Column

Economics and Economic Policy amid the Global Economic Crisis

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Profile

Dr. Kobayashi joined RIETI as Fellow in 2001 and has served as Senior Fellow since 2007. He has extensive experience in macroeconomics research in areas such as endogenous growth theory, business cycles theory, financial crises, and bad debt problem. He received a Ph.D. in economics in 1998 from the University of Chicago. He was guest editorial writer at the Asahi Shimbun News Paper from 2002 to 2007. He received the Nikkei Economics Book Award (2001) and the Osaragi Jiro Critics Award (2002) both for the publication of *Trap of the Japanese Economy* (co-authored with Sota Kato, published from Nikkei Inc. in 2001, in Japanese).

The current global economic crisis has demonstrated the close relationship between the stability of the financial system and macroeconomic growth and stability.

In order to correctly analyze the crisis and formulate effective policy responses, it is necessary to create a new framework of thought within the field of macroeconomics that can link macroeconomic movements to the stability of the financial system and discuss them in an integrated manner. When thinking in terms of such a framework, global economic recovery policies will consist not only of public expenditure and coordinated monetary easing among affected countries, but also the prompt implementation of policy measures capable of stabilizing the financial system.

The challenge for macroeconomics

In the minds of many economists, the global economic recovery and the stabilization of the financial system are seen as two distinct and separate events. However, treating these two events separately was also a problem in the consciousness of Japanese economists and commentators during the 1990s, and may in fact be considered a significant problem inherent in the framework of modern economics. Currently, the standard view may be described as follows:

"For the economy to recover, the only acceptable policy response is Keynesian policy (fiscal policy and monetary policy). The disposal of non-performing assets and the injection of capital are necessary in order to stabilize the financial system, but this has no direct relationship to the macroeconomic recovery. On the contrary, when economic recovery is realized through fiscal and monetary policy, there will be a decrease in nonperforming assets, thus eliminating the need for policies specifically designed to stabilize the financial system."

The experience of Japan in the 1990s, however, seems to indicate that such expectations are mistaken. Proof may be seen in the case of Sweden, where an asset bubble burst around the same time as in Japan, but in Sweden policymakers designed a fast-track economic recovery through a surgical nationalization of the banks.

Currently, signs of economic recovery are beginning to appear and fears of the crisis overwhelming the world economy are starting to fade, but if the policy responses of U.S. and European governments toward the disposal of nonperforming assets begins to lag behind as a result, the financial systems of Europe and the U.S. will once again be vulnerable to recurring financial crises (something that Japan repeatedly experienced in the 1990s).

There have been people in Japan, the U.S., and Europe who have recognized that resolving the issues affecting the financial system is a necessary precondition of economic recovery, but this recognition has been based purely on empirical principles. The theoretical structure of economics has not been used to address both macroeconomic performance and the stability of the financial system in an integrated manner (perhaps this is why economists are of the opinion that no relationship exists between the economic recovery and the stabilization of banks).

For example, it is well known that the banking sector is not considered to have a central role in economic activity, either in the standard neoclassical economic growth model or in the New Keynesian model. In addition, the issue of non-performing assets is invariably viewed as a microeconomic issue related to the banking industry.

In fact, the crisis we are currently experiencing may call for a change in the theoretical structure of macroeconomics. In order to analyze the current crisis, a macroeconomic approach that encompasses financial intermediaries at the center of its models is necessary. In particular, there is a need to focus attention and research on the conditions that cause payment intermediation in the financial system to malfunction. Perhaps this kind of macro-model can be created through developing the framework of the monetary theory of Ricardo Lagos and Randall Wright. Moreover, this new macroeconomic approach should provide a framework for discussing the cost and effectiveness of three different kinds of policy—fiscal policy, monetary policy and the stabilization of the financial system—in an integrated manner that also considers the relative weights to be given to all three. This is necessary because the fragility of the financial system exerts a major macroeconomic impact on the global economy, as seen below.

The vicious macroeconomic circle produced by nonperforming assets

The fragility of the financial system and the accumulation of large volumes of nonperforming assets have major short- and long-term effects on the macroeconomy.

In the short term, as seen in the months following the Lehman shock, a confidence crisis causes the economy to rapidly deteriorate. Whereas risky assets had previously been traded as a means of payment, the confidence in such assets for settlement purposes is lost once such a crisis occurs, causing a sharp rise in the demand for liquid assets such as bonds and cash/deposits. As a result, the markets are depleted of liquidity and trading is inhibited in real terms, with aggregate demand plunging. Falling aggregate demand pulls down asset prices, which weakens the balance sheets of financial institutions and further exacerbates the confidence crisis.

In the long term, a phenomenon occurs that I have named the balance sheet trap, based on the experience of Japan in the 1990s.[*1] In this phenomenon, as nonperforming assets increase and the soundness of financial institutions' balance sheets decline over the long term, credit transactions stagnate between all kinds of economic entities, suffocating the supply network between companies. Due to the deterioration of the balance sheets of financial institutions, companies increasingly lose trust in each other with regard to the execution of payments, and this inhibits the development of the division of labor between companies. As the development of the division of labor is a major source of productivity growth, the balance sheet trap inhibits the rise in productivity of the entire economy, which causes asset prices to fall further and balance sheets to deteriorate even more.

