

The Financial Crisis and the Ensuing Reform: Neglected Wisdom

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Good afternoon, ladies and gentlemen. It is a great pleasure to speak on this occasion. I have frequently come to Harvard during the past decade and a half. In the late 1990s, when I worked in New York as head of the Bank of Japan's office there, I visited here to collect wisdom with respect to banking reform in Japan. After I returned to Tokyo in 2000, I continued to visit Cambridge and Boston in order to discuss monetary policy with eminent people here as well as to see my daughter, who was studying music at New England Conservatory as long as seven years.

After those frequent visits, however, this is a special occasion for me. It is the greatest honor of mine to be invited to speak as one of the first beneficiaries of Ezra Vogel Distinguished Visitor Program. It is an honor not because I am considered to be a distinguished visitor but because I am associated with a distinguished man of achievements, Professor Ezra Vogel. His achievements cover not only academics but policy making and practice. His contributions span not only the United States but many countries across the Pacific Ocean, including my country Japan. Thank you, Ezra for your invitation!

This afternoon, I would like to discuss the on-going financial crisis and the financial reform under discussion at international as well as national fora. I have experienced several financial crises, fighting – or to be more precise, having been forced to fight – on the front line, sometimes in Tokyo, and other times in New York and Basel, Switzerland. In other words, I am a veteran soldier who spent more time in the field than at the defense headquarters. I am not so sure if this is a very respectable career, but I think I can offer you some pragmatic thinking rather than hypothetical propositions. Because of the nature of my talk, allow me to express a central banker's usual disclaimer although I am now an ex-central banker, i.e., the views I express here are my own and do not represent the Bank of Japan or the Canon Institute for Global Studies.

It was in early August 2007, when a crisis erupted in Europe's interbank market. Triggered by bad news about French hedge funds, liquidity in European markets dried up all of a sudden, putting the financial systems of major economies on

the verge of a meltdown. That morning, I was on holiday and sleeping comfortably in my mountain house. The previous evening, I had set the alarm on my cell phone for 7 a.m. to wake up for a golf game with my neighbors. The cell phone rang and I reached for it to stop the alarm. Unexpectedly, a voice came out of the phone. It was a call at 6 a.m. from New York, telling me that Tim Geithner, the then-president of the New York Fed, wanted to hold a conference call with a few central bank governors that evening. The first thing I had to do after I hung up was of course to call off my golf game. Then, I telephoned my Governor, Mr. Fukui, and a few colleagues to begin preparations for the conference, and went back to Tokyo, terminating prematurely my summer holiday. By the time the conference call began, the list of participants had become a little longer than just a few. This was the beginning of rough three years for me, during which period I had to make more than a few overseas trips every month, and a lot of telephone and video conferences in the late evening or early morning.

Even worse at times of crisis like Bear Sterns of March 2008, Lehman Brothers of September 2008, a few European banks of October 2008, and the European sovereign debt crisis of May 2010, my colleagues and I had to stay up all day and night. You know that the Tokyo market opens ahead of European and American markets because Tokyo is located closer to the International Date Line. Therefore, Monday morning becomes particularly sensitive in Tokyo if a Western financial institution is rumored to be in trouble. The Bank of Japan might have to decide whether it provides it with liquidity, when its mother market is closed on Sunday. In the case of Bear Sterns, it was at 7 p.m. Sunday, New York time that the assisted purchase of Bear Sterns by JP Morgan Chase was announced. It was 8 a.m., Monday, Tokyo time. It was of course not a coincidence that the arrangement was completed before Tokyo opened. At the time of Lehman Brothers' collapse six months later, Monday, September 15 was stressful for us again but to a lesser extent this time because that Monday was a national holiday in Japan and the Tokyo market was closed. So was it in Hong Kong and Singapore. The first wave of tsunami hit the European markets, where there was no clear mechanism for an orderly resolution of a large, complicated financial institution. The debacle of Lehman Brothers turned the prevailing unrest in the financial system into a real crisis. Banks became so sensitive about counterparty risks that financial intermediation virtually stopped in the market. Banks became so concerned about capital shortage that banking de-leveraging accelerated despite monetary policy easing. The financial disintermediation quickly invited a deep recession in the world economy.

