Masaaki Shirakawa: Coping with financial crisis – Japan's experiences and current global financial crisis

Address by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at the Fourth Deposit Insurance Corporation of Japan Round Table, Tokyo, 25 February 2009.

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Introduction

I am much honored to be invited to address the 4th Deposit Insurance Corporation of Japan Round Table in Tokyo.

As you are well aware, the global financial system is unstable due to the burst of the global credit bubble. In particular, global financial markets have been under severe strain since the collapse of Lehman Brothers last autumn. Both the central bank and the deposit insurance corporation do not draw much attention under normal circumstances, and their presence stands out only when depositors and financial market participants do not have full confidence in the soundness of financial institutions and financial system stability. Today, the activities of the deposit insurance corporation and the central bank draw much attention from the public, and that is a testament that we are facing difficult challenges.

From a longer-term perspective, it was in the early 1990s when the activities of the Deposit Insurance Corporation of Japan, hereafter DICJ, started to draw attention from the public and the media, and the financial assistance by the DICJ was carried out in 1991 for the first time in its history. At the time, the Deputy Governor of the Bank of Japan was an ex-officio Governor of the DICJ, and I, as a staffer at the Financial System Department of the Bank of Japan, had an opportunity to be deeply involved in the process in which the financial assistance was actually utilized. As events unfolded, Japan had to handle more severe financial crisis since the latter half of the 1990s. Through those experiences, it was shown how critical various functions of the deposit insurance system were in achieving financial system stability. In my address today, I will express my views on how to cope with a financial crisis by comparing Japan's experience and the current global financial crisis.

1. Financial crisis in Japan after the burst of the bubble

During Japan's financial crisis, while real estate prices varied according to the region and the usage, the representative index plunged to almost a quarter of its peak. Banks played a predominant role in financial intermediation, and Japanese banks incurred cumulative losses of some 110 trillion yen, equivalent to 20 percent of Japan's GDP. It was after 2003 that Japanese banks' capital strength and profitability bottomed out and the stability and functioning of the financial system started to improve, when Japan's economy returned to a full-fledged recovery path supported by the global economic growth. In the meantime, the average growth of Japan's economy had been stagnant, compared with the previous decades. While the economy of this period is often called as "Japan's lost decade", in my view, such a categorization might not be perfectly capturing the nature of the problem and challenges of policy measures taken to cope with a financial crisis. I will touch on this issue later, but it is true that it took a prolonged period of time for Japan to return to a full-fledged recovery path after the burst of the bubble. Today, I will emphasize three points focusing on policy responses on the financial system front, although we also have to examine the macroeconomic policy responses in order to make a comprehensive analysis of how to cope with a financial crisis.

First, there was a delay in recognizing the severity of the impact of massive nonperforming assets on the economy. It was a few years after the burst of the bubble when we recognized how seriously the decline in real estate prices affected financial institutions. However, we lagged behind in recognizing how powerful the macroeconomic significance of the impact – or to borrow the recently much talked-about expression, “an adverse feedback loop between the financial system and the real economy” – could be.

Second, there were imperfections in accounting and disclosure standards. At present, vigorous discussions are going on about how to cover the expected losses over the credit cycle in terms of accounting. At the time, there was a lag in showing the incurred losses of financial institutions on the accounting and disclosure front. Partly because of that, there was only an insufficient incentive mechanism at play to urge banks to promptly address the nonperforming asset problem.

Third, partly as a result of the aforementioned two points, the authorities could not resolve troubled financial institutions in a timely manner, because of the delayed progress in establishing a framework of resolution to cope with troubled and failed large financial institutions. Arguably, the legal framework of resolution, operational procedure, and, above all, public funds to cover a capital shortage are vital in ensuring the smooth resolution of troubled and failed financial institutions. And it was in early 1998 after we experienced a series of failures of large financial institutions that the full-fledged safety net framework was put in place. It is clear in my memory that, the DICJ in the meantime had been tackling the resolution of failed financial institutions by making full use of what it had in its arsenal. Until the safety net framework was established, there were some cases that the Bank of Japan also played an unconventional role as a central bank in dealing with failed financial institutions by injecting its money as capital.

2. Current global financial crisis

In light of our experiences during the financial crisis in Japan, the development of the current global financial crisis gives me a surprising sense of *déjà vu*. Until recently, Japan’s financial crisis has been considered as an isolated event unique to Japan. It appears that people around the globe are gradually coming to understand the implications of the massive credit bubble and its burst through the bitter experience during the current crisis.

