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The Current Credit Market Crisis: Lessons from the Japanese Banking Crisis?

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People don’t seem to learn much from past crises

- Lessons from the U.S. S&L crisis in the 1980s:
  - Financial innovation and deregulation sometimes lead to lax bank behavior and bad loan problems.
  - Regulatory forbearance raises the ultimate cost of crisis resolution.
- Japan did not learn much from the S&L crisis.
  - Financial innovation and deregulation in the 1970s and 80s, and subsequent surge in real estate loans were a yellow light, which was not ignored but not adequately addressed.
  - Even after the burst of the bubble in the early 1990s, serious attempts to address the bad loan problem did not begin until 1995.
- People cannot escape from the “this time is different syndrome.” (Reinhart & Rogoff (2008).)

This time is not different

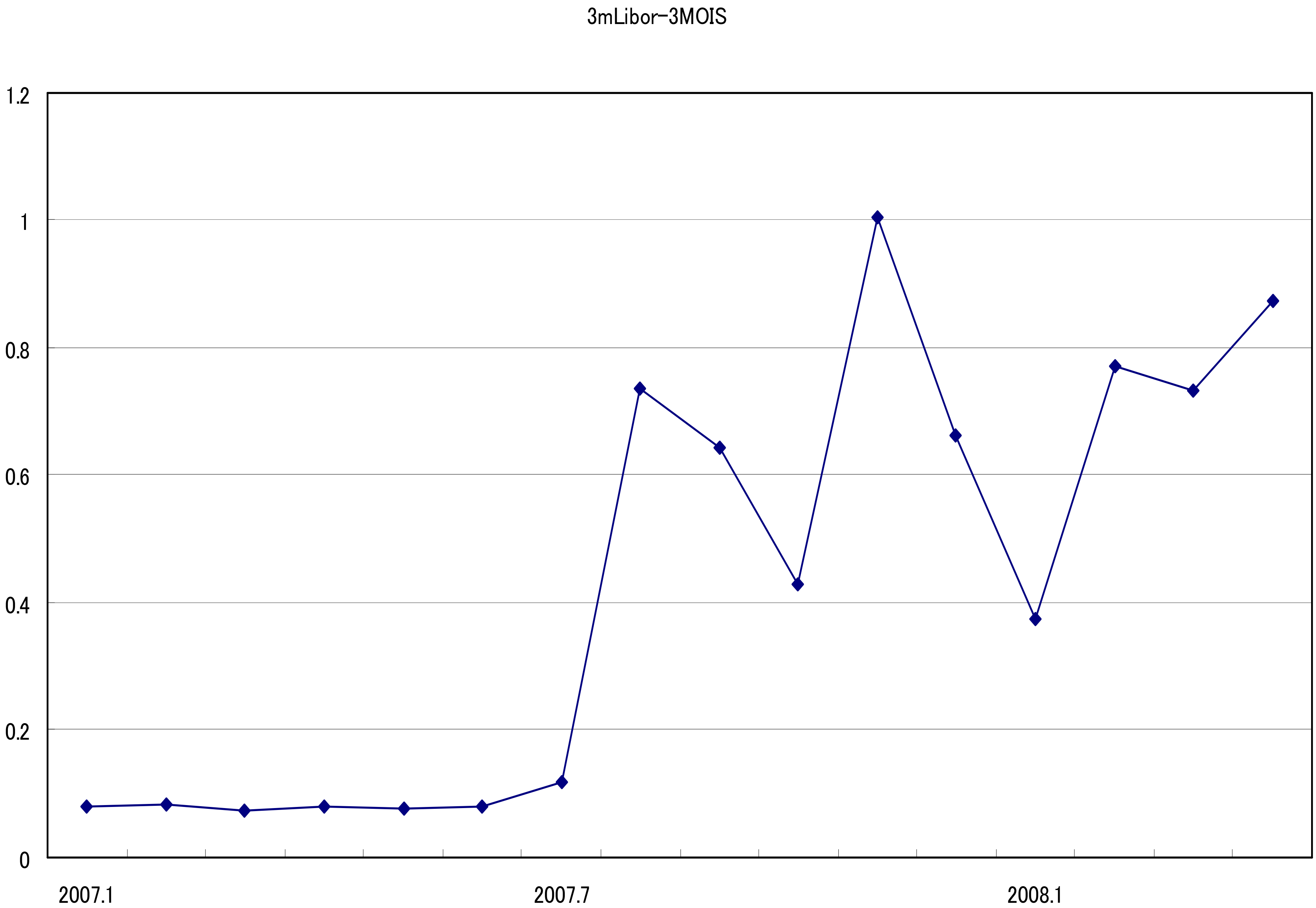
- The BOJ's easy monetary policy in the late 80s.
- Financial innovation & deregulation in the late 70s & 80s.
- The real estate & stock market boom.
  - Business fixed investment was also very strong.
- The Zai-Teku boom.
- Insufficient credit analysis by banks.
- The "cozy" relationship between the financial industry and regulators.
- Regulators did not know much about what Jusen was doing?