This episode reminded us of one bitter lesson: the health of the financial system is hard to restore once it has been lost and that this loss of health can cause costly damage to the economy. This is by no means a new lesson. The Japanese had bitter memories of the decade-long banking crisis before the present episode began in 2007.

So did the Scandinavians about their own banking crisis of the 1990s. For Emerging Market Asians, the boom and the bust of the speculative bubbles a decade ago rankled for a long time in their hearts. In the United States, too, some people remember with bitterness the S&L crisis and the Latin American debt crises of the 1980s, the latter of which had happened at the same time as the East European debt crisis for European banks. What is truly new about the current situation is perhaps the very global nature of the financial crisis, which covers virtually all the financial markets in the world simultaneously.

During the period of financial turmoil, the Bank of Japan, the Federal Reserve, the European Central Bank, the Bank of England, the Swiss National Bank and many other central banks tried to provide the financial market with liquidity. They did so initially by expanding the types of collateral for their lending, and lengthening the duration of the liquidity supply. While short-term target interest rates were lowered closer to zero, some central banks widened the list of counterparties they do business with and also expanded the list of assets they buy in the market beyond what monetary policy had usually been associated with. Quantitative easing (QE) and QE II, whatever termed, monetary policy has gone beyond the conventional sphere. The central banks of major financial markets, as well as some emerging markets, also engaged in supplying their own markets with US dollars, which they acquired through swap arrangements with the New York Fed.

Outside the monetary policy area, too, there have been a number of extraordinary policy measures taken by the governments as well as the central banks. On the financial stability side, many governments guaranteed banking debts and provided capital for systematically important financial institutions. On the fiscal policy side, the governments stepped up budgetary spending in the United States, Japan, China, and many other countries. These extraordinary policies were successful in arresting downward momentum of economic activity and led to a recovery of the world economy in 2009.

As the inventory restocking became complete, however, the recovery lost momentum in 2010. The final demand still remains lackluster in the United States and other industrial countries. For one thing, the household sector of the United States is still over-leveraged after a prolong period of spending spree. That excess leverage was masked at a time when housing prices were expected to rise, but loomed large after prices had turned downwards. As personal consumption weakens, producers of goods and services are facing a secular decline in demand. There are many such producers in many parts of the world. Thus, corporate restructuring is underway on a global scale, cost-minimizing on both investment and employment, which also curbs growth in final demand.

The financial systems of the United States and Europe have also yet to regain full confidence in their resilience, although the public intervention has made the probability of a systemic meltdown remote. A sizable amount of bad assets remain on the balance sheets of financial institutions. Even if bad assets are identified and provisioned properly, the Japanese experience of the banking crisis of the 1990s and early 2000s tells us that until those bad assets are removed from the balance sheet of the financial institutions, there remains a significant degree of uncertainty over cash-flows and profitability of the financial institutions. As a consequence, banks tend to be cautious about credit risks, and bank lending remains weak.

It is therefore a good idea to have banks discharge their non-performing assets from the balance sheets and remove the non-performing businesses from the banks' business lines. This is easy to say but difficult to do in practice. The Japanese and Swedish episodes of the 1990s tell us how painful this process can be. The negative feedback from asset sales to a decline in property prices and to an increase in non-performing assets tends to create a strong downward pressure on economic activity, which the then Federal Reserve Chairman Alan Greenspan referred to as "fifty miles per hour headwind" to the economy at the time of S&L crisis. You may say there is now a hundred miles per hour headwind in light of the magnitude of the problems in US and European financial systems.