First, in terms of “the recognition of the problem”, for example, the estimate by the IMF on the total losses on U.S. credit-related debts has been increasing as time went. That typically suggests that the impact of an adverse feedback loop between the financial system and the real economy has also been underestimated in the current crisis.

Second, there have been the issues related to accounting and disclosure standards. While the standards have improved compared with those of Japan in the 1990s, there are some new issues. Those include how to evaluate complicated structured products whose market liquidity is extremely low, and how to incorporate off-balance sheet vehicles. In addition, the traditional issues also persist. The nonperforming asset problem of U.S. and European financial institutions appears to have been gradually shifting to a traditional problem of loans on the banking book. The difficulty of evaluating the loan asset value, when the adverse feedback loop between the financial system and the real economy is at play, seems to be an unflagging issue at any time.

Third, the framework to deal with troubled financial institutions was not well-equipped. It can hardly be said that the process of the disposal of the Northern Rock and Lehman Brothers was carried out within the sufficiently robust institutional framework. Even if such framework was in place, public capital injection into financial institutions is unpopular among the public in any country. In addition, there is a stigma on the part of financial institution to apply for injection of public capital. Furthermore, it is also a daunting task to identify the amount of losses incurred by financial institutions, which is the precondition for public capital injection. Those were all the difficulties that Japan actually confronted.

3. Measures addressing the liquidity problem

I will now turn to the policy responses when a financial crisis takes place. As I have just mentioned, there are many similarities between Japan's financial crisis and the current global financial crisis. Nevertheless, we are not likely to find a "one-size-fits-all" solution. Therefore, let me point out that what I describe from now will be an attempt to present a conceptual underpinning.

Both in the cases of Japan after the burst of the bubble and the current global financial crisis, the crisis always surfaced in the form of liquidity shortage. In Japan, the default of a mid-sized securities firm in the interbank money market, despite the small amount of default, triggered a steep liquidity contraction in the money market and led to turmoil in Japan's financial system as a whole. In the current financial crisis, after the severity of the credit-related debt problem surfaced in August 2007, U.S. and European financial institutions faced a liquidity shortage, and the collapse of Lehman Brothers further exacerbated the conditions in the funding markets.

As such, while a lack of liquidity was the starting point of the problem, the root cause of the problem was an issue of the solvency of financial institutions.

In the early phase of a crisis, it is difficult to recognize how serious the liquidity problem is and how serious the solvency problem is. In case it is purely a liquidity problem, which is a relatively idyllic case, the central bank plays a role as "the lender of last resort" based on classical Bagehot's principle. If it is likely that the problem is not a pure liquidity problem but a solvency problem from a system-wide perspective, there would be various challenges in carrying out policy responses in a timely manner. In such a case, while the central bank prevents the financial system from further destabilizing through aggressive liquidity provision, the financial institutions should identify their incurred losses and need to cover the capital shortages in the market, and the government ought to carry out public capital injection when the capital raising turns out to be insufficient.

Put that in the context of the current global financial crisis, concern over counterparty risks intensified to an extraordinary level after the collapse of Lehman Brothers. And not only the confidence of depositors declined but also interbank money markets faced malfunctioning, where a high degree of mutual trust between the participants is a prerequisite. Once confidence collapses, the restoration of confidence becomes a top priority. In that regard, several countries expanded the coverage of deposit insurance and provided a government guarantee for financial institutions' funding in the markets. Those measures were indeed effective. The deposit insurance system is intended to ensure bank depositors' confidence through protecting deposits up to a predetermined amount. In the current crisis, the expansion of the coverage of deposit insurance indeed had effects of stabilizing depositors' behaviors to some extent. Moreover, central banks have been trying to stabilize global financial markets by making extraordinary arrangements to provide liquidity to the markets in the U.S. dollar together with their own currencies.

Through those measures, the funding conditions of U.S. and European financial institutions have been eased to some extent, compared with the situation immediately after the collapse of Lehman Brothers. However, as each government decided to introduce a guarantee scheme and the expansion of deposit insurance coverage, it created some unintended problems. The international flow of funds has changed, and some sound financial institutions that were in no need of receiving government guarantees have faced unfavorable funding conditions. While Japan has not introduced a government guarantee scheme, fund-raising by international financial institutions that received government guarantees, in off-shore markets or in the Samurai bond market in Tokyo, has adversely affected the corporate bond issuance of Japanese firms in the yen-denominated bond markets. In addition, in Japan's interbank money market, it took some time for international financial institutions to raise funds easily, because the coverage and the procedure of a government guarantee were not clearly recognized by market participants. In that regard, during the financial crisis since the late

1990s, Japan adopted a blanket guarantee of all liabilities of financial institutions. While that was an extraordinary measure, it was quite effective in averting the collapse of the financial system.

