Japan's financial markets. Similarly, the collapse of Lehman Brothers in September 2008 caused acute liquidity seizure, thereby shattering the confidence chain in the global financial markets and clogging credit flows between lenders and borrowers.

Fourth, even when financial stability was in jeopardy, decisive measures such as public capital injections did not come until the market disruptions reached a critical point in our two countries. Several reasons explain this. Even in countries like Japan where banks' executive compensations are relatively modest, financial institutions are not necessarily popular. Moreover, ordinary citizens do not appreciate the importance of credit intermediation until they lose it. For these reasons, we tend to be slow in taking decisive steps. Even if we agree on the need to use taxpayers' money to stabilize the financial system, policy actions tend to be piecemeal in the face of public outrage over the mismanaged financial firms.

In Japan's case, the authorities decided in the mid-1990s to provide a financial support to small credit cooperatives and specialized mortgage lenders. But the reckless lending by some of these entities sparked public anger and the financial support with taxpayers' money was hotly contested in the Diet. This is part of the reason why recapitalization of systemically important banks was delayed to the late 1990s in Japan. Such policy procrastination continued in spite of the voluntary curbs on banks' executive pay and therefore worsened the spiral between the economic contraction and the banking sector problems, making the disposals of bad assets even more difficult. As late as in 1999, the Japanese government finally infused sizable amount of capital into major banks. But even this turned out to be insufficient to revitalize Japan's banking industry.

Fifth, there are similarities on monetary policy front. During the crisis, the Bank of Japan provided ample liquidity and brought the policy rate down to zero. In so doing, the Bank of Japan extended the maturities of liquidity-providing operations while expanding the range of acceptable collateral and counterparties. We also introduced a special lending facility to ease funding stress in the markets. Furthermore, we purchased private-label securities such as asset-backed commercial paper (ABCP) and asset-backed securities (ABS). In this crisis, the US authorities have implemented a variety of measures similar to those innovative steps the Bank of Japan took in the past. I will take up this point later.

What was Japan's "lost decade"?

As I mentioned at the outset, Japan's 1990s is described as a "lost decade". This catchy phrase has a straightforward implication that Japan's economy was plagued by a long stagnation. But I do not like this characterization because it is too simplistic, misguiding us in terms of the way we address the problems and thereby formulate appropriate policy responses. So I would like to do some reality check again for a more balanced assessment of Japan's experience in the 1990s.

First, it is true that Japan's economy was lackluster throughout the 1990s. In that period, Japan's average yearly growth rate was only 1.3% in real terms, much less than the preceding decade’s average of 4.0%. However, even in 1998, the worst year in the post-bubble period, Japan’s growth rate was minus 1.5%, apparently less dismal than the sharp slowdown we are facing now. Also, even during the financial crisis, Japan’s real GDP did not fall below the level registered at the peak of the bubble days (1989). I think this owed much to the authorities’ efforts to avert financial meltdown by using all means available, including the extension of blanket guarantees for all forms of bank liabilities.

Second, even in the low-growth 1990s, there were some tentative recoveries in Japan’s economy, which led people to hastily believe that the economy has finally regained traction. They turned out to be false dawns, but it is human nature to become optimistic when things improve a little.

Third, Japan’s crisis episode tends to be discussed in the context of deflation. To be more precise, however, what worried us most in those days was asset deflation, rather than price deflation as we usually presume by the terminology “deflation”. In fact, the peak-to-bottom declines in real estate valuations of large cities in Japan were in the order of minus 70-80%, while the cumulative fall in CPI between 1997 and 2004 was minus 3%. The real difficulties Japan confronted were the dangerous interactions between asset deflation and the banking sector fragility.

Fourth, we should also note that, following the crash of the bubbles, Japan’s trend growth stagnated for a sustained period of time and there are structural dimensions to that. From the late 1980s through 1990s, Japan did not adapt successfully to the profound changes in the global economy; namely, a wave of deregulation, globalization and revolution of information and communication technology. These tidal waves prompted a deeper integration of global markets, supported by the division of production processes on a global scale. In this new landscape, foreign companies optimally deployed their production sites and distribution channels to create value added, making greater use of outsourcing for cost efficiency.

But this posed a challenge to Japanese firms whose comparative advantage was in a centrally-controlled and team-oriented production chain. This Japanese industrial model was supported by high-skilled domestic workers who were under the umbrella of life-time employment. Preoccupied with the past success of their business models, however, Japanese companies were slow in responding to the changing realities in the global economy. Japan’s economic bubbles added to the sense of complacency, too.

