Subprime Loan Crisis – Lessons from Japan's Decade of Deception[1]

KOBAYASHI Keiichiro[2]
Ph.D. (Economics, the University of Chicago)
Senior Fellow, Research Institute of Economy, Trade and Industry (RIETI)

March 2008

Summary
Housing prices in the United States could continue to fall for many years to come. Losses could grow and eventually lead to bank insolvencies. Once the fear of prospective insolvencies in U.S. financial institutions spreads in the market, ordinary monetary policy becomes powerless since liquidity provision works only if all financial institutions in the payment network are solvent. With the problem being in the payment system, fiscal policy to save mortgage borrowers cannot restore market confidence. Capital augmentations by banks themselves only buy time but cannot stabilize the financial system if the market feels that bank insolvencies are inevitable. A payment system facing insolvencies becomes caught up in a game of musical chairs, in which each party tries to push the prospective losses on the others. To stabilize the payment system, the U.S. government should eliminate fear in the market. One promising policy plan is to set up a scheme and a sufficient public fund for capital injection into banks in the case of insolvencies. This scheme would stabilize the market by eliminating fear, and public funds would not actually be injected into banks.

1. Financial turmoil could continue

The financial problem associated with U.S. subprime loans is becoming a global economic problem. Arguments are increasing from Europe and Japan that this is the beginning of the end of the U.S. globalization system and may become a serious international political problem if it persists over a long period. We may recall that political support of fascism and communism grew in certain parts of the world 80 years ago because the international great depressions in the 1930s invoked serious feelings that global capitalism was collapsing. Therefore, resolving today's financial crisis quickly may not merely be a problem of U.S. economic policy but should be considered an urgent action point for stability of the international community as a whole.

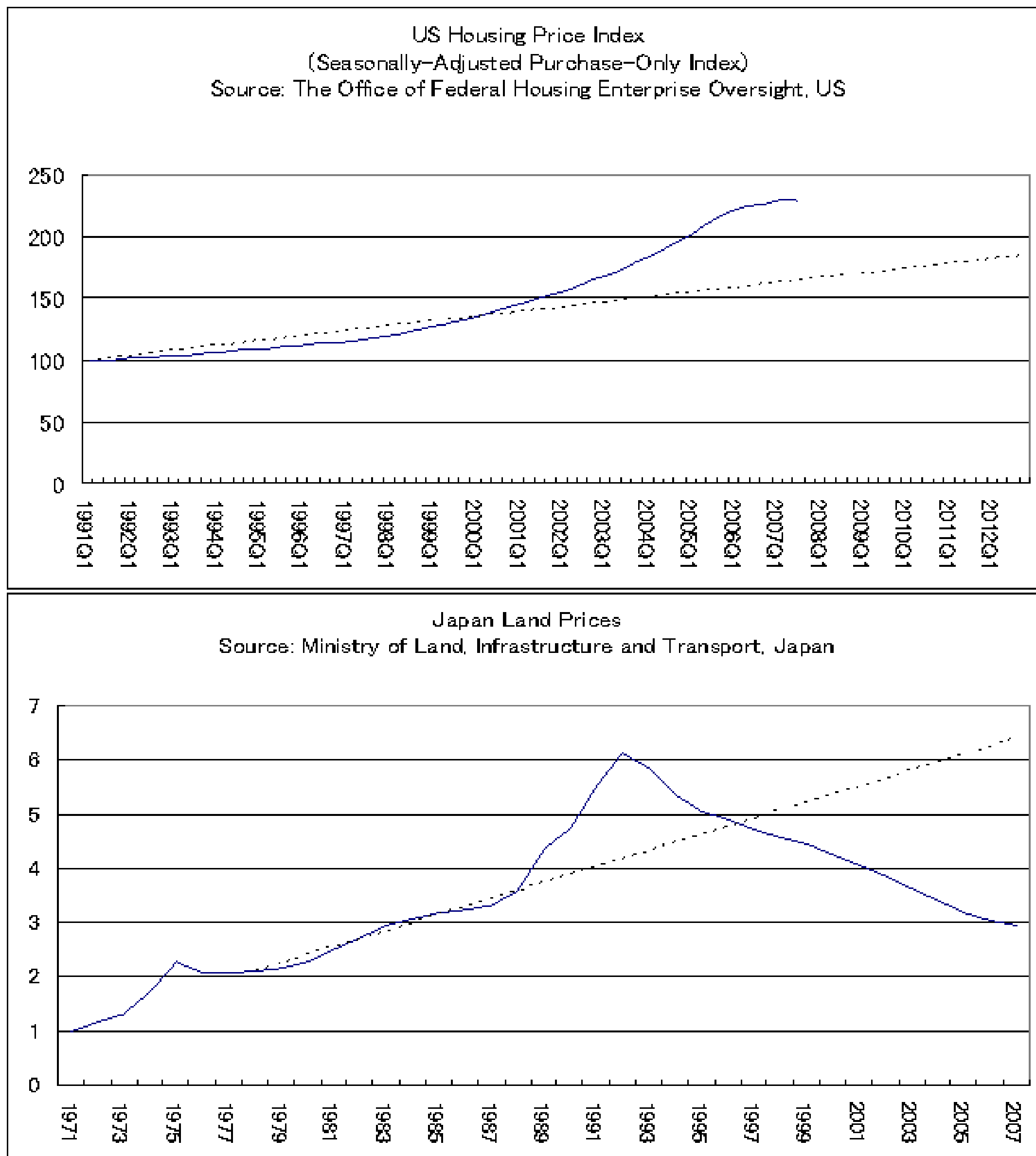
How far will housing prices in the U.S. fall? If we base our projections on the trend line during the