- The Fed's easing during 2001-03.
- The emergence of originate & distribute (O&D) model.
- The surge in property prices & housing investment.
- Leveraged investment in risk loans.
- Less incentive by banks to screen and monitor borrowers in the new model.
- Lax monitoring of loan originators.
- Policymakers did not know much about the securitization model.

This time is different

- Cosmo Credit Corp. failed in 1995, but money rates went up sharply only in late1997 after the failure of Sanyo Securities.
- It took almost 10 years for the extent of the bad loan problem to be revealed.
  - The pace of loss recognition was determined by the levels of banks' profits & unrealized capital gains on stocks.
  - It was not until the late 90s that the government decided to use public money on a large scale for resolving the crisis.

- The money market felt the stress immediately.
- Market prices telegraphed the turmoil in real time.
- The B/S of financial institutions have been largely marked to market.
- Banks have swiftly raised capital in the market.


3mLibor-3MOIS
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0.8
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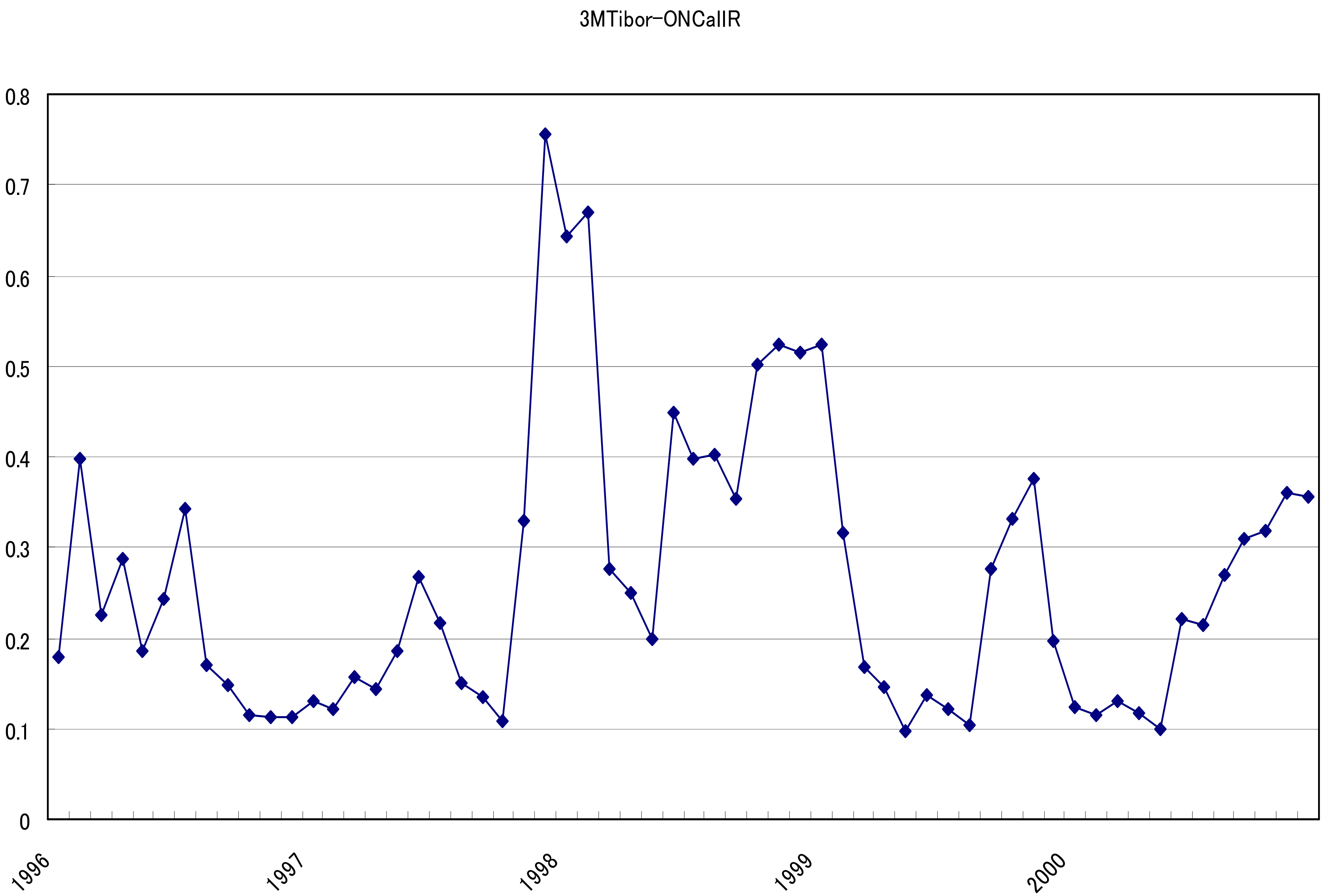


3MTibor-ONCallR
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
1996
1997
1998
1999
2000

The Current Crisis and the “Shadow Banking System”