4. Restoration of solvency

Together with policy measures on the liquidity front, measures to restore solvency are of vital importance in a financial crisis. In the current global financial crisis, several measures have been already taken since last autumn to restore the solvency of financial institutions by using public capital. Those measures have proved to be effective. Nevertheless, there have been some cases in which financial institutions that received public funds continued to face weak stock prices and widening CDS premiums, and thus needed to have the second round of public capital injections.

In those cases, it could be pointed out that pricing of structured products has become difficult, due to the decline in market liquidity, and the quality of loans continues to deteriorate because of the adverse feedback loop between the financial system and the real economy. A "mirage" phenomenon is taking place in that, despite public capital injection, concern over additional losses on the assets mounts over time and such concern in turn will heighten concern for a capital shortage of financial institutions.

Under those circumstances, it is of vital importance to remove uncertainty. There are two options to remove uncertainty stemming from financial institutions' nonperforming assets; the government purchases those assets or provides a loss guarantee to those assets. Nevertheless, even in both cases, uncertainty might not be removed for the assets not covered by the purchases or the guarantees, and investors thus would continue to ask the institutions for high risk premiums. Consequently, the institutions might not be able to fully restore confidence in the market. In addition, there are also other difficulties; how to set the selling price of the nonperforming assets in the case of asset purchase scheme and how to set the fee in the case of guarantee scheme. What Japan faced in the past and what the U.S. is facing now is arguably those difficulties. However, even with such difficulties, it is an indispensable process to promptly identify the amount of losses and to carry out recapitalization to secure financial system stability, if necessary.

It should be noted that new issues have emerged in the global financial system as public capital injection prevails. One of them is a gap between the level of capital recorded on the balance sheet and market participants' perception of franchise value of financial institutions. The level of capital presumably should reflect market expectations about earning growth potential of a firm. On one hand, recapitalization by the government serves as a buffer for future losses, in the same way with privately raised capital. On the other hand, it comes from different incentives from private capital, in which investors shoulder the risk with an expectation to recoup their investments by the future growth of the firm.

In addition, if people increasingly tend to judge the soundness of a financial institution simply by looking at the level of capital on the balance sheet – in other words, looking at the capacity to absorb future losses rather than the earning growth potential –, a financial institution could face a paradoxical situation. A financial institution which does not accept public capital because of its financial soundness might suffer a competitive disadvantage against another institution which accepts public capital, because the sound institution has a lower capital adequacy ratio as a result. Furthermore, if many financial institutions intend to raise regulatory capital adequacy ratios at this juncture in order to avoid such disadvantage, the real economy will be adversely affected. When reviewing financial regulation and supervision in the future, the role of capital regulation will definitely be an important issue on the agenda. Aside from such a general point, it is also necessary to take into account that, during a financial crisis, the regulatory framework of capital adequacy ratio should not amplify pro-cyclicality.

Closing remarks

I have so far expressed my views on the steps to cope with a financial crisis. In closing, I will offer two thoughts with respect to financial crisis responses.

First, it is necessary to make an objective assessment of what can be solved and what cannot be solved by policy responses to a financial crisis. Both in terms of macroeconomic policy and financial system measures, to take prompt and bold measures to address a financial crisis is not easy for any country, but is quite important. Without those measures, the economies will be forced to experience heavy adjustments and might end up in a perfect storm. At the same time, however, crisis responses do not eliminate the excesses accumulated in the periods preceding the crisis. When those excesses are really massive, it will take long for the economy to return to a sustainable growth path. Japan's "lost decade" was partly attributable to such an element. If protectionism spreads triggered by intensified frustrations under such dire economic conditions, the economy's potential growth rate itself might decline. In that regard, we also need to make a realistic assessment of the nature of the current crisis and limits of the crisis responses.

Second, in a financial crisis, it is critical to ensure cooperation between the authorities – the deposit insurance corporation, the central bank, and financial supervisory authorities – which are responsible for financial system stability. Cooperation between each country's authorities has also become increasingly important, reflecting the globalization of financial markets and hence the globalization of a financial crisis. Cooperative ties in terms of the nuts and bolts seem to have been furthered during the current crisis. At present, the cooperative relationship between jurisdictions appears to be strengthening at various levels. One element of the cooperative relationship is to share each country's experience and lessons. In closing, I sincerely hope that the 4th Deposit Insurance Corporation of Japan Round Table in Tokyo would offer such a valuable opportunity to share each other's recognition and exchange views between participants.

Thank you very much.