[1] Opinions expressed or implied in this paper are solely those of the author, and do not necessarily represent the views of the Research Institute of Economy, Trade and Industry (RIETI).

[2] e-mail: kobayashi-keiichiro@rieti.go.jp

1990s, they will pick up by 2012 at the latest. But this reasoning reminds me of a similar mindset in early-1990s Japan. When Japan's real estate bubble burst in 1991, the trend line indicated that land prices would bottom out around 1995, when in fact they continued to decline steadily for 12 more years, until 2007.

Figure 1. Land prices in Japan, housing prices in U.S.



Enduring wishful thinking that land prices would soon recover, and the subsequent disappointments, paralyzed Japanese banks and policy-makers and brought on a full-fledged banking crisis in 1997-1999.

At the beginning of the 1990s, Japanese policy-makers and banks believed that the problem was perfectly under control and that the banks then holding huge unrealized capital gains could easily overcome losses from disposals of bad loans, just as their U.S. counterparts believe so today. We may recall that *all* of the world top-10 banks (measured by amount of deposits) in 1989 were Japanese. Although Japanese banks were hit by a huge number of nonperforming loans as a result of the collapse in land prices, the primal prescription then was self-help by the lending banks, which is basically the same prescription adopted in the 2008 February G-7 meeting for U.S. financial institutions. Nobody anticipated that Japan's land prices would continue to fall for 17 years but this actually happened. I believe that the continuous fall in land prices was a result of a vicious circle brought on by the inaction of policy-makers at the outset of the problem.

The point is that housing prices could cease to fall soon or they could continue deteriorating for years. Both scenarios could be self-fulfilling and which of them will be materialized depends upon policy actions now. Japan's experience tells us that policy-makers should prepare for a worst-case scenario in which a vicious circle continues. My concern is that economic policy-makers in the U.S. and other G7 countries seem to have chosen a wait-and-see policy on the U.S. financial system, laden with risky and wishful thinking.

2. A vicious circle in the payment system and asset prices

The nature of the current financial turmoil should be understood not as a liquidity crisis but as an "insolvency crisis," so to speak. Once a fear of future insolvencies in U.S. financial institutions emerges in the market, a vicious circle will set in, and ordinary macroeconomic policies, i.e., fiscal and monetary policies, may not work, since these policies are designed for liquidity crises.

Suppose that public concern arises about a worst-case scenario in which housing prices continue to fall for many years. In this scenario, concerns about bank insolvencies may in fact materialize. Continuous decline in housing prices will increase the amount of loans that cannot be secured by housing collateral. In this situation, banks will have no choice but to dispose of bad loans in excess of the collateral value. If the collateralized houses continue losing their value over many years, bank capital may dry up. Of course, large financial institutions are now fighting against capital impairment with swift capital augmentations by foreign investors. But current movements in market prices seem to signal that the tide is against them. If housing prices continue to fall, capital augmentation in the private sector will only postpone eventual insolvencies. If market participants start to feel future insolvencies in U.S. financial institutions are inevitable, there will be no investors for bank capital and bank failures will become a significant threat. Anxiety over this worst-case scenario materializing may worsen the prevailing mood in the market and among consumers, leading

to continually lesser consumption and lower housing prices.