When the fragility of the financial system has a major negative impact on the performance of the macroeconomy through the confidence crisis and balance sheet trap, macroeconomic policies such as fiscal policy and monetary easing are not capable of bringing about an economic recovery, instead they only buy time and alleviate the pain of the economic downturn. Public expenditure maintains employment temporarily, eases the abruptness of the change and buys time, but it will unlikely be the solution to the fundamental problem. Monetary easing policies may make up for the lack of liquidity and soften the economic downturn, but they will not eliminate the nonperforming assets and capital deficits that are plaguing banks, and thus will not dispel the sense of insecurity in the markets. The true light at the end of the tunnel for the global economy will not be seen until the financial system is stabilized through a rigorous disposal of assets and the temporary nationalization of banks.

The necessary policy package

The Geithner Plan, which proposes establishing a fund consisting of public- and private-sector funds to buy nonperforming assets from financial institutions, will probably not work. A similar type of fund was created in

*1 For further details, please refer to "Financial crisis management: Lessons from Japan's failure," VoxEU website column (www.voxeu.org/index.php?q=node/2483), October 27, 2008

Japan in the mid-1990s with funds from the banking industry designated for the purchase of nonperforming debts, but little process was made in disposing of the debts. The fundamental problem lies in the banks, which are holding the nonperforming assets but have no intention of selling them to the newly established fund at reduced prices. The public-private fund, in order to buy the nonperforming assets with taxpayer money, must pay the correct price that reflects the value of the assets (which will be prices even lower than book value). For the banks holding the nonperforming assets, it makes more sense to hold onto them until the economy recovers to see if the nonperforming assets are eventually miraculously transformed into prime assets, rather than selling them immediately at low prices and a certain loss. This phenomenon has been referred to as the "gamble for resurrection" (Diamond and Rajan, 2009, made a model of this based on the risk-shifting effect). It is precisely why attempts to dispose of nonperforming assets were unsuccessful in Japan over a 15-year period stretching from the early 1990s to the mid-2000s.

Nothing short of political pressure exerted by governments on the financial institutions holding nonperforming assets through extreme methods, such as strict asset evaluations, will break this deadlock. With regard to the package of policies required to accomplish this feat, a number of practical lessons can be learned from the experience of Japan.

For starters, the policy chiefs responsible for the regeneration of the financial system should be outsiders, rather than financial industry insiders including people associated with the Treasury and the Federal Reserve Board (FRB). Financial regeneration only made progress in Japan after the position of minister in charge of finance was assigned to the economist Heizo Takenaka, who had only loose connections to the financial world. In addition, the first president of the Resolution and Collection Corporation, which actually made progress in the disposal of nonperforming assets, was originally a prosecutor. The top officials of the Industrial Revitalization Corporation of Japan were also management consultants who had never been involved in the banking industry or the Ministry of Finance. Similarly, the top policy chiefs for financial regeneration in the U.S. should not be selected from Wall Street insiders, but instead from university economists, people associated with the judiciary, people associated with investigative organizations, people associated with the military and so on, in order to create a structure capable of resisting political pressure from Wall Street.

Authorities with a high degree of independence from the financial world will also be needed to repeatedly administer strict asset evaluations for financial institutions —strict to the point of being considered excessive. Only the most rigorous asset evaluations will create the necessary situation where financial institutions are not tempted to "gamble for resurrection," and thus remove the nonperforming assets from their balance sheets.

Finally, in coordination with the strict asset evaluations it will be necessary to create a structure for deploying sufficient amounts of capital to meet the capital needs of undercapitalized financial institutions. In other words, the government needs to secure a sufficient framework of public funds (probably another $1 trillion) so that it can make use of these funds whenever it sees fit. In the present U.S. political situation, the biggest problem lies in securing public funds.

Japan was also confronted with this problem, as bailing out banks with public funds was considered politically taboo in the mid-1990s. The Japanese government waited three years before finally intervening. During this time, however, the severity of the nonperforming debt problem became untenable, sending the Japanese economy into financial panic. Ultimately, the government was forced to inject more than ten times the amount of public funds into the banks than had initially been required in the mid-1990s. Based on the experiences of Japan and other countries' financial crises, U.S. policymaking authorities and politicians must convince U.S. citizens that it is imperative to take immediate action in preparing an additional framework of public funds.

A question for future economic consideration

In the ongoing economic policy disputes, economic recovery is invariably discussed in terms of policy devices involving public expenditure and monetary easing, while the stabilization of the financial system is only considered possible with the design of new financial regulations capable of preventing recurrence (once we manage to come out of the current crisis). But when will we emerge from the current crisis? It seems unlikely that we will come out of it soon.

Designing and implementing policies capable of disposing of nonperforming assets and stabilizing the financial system should not be left to financial community insiders. It will probably be necessary to inject additional government resources (taxpayers' money) for financial stabilization going forward. We need to openly discuss what form these public fund injections should take. Financial system stabilization policies including the disposal of nonperforming assets and capital injections for financial institutions (temporary nationalization) must be considered alongside fiscal policies and monetary easing, with a new consciousness that these also constitute macroeconomic policies. We need to switch to a new paradigm of economic thought.