In these circumstances I believe that fiscal policy has a role to play to prevent the negative feedback from becoming too strong. However, it would be too optimistic to expect that fiscal policy will engineer a sustainable economic growth. Once again, the Japanese experience of repeated fiscal stimuli in the 1990s shows that the financial stimuli supported economic growth while they were applied to the economy, but the sad reality is that the effect quickly faded when the stimuli were removed. There was virtually no multiplier effect stemming from the fiscal expenditure and tax reduction in these instances. This is not surprising. In general, when the economy has a lot of excesses to work out, fiscal policy will help ease the adjustment process, but is not likely to reverse the course of corporate and/or household restructuring. Particularly when the banking system is de-leveraging in order to discharge its bad assets, banks are quite naturally reluctant to expand their balance sheets, which limits the pump-priming effect of fiscal stimuli.

In short, extraordinary measures deployed by monetary policy, financial stability policy, and fiscal policy have had a positive impact on the economy but only to a limited degree in terms of sustainability of economic growth. At the same time some negative aspects of the extraordinary policies loom large. With respect to monetary policy, the balance sheets of a few major central banks are bloated with riskier assets. Government budgets are deep in the red, and there are mountains of debt in many parts

of the world. A large amount of toxic assets still sit on the balance sheets of financial institutions. Worst of all, people are angry, blaming banks, the government, and the central bank for the loss of jobs, incomes, and property value. They have of course good reasons for their anger and bank regulators are under intense political pressure to penalize banks. All this is liable to create a political momentum to kill the animal spirit, which is in any case in short supply in a depressed economy.

Discussion of financial reform has been going on in this political climate. A number of problems have been pointed out as causes for the credit bubbles in the early and mid-2000s and the subsequent turmoil in the financial system. One obvious cause was poor risk management on the part of individual financial firms. For example, pricing models for structured products proved to be based on too optimistic assumptions. Corporate governance of some large complex banks was poor and the bank management was not as “fit and proper” as was expected by US Banking Act. However, the fact that a large number of banks and other financial institutions went into trouble indicates that there were defects and deficiencies in regulations, guidelines and supervision of the financial industry.

The Financial Stability Board, the Basel Committee on Bank Supervision, and other international standard setting bodies have examined a long list of regulatory issues and have come up with recommendations for reform. To be more specific, lopsided incentive mechanism in financial institutions seem to have fueled risk taking without proper control of risks. Thus, the guidelines of compensation have been published by the FSB, and “skin in the game” will also be introduced in the United States under the Dodd-Frank Act. Weak regulations on bank capital and liquidity have been considered to allow risk taking easily, and thus a higher level and quality of capital will be introduced under so-called Basel III together with a tough liquidity regulation. Large, complex, interconnected financial institutions have been regarded as systemically important financial institutions (SIFIs) and thus too big to fail, which entailed moral hazard on the part of those banks and their counterparties. Against this problem, SIFI surcharge and the so-called Volcker rule have been proposed to check expansion of their business. In order to minimize moral hazard, resolution mechanism has also been examined. Poor infrastructure is responsible for opaqueness of some derivatives transaction and insufficient risk management. Thus, the central counterparty for OTC derivatives has been promoted by the Committee on Payment and Settlement System. During the past decade, financial innovation cum the originate-to-distribute model of banking spawned peripheral financial entities, and as a consequence, a vast structure of shadow banking were built outside the regulated banking system, where risks accumulated undetected. Thus, oversight on non-bank financial firms will be tightened under the Dodd-Frank Act.

Besides these discussions of risk management and prudential regulations, there is an argument that the current crisis occurred because of a lack of a cohesive framework by which to assess systemic risks in finance. It goes on to argue that the risk profile of the financial system as a whole needs evaluating, bearing in mind the interactions between segments of the financial system and real economic activity. This argument called for the establishment of a framework for systemic risk oversight, and in fact the Financial Stability Oversight Council has been decided to be created in the United States and the Systemic Risk Board in Europe.

I took part in the discussion of all this before I stepped down from the Bank of Japan five months ago, and I hope these reforms will help reduce the probability of financial crisis and the cost thereof. I am afraid however they will not prevent the next crisis from breaking out some day. A crisis will happen just like automobile accidents do happen despite tight traffic regulations. Risk taking becomes excessive before it backfires. In my view it is because human nature is pro-cyclical in the sense that people believes “nothing succeeds like success” and get carried away. Building a system of regulations which make financial activity less prone to pro-cyclicality is a good thing but in order to guard against easy risk taking, it takes prudent supervision, which I mean prudent supervision of not only individual financial institutions but the entire financial system.