Coupled with the weakening credit intermediation owing to the non-performing asset problem, such inability to change undermined an efficient allocation of resources and reduced Japan’s growth potential. Lower trend growth, in turn, protracted Japan’s economic ailment after the bubbles burst. Together with the excesses left by the bubbles which I will explain later, this is one of the fundamental reasons why Japan’s economy remained sluggish in the 1990s.

Lessons from Japan’s “lost decade”

Next, let me talk about what kind of lessons we should take from Japan’s so-called lost decade.

The term “lost decade” has a connotation that rapid and bold actions by the authorities could have resolved the crisis much sooner. I do not deny the importance of aggressive policy responses in exigent circumstances. However, as a central banker who muddled through the tough times following the asset bubble crash, I suspect the simplification of this sort fails to capture the totality and subtlety of the problems Japan encountered in the 1990s, or for that matter, any economic crises of a comparable magnitude. In order to understand why Japan took a decade to put the economy back on a sustainable growth trajectory, we need to review Japan’s experience from a broader policy perspective. I would like to emphasize three points in particular.

First, it is not always the case that “bold actions” are judged to be bold afterwards. As I said, the Japanese government embarked on large capital injections in 1999 but this was not enough to limit the vicious spiral between the economic deterioration and the financial crisis. After all, this is what the adverse feedback loop is all about.

Second, as I already mentioned in regard to the banking crisis in Japan, bold and rapid policy actions for securing financial stability tend to be politically unpopular. Therefore, policymakers should convince the public that crisis management operations by governments and central banks are not intended to rescue the failing banks but to save the entire financial system.

Third, macroeconomic policies are no panacea although they play a key role in combating a sharp slowdown in the economy. We cannot regain strong economic growth unless we clean up the excesses created in the bubble period. Likewise, macroeconomic policies cannot deal with the productivity losses arising from the inability of companies to adjust their business models. As these points are essential, allow me to spend a few more words.

Japan’s economic imbalances accumulated in the exuberant times were enormous. In the booming 1980s, Japanese businesses increased borrowings substantially and their investment surged at a double-digit pace in the three years to 1990. Once the bubble began to collapse in the early 1990s, resource utilization declined sharply and non-performing assets started to rise. In short, Japan piled up excesses in debt, capacity and labor. As you can see, imbalances of this size take a long time to unwind.

Japan’s economy recovered on the back of the stabilization of the financial system. But equally crucial for Japan’s economic revival was the elimination of those excesses. After shedding excesses, Japanese companies began to integrate themselves into the global value chain. This transformation was particularly visible for manufacturing industries such as electronics, automobiles and general machineries. In other words, following the structural shake-out in the late 1990s, Japanese companies re-invented themselves to be able to reap the benefits of global economic dynamism that involved both advanced and emerging economies.

Policy actions for crisis resolution

So far I was speaking in a past tense, talking mainly about Japan’s crisis experience in the 1990s and early this century. In the remaining time, I would like to discuss policy actions needed in the current environment.

I already mentioned the striking similarities between Japan’s economic difficulties in the 1990s and the current US economic crisis. But we should not forget about the differences, either. For example, unlike Japan where banks play a larger role in credit allocation, the US relies more heavily on capital markets for financial intermediation. In addition, while Japan’s non-performing assets were mostly concentrated in commercial real estate loans, the US problem originated in the securitization market. In theory, losses on securitized assets are easier to crystallize than those on commercial real estate loans because securitized assets are constantly re-priced in the market. However, fair values of securitized assets become much harder to determine when their market liquidity is impaired. Dispersion of securitized assets throughout the investor universe creates additional complexity, too.

Since the onset of the current crisis, policymakers around the world have been treading very carefully between the two requirements: facilitating financial de-leveraging on the one hand, while preventing a sharp contraction in economic activity on the other. This is a fine balancing act because de-leveraging and economic downturns can be trapped in an adverse feedback loop. Policies I would suggest to combat the crisis of this sort are based on four pillars. They have already been adopted in our two countries, but let me repeat them.

First, we need to make sure that the liquidity needs in financial markets are smoothly met. This is indispensable for financial stability. As I said before, most of the past financial crises started from a sharp pullback in funding liquidity. Liquidity concerns are highly contagious and capable of eroding the foundations on which our financial system is built. In the present crisis, therefore, a number of central banks have substantially expanded their liquidity operations in domestic currencies. To alleviate dollar funding pressures, major central banks have also activated temporary swap lines with the US Federal Reserve to provide dollars to financial institutions in their national markets.