In other words, once there emerges uncertainty that some banks may eventually go bankrupt, all participants in the payment system get caught up in a game of musical chairs, in which each party tries to push the prospective losses on the others. This exhausting game between banks and investors dramatically shrinks economic activity and incites a persistent recession and a continuous fall in asset prices.

Self-help by financial institutions may not be able to stop this vicious circle because losses can swell beyond control as asset prices fall sharply. In this situation, a fear of future insolvencies in financial institutions persists as part of a "self-fulfilling prophesy," in which fear shrinks the economy, which in turn lowers asset prices; and lowered asset prices in turn justify the fear of insolvencies. Banks cannot be released from this vicious circle by reinforcement of their capital unless investors are committed to unlimited capital augmentation.

3. Macroeconomic policies may be powerless

When the fear of future bank insolvencies is at the core of the crisis, ordinary monetary policy may be powerless. Japan's recent experiences with monetary policy clearly prove this. Although considerably slower than today's response by the Federal Reserve, the Bank of Japan (BOJ) in the 1990s also conducted aggressive monetary easing by cutting the interest rate repetitively until the nominal interest rate hit its zero bound. Japan's nominal interest rate has been virtually zero since 1995. Despite massive liquidity provision by the BOJ, the financial system stayed in a crisis situation throughout the late-1990s and early-2000s, the economy suffered from protracted recession, and price deflation has continued from 1998 to the present. The cause of Japan's ineffective monetary policy is still a hot topic in macroeconomic research. My opinion is that this episode is evidence that the cause of Japan's recession in the 1990s was the fear of bank insolvencies, not a liquidity shortage.

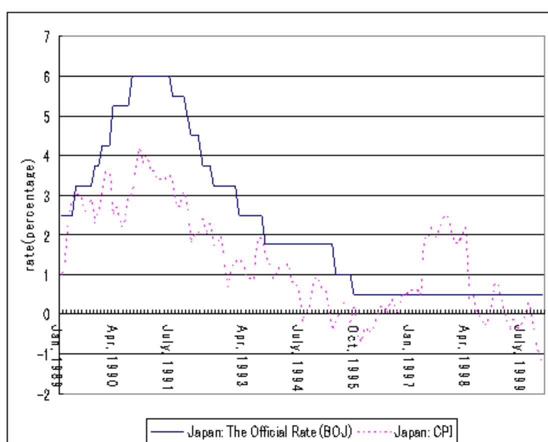
In a liquidity shortage banks temporarily run short of money, while they are ultimately solvent in the long run. A liquidity provision by the central bank is merely a temporary loan to banks. If banks suffer only from a liquidity shortage, it suffices for restoring stability in the payment process. A massive liquidity provision or aggressive interest-rate cut such as that currently conducted by the Federal Reserve aims to stabilize the payment system. But this provision can work only if the problem is a temporary liquidity shortage, that is, all financial institutions in the payment network are and/or will be solvent (or insolvent banks are immediately identified and isolated from the payment network). A liquidity provision cannot eradicate the fear of bank insolvencies because it is

by definition just a temporary loan and does not make up for losses. Therefore, in a situation wherein the market is concerned with prospective bank insolvencies, monetary policy alone may not be able to restore confidence.

We should also note that the Federal Reserve has little more room for interest-rate cuts than the BOJ had in 1991, when the land-price bubble burst in Japan (see Figure 2). If the fear of bank insolvencies persists in the market and policy-makers try to stabilize the economy only by means of monetary policy, the U.S. nominal interest rate may hit the zero bound quite soon. We cannot expect the Federal Reserve to play much of a role in stabilizing the economy once the insolvency crisis sets in.

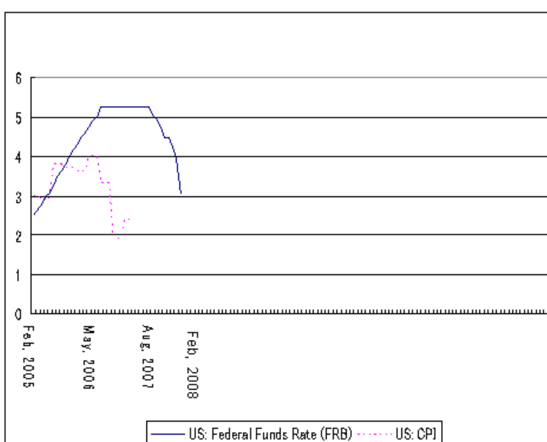
Figure 2. Interest rate and inflation rate (U.S. and Japan)