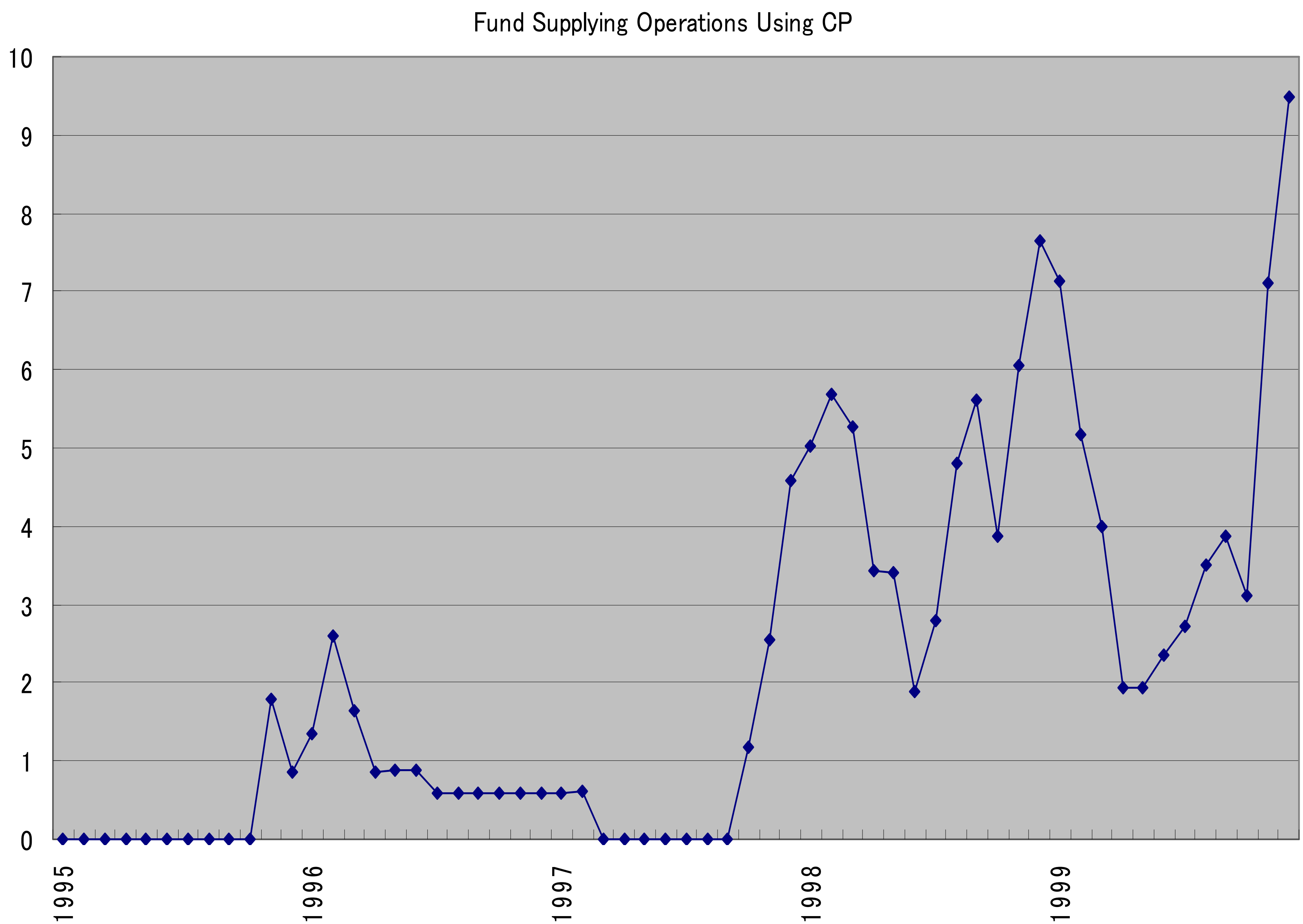
- Financial innovation & bank capital regulations have led to the rapid growth of banks’ off-B/S activities and, along with low interest rates, promoted leveraged play on risky debt.
  - There were attempts to check the excessive growth of the O-D model, but have been resisted by the US.
- The off-B/S vehicles have often been banks’ “subsidiaries”.
- The liquidity of the securitized loan market depended critically on banks’ supply of liquidity in case of emergency.
  - It was fairly low to begin with given the tailor-made nature of the products.
- With the onset of the crisis, the liquidity of the securitized loan markets fell sharply, generating fire sales across capital markets and unusually high correlation of returns.
  - Asset prices fell below fundamentals and these prices have had direct effects on banks’ B/S.
- Banks have had to supply liquidity to the capital market, and at the same time, take on the assets held by the subsidiaries.

The stress remains

- Banks failed to carry out ,in advance, stress tests that encompass such interactions between the banking system and the capital market.
- Now, market participants are losing faith in the new securitization model.
- Those who know the situation most, the banks, are not lending to each other. Thus, money market rates remain high.

Lessons from Japan’s Crisis?