Second, when credit markets are under severe stress, a central bank is sometimes expected to step in to support market functioning. The modality for central bank intervention differs across individual circumstances. For instance, the Federal Reserve has pursued credit easing policy to unfreeze the US financial market by purchasing plain as well as asset-backed commercial paper, agency-related securities and so forth. In spite of its bank-centered system, Japan has also been affected by the turmoil in global capital markets. In fact, Japan's commercial paper and corporate bond markets tightened sharply in the last several months, which caused an acute squeeze in Japan's corporate finance. To counter this, the Bank of Japan has started buying commercial paper and shorter-term corporate bonds, assuming credit risk of private sector debtors.

Overall, Japanese banks are in stable conditions and we do not see a systemic problem in them. However, Japanese banks have sizable holdings of corporate shares and part of the unrealized gains on those share-holdings constitutes banks' Tier II capital. Therefore, falling equity prices reduce their capital buffers and constrain the financial intermediation process. To alleviate this, the Bank of Japan has restarted the purchase of bank-held corporate shares. In a similar vein, the Bank of Japan has also announced a plan to supply subordinated loans to the Japanese banks subject to international capital standards. This is aimed at bolstering their Tier II capital. I would like to emphasize that these measures are quite exceptional by central banks' standards.

In a nutshell, the US and Japan are working in their own ways to relieve the tensions in the credit markets.

Third, when the vicious circle between the economic downturn and financial instability is in motion, macroeconomic policies should play an active part in boosting aggregate demand. Interest rate reductions are most traditional in the policy tool-kit and both the Federal Reserve and the Bank of Japan have cut their policy rates to effectively zero. Fiscal stimulus should be considered as well, without putting the long-term fiscal discipline at risk. As highlighted in the recent G20 summit communiqué, major countries are already undertaking a fiscal expansion that will amount to $5 trillion by the end of next year.

Fourth, a holistic approach is needed to restore financial stability. By "holistic", I mean implementing a range of policy measures in tandem, including capital augmentation for banks and the removal of problem assets from their balance sheets. Financial system is built on the trust between lenders and borrowers. Once this foundation is shaken, it takes time to resume a normal functioning of the financial system. Currently, the global financial system is still afflicted by a loss of confidence. In order to allay widespread fears over financial instability, the authorities around the world have taken numerous steps such as capital injections, public guarantees for banks' debts, separation of toxic exposures and the like.

Separating impaired assets from banks while reinforcing their capital bases is a critical but the most difficult part of the financial rehabilitation strategy. In the first place, it is far from easy to grasp the extent of banks' capital shortfalls. Securitized assets have a complex risk profile due to their multi-tranche structure. Worse still, market liquidity for these complex assets has evaporated for the past year or so, further complicating their fair value measurement. The negative interactions between the economic downturn and financial instability are generating fresh losses, thereby aggravating concerns over banks' capital shortages. Any attempt at breaking into this sinister feedback loop is as tricky as chasing after a moving target. On top of that, it is politically hard to reach a consensus on the sufficiency of government capital infusions.

This is why public capital injections tend to be insufficient and behind the curve. But there is no quick fix. While making the best efforts to capture the extent of banks' asset degradation, policymakers should communicate the importance of financial stability to taxpayers so that they become more receptive to the needed policy steps, however unpopular they might be.

To sum up, I spoke about four key elements of financial crisis management: 1) ample liquidity provisions, 2) support for credit market functioning, 3) macroeconomic stimulus, and 4) injections of public capital and elimination of balance sheet uncertainties. Without effective policy measures on these fronts, the economy will deteriorate much faster and deeper.

But we need to be aware that policymakers are not omnipotent. The policy actions we have taken in the past twenty months are no substitute for the necessary unwinding of economic imbalances accumulated in the preceding booms. As I mentioned earlier, Japan's economy did not resume sustainable recovery until it eliminated excess debt, excess capacity and excess labor. The same goes for the current crisis. I think the US economy needs to work out excesses, which include unsustainable financial leverage, household over-indebtedness, and perhaps the over-extension of the financial industry. This will be painful but inescapable. In view of Japan's decade-long experience, there are no palatable alternatives.

One more note of caution. Because of the pain associated with the unwinding of excesses, we might be leaning toward protectionist measures in trade and finance. But we must resist a descent into protectionism by any means. Like protectionism, regulatory overreaction will also undermine the economic efficiency, thereby putting downward pressure on productivity growth. Without question, this is the last thing we intend to achieve.

Challenges ahead: crisis prevention

What I have so far said concerns crisis resolution. But crisis prevention is equally important from the longer-term viewpoint. Let me sketch this out.