The Official Rate (BOJ) and CPI in Japan



Source: Bank of Japan, Ministry of Internal Affairs and Communications

Federal Funds Rate (FRB) and CPI in US



Source: The Federal Reserve Board, Ministry of Finance (Japan)

Let me digress a little. We may draw a political lesson from the debate on Japan's monetary policy in the crisis period. Since the decade-long (1998-2007) persistent deflation in Japan is truly unprecedented in modern world history, it attracted much attention among prominent U.S. economists. Many well-known and influential professors, most of whom are New Keynesians in East Coast universities, advocated the BOJ undertaking extraordinary monetary easing to boost the economy. The BOJ, which for years had already stretched the limits of its abilities, took the advice and embarked on an unprecedented "quantitative easing policy," in March 2001. Economists are still debating whether or not this helped Japan's economic recovery, though there is no clear evidence that quantitative easing had any significant effect. The Japanese (except for some economists) feel that economic recovery was brought on by the restoration of solvency in the banking system through aggressive disposals of nonperforming loans and bank recapitalizations during 1999-2005. Although

the New Keynesians advice of extraordinary monetary easing may have been effective in mitigating Japan's crisis, it also had a serious political side effect, that is, the advice was used by pro-bank economists and policy-makers as an excuse to avoid drastic policy measures to attack bank insolvencies. The advice diverted public opinion away from the systemic banking problem to the technical issues of monetary policy methodology at the very moment Japan needed to form a strong political initiative to restructure the banking system. Of course it is not the fault of the New Keynesian economists, since they also noted that resolving Japan's banking problem was important, though their emphasis was too greatly on monetary policy, and therefore their advice made some among Japan's general public believe wrongly that monetary policy alone could solve the financial crisis.

The lesson from this episode is that we should be very careful not to have excessive expectations that monetary policy is almighty in an insolvency crisis. I completely agree with Professor Robert E. Lucas, Jr., the 1995 Nobel laureate, when he said, "monetary policy should concentrate on the one thing it can do well – control inflation. It can be hard to keep this in mind in financially chaotic times, but I think it is worth a try" (*Wall Street Journal*, September 19, 2007). My interpretation of his remark is that monetary policy may not be as effective in resolving bank insolvencies or in boosting housing prices. (Note that housing prices are asset prices and are not included in general prices. Inflation is the growth rate of general prices.)

Fiscal policies to save mortgage borrowers and boost aggregate demand may not work in insolvency crises either. Whether or not fiscal policies are effective in restoring confidence depends on expectations on the future path of the economy. If aggregate demand shrinks due to the vicious circle in the payment system invoked by the fear of future bank insolvencies, fiscal policies, such as tax cuts, public works, and moratoriums for depressed borrowers are far too indirect a policy to eliminate the fear. (All these measures were tried repeatedly throughout the 1990s in Japan, and could not stop deteriorating land prices.) If the public continues to suspect housing prices will decline, the fear of future bank insolvencies will remain and the vicious circle will go on to wipe out any positive effect of fiscal policies.

4. New policy scheme may be necessary

Policy-makers need to prevent the self-fulfilling vicious circle in the payment system by demonstrating that they are setting out a clear provision against insolvencies in large financial institutions. That is, they need to set up a policy scheme and a government fund for unlimited capital injection into banks in the case of insolvencies. This recommendation for apparently hard-line government intervention in the market economy can be justified as a legitimate economic policy to

eradicate external diseconomies generated in a crisis period. (See Kobayashi 2006; Kobayashi and Inaba 2008; and references therein for theoretical treatment of this issue.)

Setting up such a policy scheme does not necessarily mean placing cost on the taxpayers. To the contrary, this may in fact be a good investment opportunity for taxpayers. During Japan's 1999 banking crisis, the government set up a fund of 70 trillion yen (approximately $617 billion at that time) for capital injection into quasi-insolvent banks. Nearly 12.4 trillion yen was invested in banks, and almost 9 trillion yen has been repaid by the banks to the government with interest added. The remaining 3.5 trillion yen is scheduled to be repaid safely. (Outside of this policy scheme, Japanese taxpayers incurred a cost of several trillion yen for bailouts of completely failed banks.) Setting up a public fund does not necessarily mean taxpayer money will be wasted in bailing out failed banks. Public money invested into banks will yield a sizeable return when market confidence is restored and the economy is stabilized.