- Financial instability, if left un-addressed for a non-negligible period, generates a vicious cycle between itself & the real economy.
  - Losses banks incurred need to be recognized quickly and new capital has to be injected.
  - Liquidity crunch that accompanies many financial crises needs to be addressed by the central bank as soon as possible.
  - In doing so, the central bank itself has to play the role of an intermediary in the money market, suppressing even some healthy risk premiums.


Fund Supplying Operations Using CP
10
9
8
7
6
5
4
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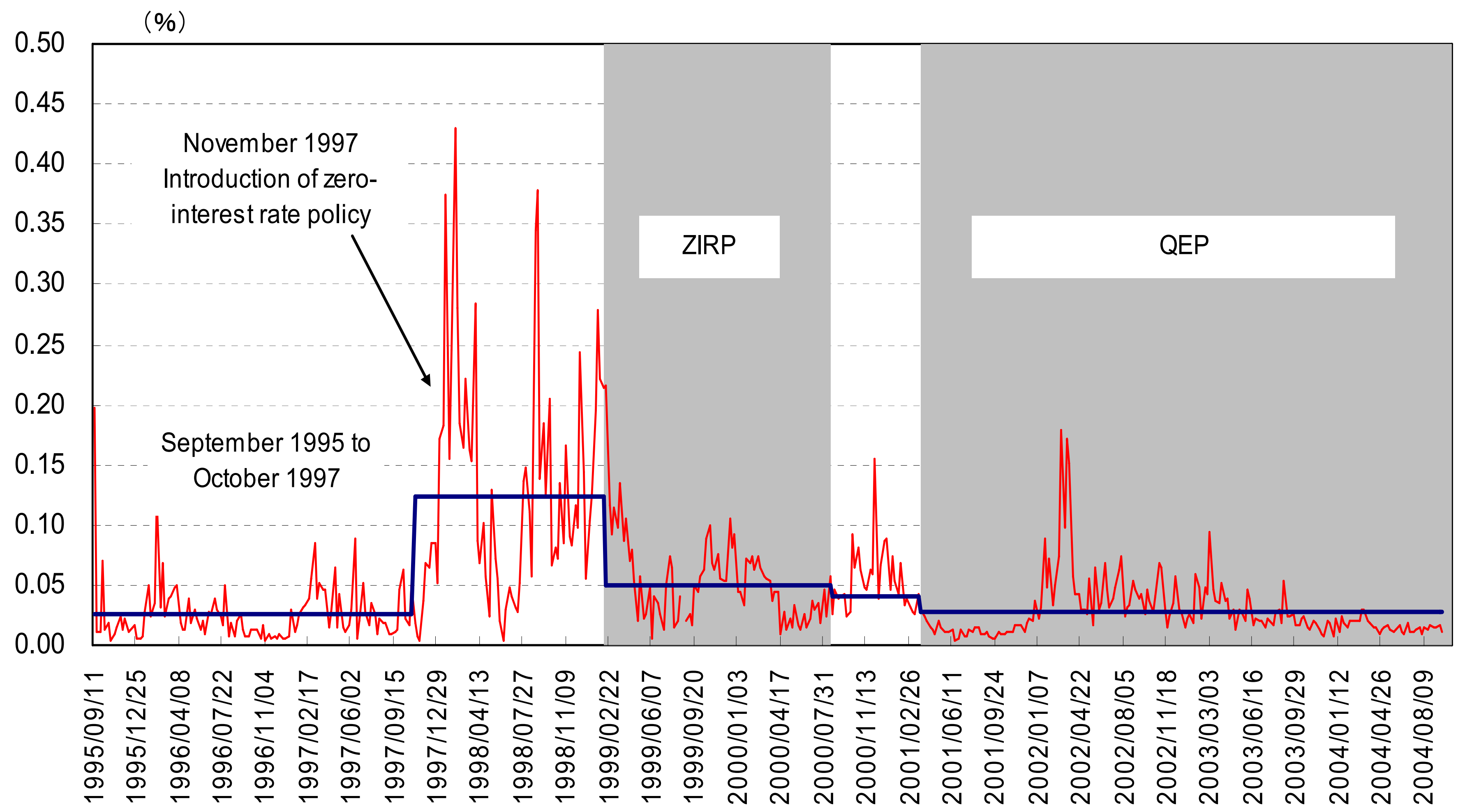
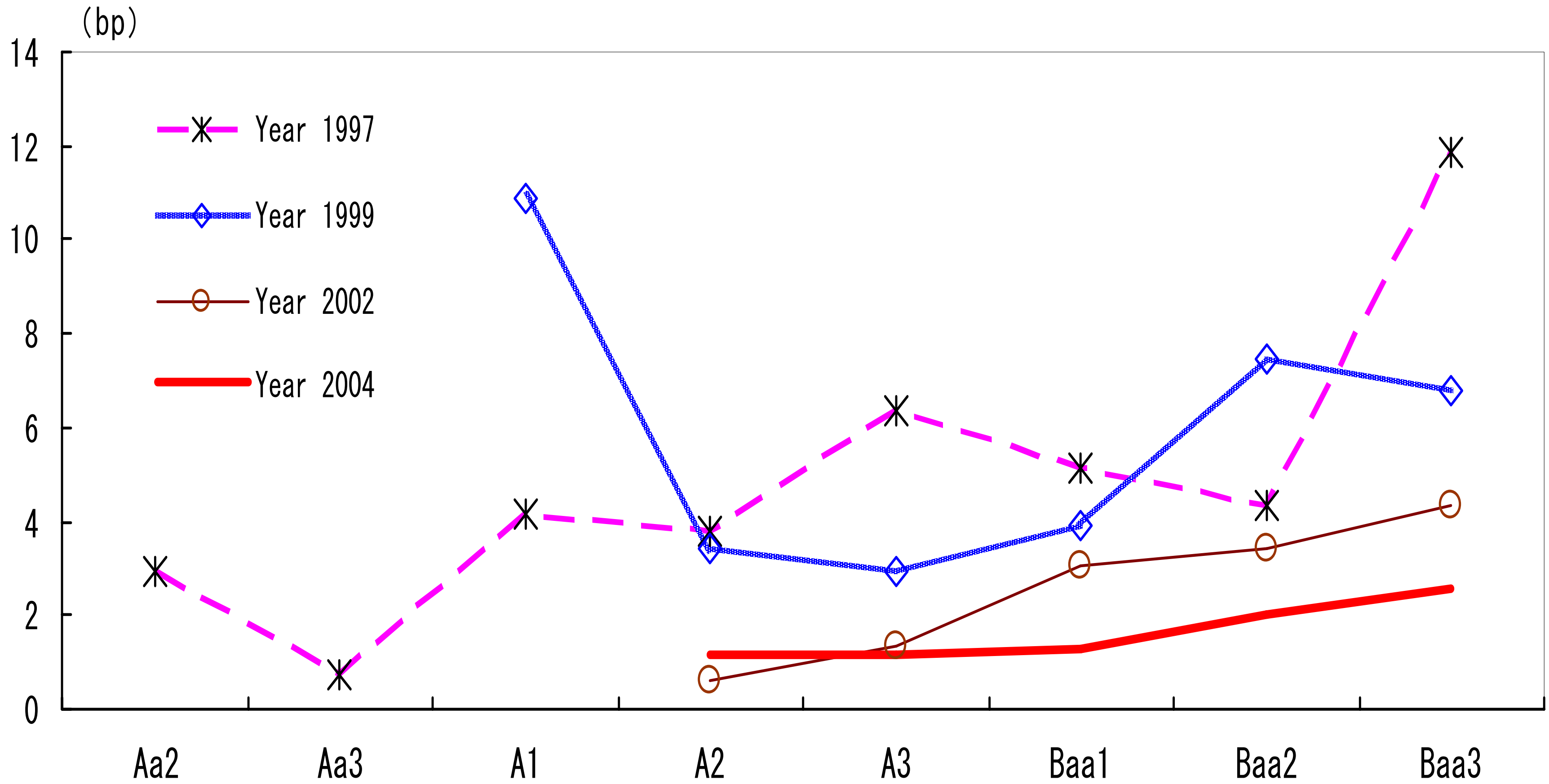
2
1
0
1995
1996
1997
1998
1999