First of all, the current crisis presents a challenge for the conduct of monetary policy. It requires a change not only in policymakers' way of thinking but also in the theoretical underpinnings on which actual policies have been formulated. In the last two decades, macroeconomics as a professional discipline has evolved with impressive sophistication. If I may put it simply, its implications for policy practitioners might be condensed into three points. First, economic growth potential is maximized under the sustained stability in prices. Second, central banks' monetary policy should be aimed primarily at achieving price stability. Third, as a corollary of the first and the second, the onus for macroeconomic stabilization should be mainly on monetary policy. Of course, there is nothing wrong with each of these propositions. But over time, they seem to have created a sense of complacency among us with regard to the potency of monetary policy.

For instance, some macroeconomic theorists have claimed that a depression is no longer a real concern. However, the current crisis, including its run-up, demonstrates that a macroeconomic theory does not take proper account of the dynamics in financial systems and the irrational behavior of human being such as herding and indulgence in excessive optimism. Therefore, from a preventive vantage point, we need to develop a broader approach.

Under benign economic conditions, imbalances could accumulate through a number of channels. As we saw in Japan in the 1980s and in the US in the early 2000s, expectations of sustained low interest rates often contribute to the build-up of economic excesses through higher leverage. In good times, financial institutions also tend to extrapolate low historical volatilities into their measurement of potential risk exposures. Intense competition puts additional pressure on those institutions to take on risks beyond their capacity. Such strong inclinations for risk-taking at the level of individual financial institutions can lead to excessive risk-taking at the aggregate level, thereby sustaining asset price hikes and making the entire financial system more vulnerable to sharp reversals of risk positions and the resulting squeeze in market liquidity.

Given these all, I think it is becoming increasingly important for policymakers to sharpen macro-prudential perspectives, by which I mean two things in particular. One is to keep monitoring risk distributions throughout the whole financial system. The other is to analyze how the financial system evolves within itself as well as through the complex interaction with the real economy. These perspectives are vital not only for regulatory and supervisory purposes alone but also for the conduct of monetary policy. In fact, there are a number of specific issues we need to examine in a macro-prudential framework. Because of the time constraints, however, I will just touch upon the most important aspect for central bankers. Namely, how macro-prudential perspectives relate to monetary policy.

How to deal with economic bubbles has been a controversial topic. One school of thought has argued that a central bank should pursue aggressive monetary easing after the bubble bursts. This line of thinking is based on a belief that bubbles are difficult to spot beforehand and central banks can merely mop up the debris of the collapsed bubbles. But I beg to differ. Quite often, bubbles are too elusive to identify even when they are crashing. On top of that, when accumulated excesses are being unwound in the aftermath of the bubble bursting, the efficacy of central bank's easing policy is materially reduced as we are witnessing now.

So what should we do?

First and foremost, central banks should be attentive to both the prevention of bubbles and the mitigation of their consequences. I believe this symmetrical approach is important. Central banks should remain vigilant as to whether excesses are lurking in the economy. As economic imbalances pile up insidiously, a narrow focus on price stability makes it more likely for policymakers to overlook dangerous signs emerging in the wider economy. This is exactly where macro-prudential perspectives come in. Financial imbalances typically manifest themselves in sharp credit expansion, outsized leverage, soaring asset prices, or combination of those. These are the parameters central banks should watch carefully.

But excesses can appear in other forms, too. The challenge for central banks is that economic imbalances have a long "formative period" so to speak, spanning much longer than the normal time horizon of monetary policy implementation. Therefore, if we focus narrowly on short-term movements in consumer price inflation, this could have an unintended consequence of fostering the creation of bubbles. In response to the bursting of the information technology bubble early this century and the deflation scare associated with that, monetary policy was eased on a global scale and for an extended period of time. Unfortunately this has proved to be one of the contributing factors to the global credit bubbles and the resulting mess in the global financial system.

Central banks should not be hesitant in pursuing aggressive monetary easing when economic conditions warrant. In a severe economic crisis, policymakers have to be careful not to mistake a temporary rebound in the economy, or a false dawn I would say, for a genuine recovery. But there is no economic crisis that never ends. So central banks should also be mindful of a timely exit from those aggressive easing measures. A late exit can be an entry into something worse.

Finally, let me add that monetary policy alone cannot prevent the recurrence of boom-and-bust oscillations. For example, a host of issues remain to be addressed in the regulatory and supervisory arena as well.

Closing remark

Since I am almost 40 minutes into my speech, I would like to finish with a final message. What we are confronting is not a garden-variety recession. This is the crisis of a truly global nature. In the early 2000s, Japan was able to benefit from the recovery in the global economy. This time, we cannot count on others in getting out of the woods. But over the past year or so, we have together achieved a lot in our fight against the crisis. In that spirit, we will continue to work out both individual and shared solutions. Let us move ahead together to rebuild sustainable and efficient financial systems for us and for our future generations.

Thank you very much for your listening.