Secondly, there will be no need to inject public funds into banks if the policy scheme is established. As mentioned, the fear of bank insolvencies leads to participants in the payment system pushing prospective losses on to each other. And, as we saw, monetary and fiscal policies may not work in this situation. The only way to restore confidence is for a party to plausibly commit to covering any prospective loss. The most credible party is the government (which, theoretically, includes the central bank). Once an unlimited guarantee by the government is put into place, the fear of bank insolvencies will naturally resolve. The vicious circle between payment system and asset prices will cease as this circle is initiated by bank and investor fears of not being paid in full when they expand lending because some of their customers will become insolvent (see Kobayashi [2006] for a formal model). A government guarantee eradicates this fear and returns economic activity to normal. Once fear is eliminated, housing prices will soon bottom out and therefore bank insolvencies will not materialize. In short, a government guarantee can inspire optimistic expectations in the market that housing prices will pick up, and no need to inject public funds into banks will emerge.

Thirdly, a provision against bank insolvencies is aimed at restoring public confidence in the stability of the payment system, not at injecting taxpayer money into banks per se. The cost for taxpayers, if any, can be justified as the price of restoring public goods, that is, the nationwide or worldwide payment system.

Put another way, stabilizing a payment system facing bank insolvencies may be regarded as a guarantee of the public's property rights, which is the most fundamental role of a government in a market economy. Because bank liabilities (bank deposits) work as money in modern economies, we hold confidence that bank liabilities will not lose their value in a *totally unexpected* manner. A

sudden rise in fear of future bank insolvencies associated with the subprime loan problem threatens the value of money as a whole, which the government should ultimately and legitimately guarantee.

5. A moral lesson from Japan's failure

Finally is the most critical problem: the responsibility of the CEOs of financial institutions. This is not a problem of economics but of politics. Nevertheless, the consequences of this problem may determine the macroeconomic performance of the U.S. and world economies in the coming years. Japan's experience provides some lessons. Making up for bank losses with taxpayer money is not just to save bankers who made mistakes, but to save the public payment system. But, in doing so, it is inevitably to save the bankers. One large reason why Japan could not act quickly to resolve bank distress in the 1990s was the problem of responsibility of the bankers who created the real estate bubble and subsequently the huge nonperforming loans. In order to avoid political struggles regarding the responsibilities of bankers and debtors, who were the powerful vested interests, the Japanese chose to deny the existence of the problem itself. We deceived ourselves by pretending for years that the bank distress was not a real or significant problem in the economy. A symbolic episode is then Prime Minister Ryutaro Hashimoto's complete astonishment at the rash of bank failures in November 1997. Mr. Hashimoto later said he had been informed of absolutely nothing on the distressed banking sector at that time. His surprise epitomized the decade-long self-deception by Japanese policy-makers and leaders.

The worst hit victims of this decade of deception were ordinary workers and consumers, who suffered from recession and unemployment. The lesson is that even though political struggles over the responsibilities of financial institutions may be extremely harsh, it is necessary to settle them quickly and move on to necessary policy actions. Restoring the financial system is necessary not for bankers, but for distressed home borrowers and ordinary people to avoid suffering from further recession.

6. Concluding remarks

My arguments here may at the moment be politically incorrect, especially among economists. This was the case in Japan 10 years ago. Why should taxpayers bear the costs, if any, of saving inept bankers? Japan found the answer: because otherwise the weakest in society will be forced to pay for the bankers' mistakes over the long term due to the malfunctioning payment system. Political damage will also be immeasurable if the U.S. economy loses its credibility as the most affluent and well-functioning market economy in the world. A wait-and-see attitude on the financial system based on wishful thinking that housing prices will soon pick up is extremely risky, since inaction feeds

fears of future bank insolvencies, which drops housing prices further. Responsible policy-makers should prevent a self-fulfilling insolvency crisis by setting out a clear provision now.

References

Kobayashi, K. (2006). "Payment Uncertainty, the Division of Labor, and Productivity Declines in Great Depressions." *Review of Economic Dynamics* 9: 715-741.

Kobayashi, K., and M. Inaba (2008). "Debt-Ridden Equilibria – A Simple Theory of Great Depressions." RIETI Discussion Paper Series 07-E-035 (http://www.rieti.go.jp/en/publications/summary/07060009.html).