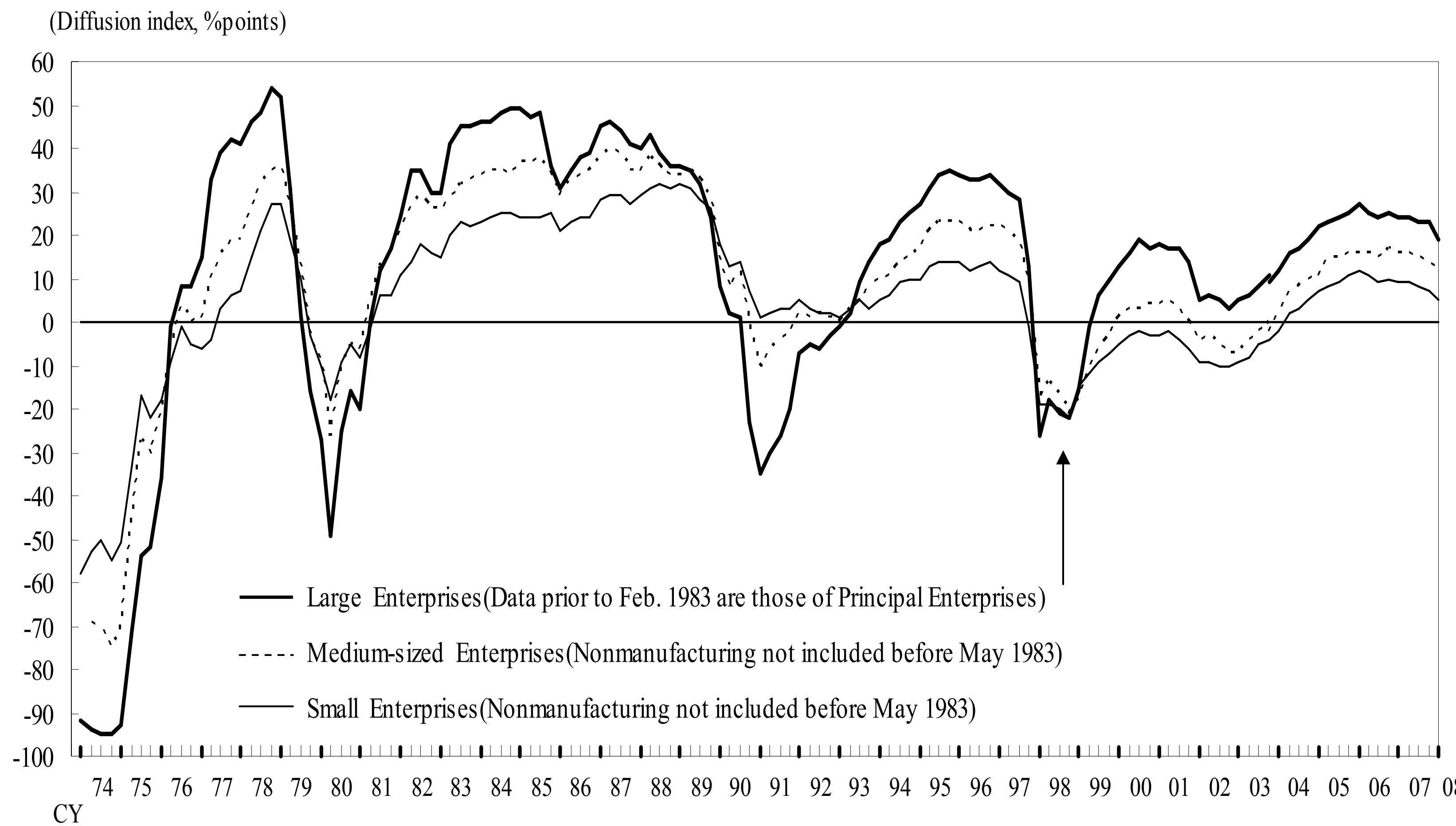
Dispersion of NCD Issuance Rates: 60-90 days