In this regard there are a few important things which I learned when I was a young economist at the Bank of Japan, e.g., “fit and proper” test for bank management, “constructive ambiguity” on the part of the central bank over the lender of the last resort, and central bank lending being “not a right of borrowers but a privilege.” These were supported by traditional wisdom, whenever they were put into practice. In recent years, however, room for such traditional wisdom to work has become narrower since central bankers and bank regulators are increasingly required to be transparent with respect to their specific actions.

The idea of inflation targeting has, in my view, made the situation worse by confining the role of the central bank in price stability and also requiring the central bank to be transparent about it. Although none of the BOJ, the ECB, or the Fed adopts formal inflation targeting, they have been influenced by the inflation targeting mentality. In fact, the lack of inflation threat was the reason that the Fed raised interest rates in 2004 and 2005 only at a measured pace, and also that the Bank of Japan exited very gradually from its quantitative easing regime in 2005 and 2006. Because central bank actions were so transparent as to be nicely predicted in the market in those years, funding risks were minimized, which fueled speculative trading, including yen carry trade.

The recent episode stimulated discussion over the stability of the financial system. As I mentioned a minute ago, both the US and EU have decided to create a financial stability board or council. The central bank is of course an important member of the board, and therefore responsible, at least in part, for financial stability. How does the central bank reconcile price stability with financial stability when there are conflicting signs? Discussion has just begun. Some suggest a combination of the two objectives, and others argue for lexicographic ordering, i.e. pursue financial stability when price stability is secured.

I am not an academic theorist but a veteran soldier, and my preference is to avoid rules, by which I mean not only inflation targeting or its grafted versions but any rules. The central bank is a guardian of the integrity of money because the central bank is the supplier of money. The integrity of money is maintained not only by price stability but also efficiency of the payment system and the soundness of the financial system. The central bank should choose the best combination of these elements, depending on circumstances.

By saying so, I am sure I will collect criticism from both academic and political circles for being too undemocratic. If the central bank is not allowed to be so independent as to be opaque, then I would like to offer an idea instead: the central bank sells put options of fixed income assets. The central bank changes the amount of option sale, depending on the degree of certainty that it wants to convey to the market. Take a situation similar to the mid-2000s for example! Suppose the Fed wants to raise interest rates because it believes the current level is lower than the long-term equilibrium. The Fed begins to raise the target interest rate but at the same time sells options by a large amount if it doesn't want to see a shocking increase in rates. When the Fed believes the interest rates have come to the equilibrium but the funding conditions are still too easy, then it decreases or even stops selling options in order to decrease the certainty of future interest rates. As a consequence, term rates will begin to fluctuate more widely to depress unfounded optimism about the future funding. Central bank sale of options can thus be an innovation in the toolkit of central banking, which influences not only the mean of expected interest rates but their standard deviation. It will give the central bank an additional weapon of maneuver and yet being transparent enough. This is nothing but an idea of a veteran soldier and it is up to academic profession to consider this and other features of monetary policy framework theoretically.

To conclude my remarks this afternoon, allow me to repeat my preference with respect to central banking in general, that is a framework which enables central bankers use more discretion so as to maintain the integrity of money. They should be

reminded of the wisdom they tended to neglect during the past decade and a half, when inflation targeting was the leading philosophy of monetary policy.

Five months ago I stepped down from the Bank of Japan and I have been extremely happy since I travel only once a month or less frequently these days. Moreover, I am no longer responsible for all the troubles associated with the Bank of Japan or any other central bank. But at the same time I am sorry for my former colleagues who continue to work under stressful circumstances. I hope you give them encouragement to do their best as well as theoretical inputs into deliberation of central banking.

Thank you for your attention!