Response to the Global Financial Crisis and Future Policy Challenges

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1. Response to the global financial crisis

It was in late October 2008 that the members who are here today last met in Hakone. At that time, the seriousness of the economic and financial problems triggered by the collapse of Lehman Brothers in September 2008 was becoming apparent. In the two years since then, I have attended many international forums, including the G7 and G20 meetings. Based on this experience, I would like to examine the responses by the international community to the global financial crisis and highlight some issues concerning the current status of the world economy and future policy challenges.

First of all, how did the international community view the background to the global financial crisis? There are both macro-economic and micro-economic components. In macroeconomic terms, during the era of “the Great Moderation” up to the summer of 2007, distortions grew due to rising asset prices and widening current account imbalances. During this period, the United States and a number of European countries experienced stable high growth with low inflation and interest rates, which encouraged financial institutions to keep taking on greater risks, leverage and credit.

The other background feature of the financial crisis triggered by the subprime problem in the summer of 2007 is inadequacies in financial systems, regulation and supervision. At the first G20 Summit held in Washington D.C. in November 2008, participants openly admitted their regulatory and supervisory responsibilities, stating that “policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovations, or take into account the systemic ramifications of domestic regulatory actions.”

With this understanding, how has the international community responded? I would like to touch upon five areas to answer this question.

First, the most urgent issue was to stabilize the financial system. In other words, avoid a chain-reaction collapse of financial institutions due to bank runs or inability to roll-over debt in the market. An emergency action plan was adopted at the G7 meeting held in Washington D.C. on October 10 amid the tense situation immediately after the Lehman crisis. Under this plan, government actions included the massive supply of liquidity by central banks, expansion of deposit insurance, guarantees for bank debts, capital injection using public funds, separation of toxic assets from balance sheets and governmental control of troubled financial institutions.

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Second, the international community responded with macroeconomic policy measures. By the time of the G7 meeting in Rome in February 2009, the drastic deterioration of the real economy had become evident particularly in advanced countries, manifested in shrunken trade and production and increased unemployment. Governments therefore agreed to take expansionary fiscal policy and accommodative monetary policy steps including “unconventional” measures in a coordinated manner. It was discussed that simultaneous, harmonized actions produced greater synergy and were more effective than separately-taken expansionary measures, preventing “free riding” on other countries’ policies.

Third, it was also important to support developing countries. Many developing countries had managed to sustain high growth right up to the crisis, thanks to prudent macroeconomic policies and expanded global capital flows. However, capital flow reversal, contracting trade, and lower confidence during the crisis put the foundation of growth under threat. At the second G20 summit in London in April 2009, the leaders agreed to mobilize funds from international financial institutions such as the IMF, the World Bank and the Asian Development Bank and bilateral assistance from advanced countries in order to support trade, infrastructure development and stimulus measures in developing countries, and to increase resources of those institutions. This would assist developing countries, while also alleviating the decline in international trade and economic activity, thereby helping advanced countries to recover.

These responses directly addressed the financial crisis. Policies to prevent another serious international financial crisis were also examined. One area to review was regulation and supervision of the financial sector, including regulation of capital, liquidity and leverage, regulation and supervision of systemically important financial institutions, cross-border bank resolution, review of credit-rating agencies, central clearing of OTC derivatives, and review of supervisory systems. Macro-prudence, which is on this symposium’s agenda, is another important subject. Concrete responses have since followed, such as agreements reached at the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision, as well as actions taken by respective countries including the financial regulatory reform act in the United States.

Finally, to prevent future crises, it is an important task to reform international financial institutions. The world leaders agreed to increase the financial resources of the IMF, the World Bank and other multilateral development banks; to strengthen the governance of these institutions; to regard the G20, which involves emerging countries, as the premier forum for international discussions; and, to reinforce the FSB, in which finance ministries, financial regulatory authorities and central banks of countries participate. Actions have been taken to implement these agreements.

2. Current status of the world economy

Let me begin with the conclusion. The international community has generally acted in harmony, helping the world economy recover and avoid protectionism. Needless to say, not every single policy has enjoyed the unanimous support of the international community. And
yet we can say that the recent experience contrasts sharply with a past example, in which governments individually pursued protectionist policies and competitive devaluation after the Great Depression, inducing a vicious cycle of reduced world trade and output, higher unemployment, and stronger protectionism. This became the economic backdrop behind World War II. Today, there is much talk about a so-called currency war. True, different countries naturally have different policy orientations that reflect their different situations. Nevertheless, on the whole, I believe that countries have behaved with good self-control by learning from history and by considering the potential impact of their actions on the world economy.

Thanks to the coordinated response by the international community, the world economy is calmer than it was two years ago. The world economy today, according to views presented by the IMF, can be summarized as follows: the world economy is recovering faster than many people expected. However, the pace of the recovery is uneven. The pace is slower in advanced countries, while emerging and developing countries are experiencing a more solid recovery. Financial markets are also recovering, while banks, particularly in advanced countries, still need to repair their balance sheets and credit growth is sluggish. Regarding future risks, rapidly increasing public debt in advanced countries is a critical challenge, as Greece and the euro zone showed this spring.