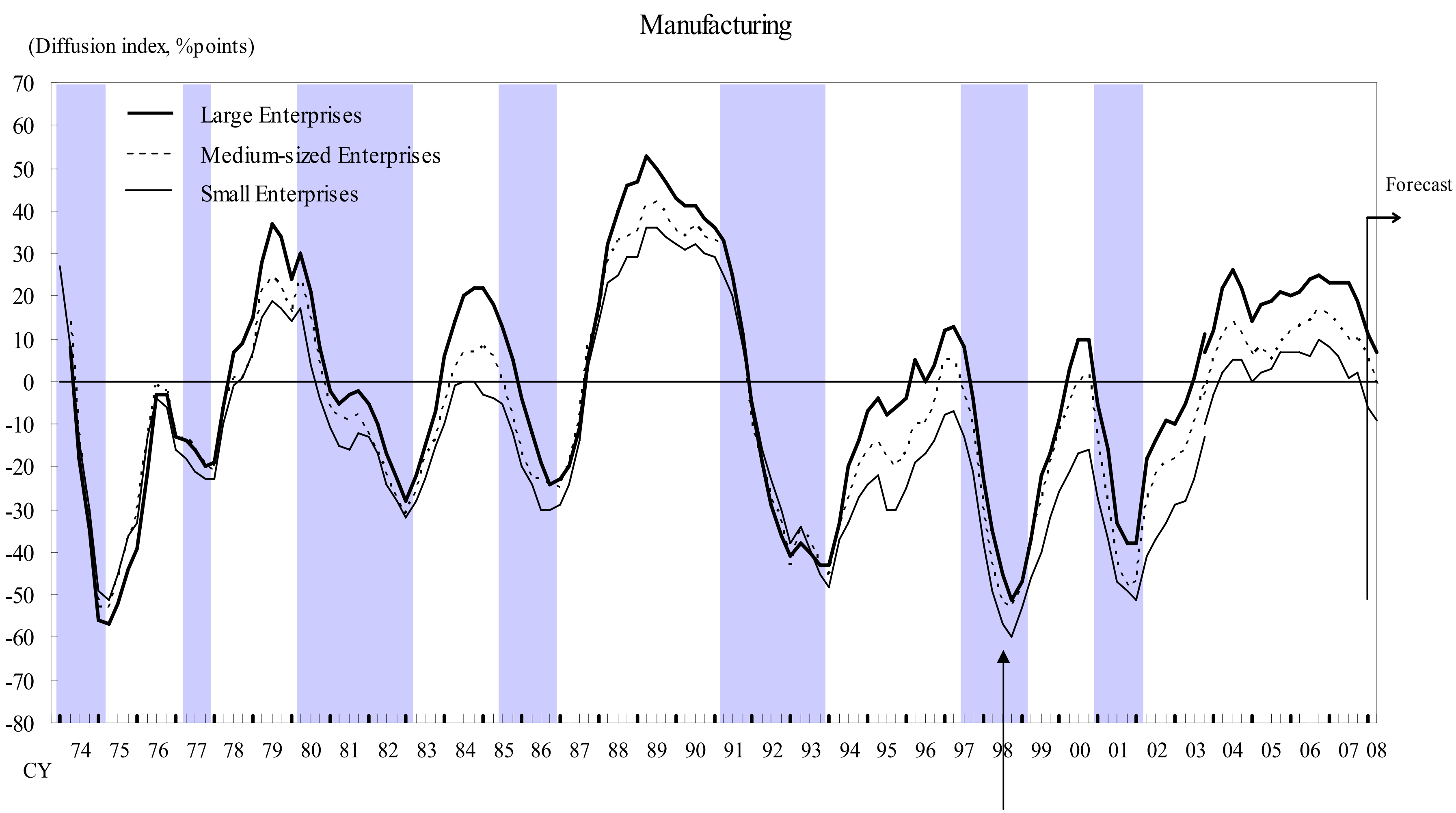
Credit curves of NCD spreads



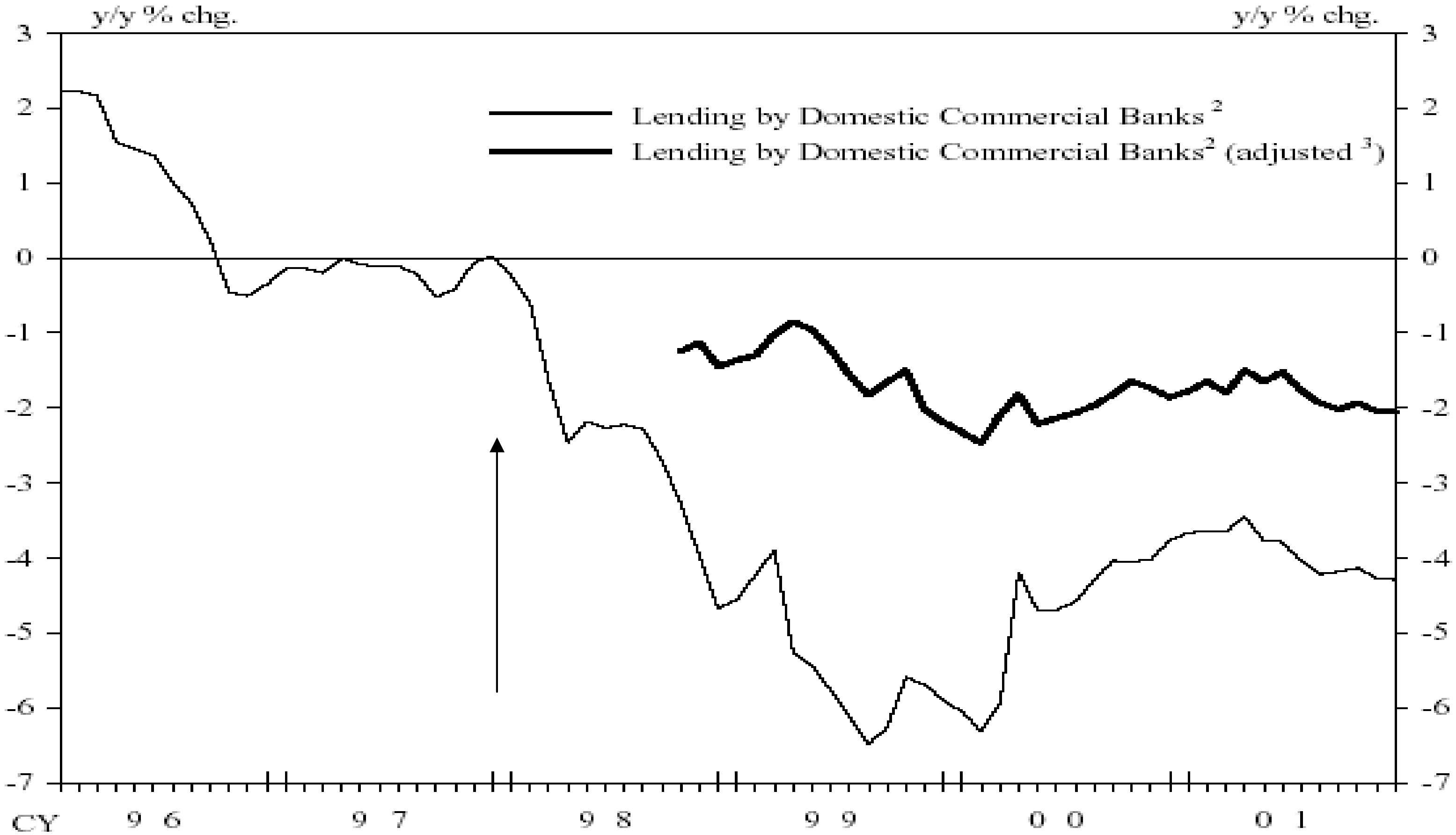
Lending Attitude of Financial Institutions: The BOJ Tankan (accommodative – severe)



Business Conditions DI: The BOJ Tankan

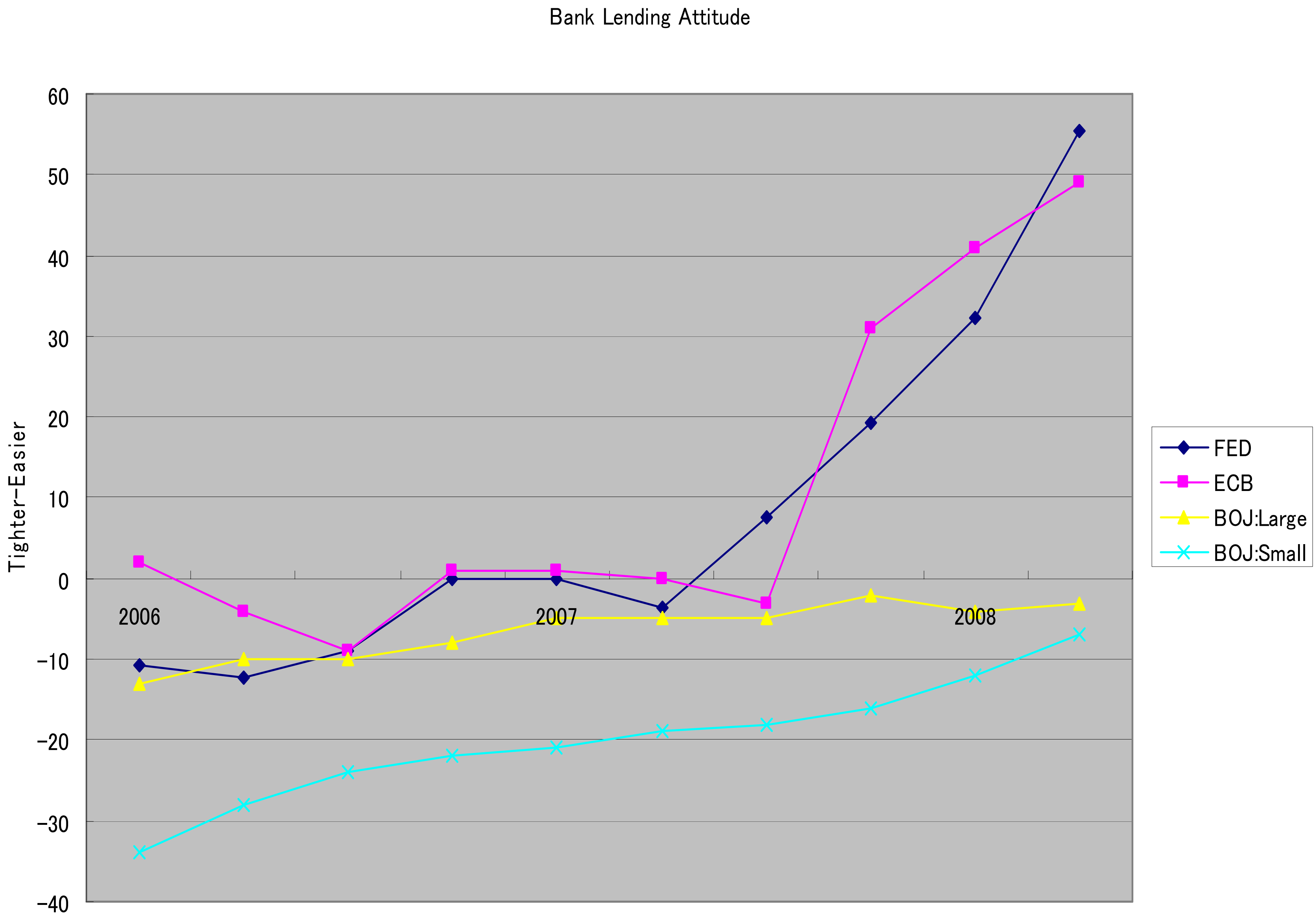


Lending by Japanese Banks:
The BOJ Monthly Report, Jan. 2002



Crisis management this time

- The authorities were slow to recognize the sharp deterioration in credit markets.
- The central bank response during July-November 2007 may not have been optimal.
  - The term fund supplying operations should have come earlier.
- The vicious cycle between the impaired financial system and the real economy may have started already.


Bank Lending Attitude
Tighter-Easier
60
50
40
30
20
10
0
-10
-20
-30
-40
2006
2007
2008
FED
ECB
BOJ:Large
BOJ:Small

Lessons from the current crisis?

- What do we want to do with the O-D model?
  - Would raising more capital and improved risk management be enough?
  - How much regulatory arbitrage should we tolerate?
- The manifestation of systemic risks is taking a new form: illiquidity & depressed price levels spreading across the financial system.
  - What is the appropriate public policy to deal with this?
  - If market prices can deviate from fundamentals for a protracted period, what should we do with accounting, risk management etc. ?