I would like to say a few words about Europe now. As the sovereign risk of euro-zone countries increases, questions emerged whether the euro-zone is an optimal currency area, given its limited mobility of labor and its restricted fiscal transferability, and whether monetary and currency integration is sustainable without political integration. However, the euro-zone countries have demonstrated much stronger solidarity in maintaining the euro system than many experts had expected, seen through their resolute support for Greece and establishment of a new facility for the euro-members - the European Financial Stability Facility. Efforts are still being made to enhance the resilience of the euro system, including stronger fiscal discipline and monitoring of the competitiveness of member states. The international community is supporting these efforts by Europe, as evidenced by financial support and policy advice by the IMF.

Let me turn now to the Japanese economy. Despite having few problems in the financial sector, the Japanese economy was hit hard by the current crisis, with the 2009 growth rate plummeting to minus 5.2%. Some claim this is mainly due to Japan’s heavy dependence on external demand, but the reality is not that simple. The percentage of exports in Japan’s GDP in 2007, when it was at its peak, was about 17%, which is small compared to China’s 35% and Germany’s 40%. However, as analyzed in an IMF paper\(^2\), Japan’s production and exports are largely in advanced manufacturing products such as machinery and other capital goods, automobiles and other durable consumer goods, for which demand is structurally vulnerable to the economic cycle. As the world economy slumped, investments and consumption for such goods were put off and demand decreased due to inventory adjustment both in and outside Japan, leading to a drastic demand decrease for goods in which Japan enjoys comparative advantage. This is actually proof that the Japanese economy is thoroughly

\(^2\) Sommer, Martin (2009) “Why Has Japan Been Hit So Hard by the Global Recession?” , IMF Staff Position Note
integrated into the world economy at the higher end, for better or worse. Incidentally, the latest IMF projection for Japan’s growth rate for 2010 is 2.8%, which surpasses figures for the United States (2.6%) and the euro zone (1.7%).

3. Several policy issues

I would like to discuss several points regarding policy management issues faced by a number of countries at the moment. Central bank policies have also become a prime focus of discussions, but I will not touch on those here.

First, addressing current account imbalances, in other words, rebalancing global demand and production, has become a major international challenge. This problem was taken up as a key topic at the G20 Toronto Summit this past June, and continued to garner attention at the G20 Meeting of Finance Ministers and Central Bank Governors held today in Gyeongju, South Korea. The fact is that the US’ current account deficit exceeded 6% of GDP prior to the crisis but is expected to shrink to about 3% in 2010; China’s surplus is expected to fall from around 10% to about 5%, reflecting the strength of domestic demand. Consequently, we can tell there have been significant adjustments ever since the crisis. However, it appears possible that the future will see expanding imbalances as the world economy, particularly the advanced economies, recover further, posing a risk to sustained and balanced global growth.

As has been agreed upon, a shift should be made from external demand to domestic demand in surplus countries including emerging countries, and excessive consumption corrected and fiscal consolidation promoted in deficit countries. It is also important that exchange rates of emerging and other countries be determined so as to reflect their economic fundamentals. However, even if exchange rate adjustments can contribute to reducing current account imbalances, it is unlikely that this alone will lead to sustained correction, and I would like to emphasize the need for structural policies in both surplus and deficit countries that encourage changes in consumption and saving patterns. For instance, emerging surplus countries, as has been discussed, need to establish social safety nets that will allow consumption without anxiety, invest in still inadequate social infrastructure and develop a financial sector that promotes domestic intermediation.

With regard to exchange rates, it has been repeatedly confirmed at the G7 and other forums that excess volatility and disorderly movements in exchange rates have adverse implications for economic and financial stability and that major countries closely monitor exchange markets and cooperate as appropriate. As mentioned earlier, participants in the G20 Summit and other such meetings have also come to the shared view that a competitive currency devaluation must be avoided.

A related problem that has arisen recently is the sharply rising capital flows into emerging economies, reflecting monetary easing in the advanced economies and the robust recovery in emerging economies. Some emerging economies have seen rising asset prices and shown concerns over drastic fluctuations in exchange rates. Dominique Strauss-Kahn, the IMF Managing Director, brought attention to the issue at a meeting held last week in Shanghai.
when he stated more clearly than ever that restrictions on capital inflows might be one option to counter enormous inflows of money. While the effects and adverse impacts of restrictions on capital inflows must be closely assessed, there is naturally no need to categorically preclude them since many of them can be regarded as an extension of prudential measures in the financial sector.

Second, debates over the fiscal policies of advanced countries concern how long economic stimulus policies are to be continued, when efforts should be steered toward fiscal consolidation, and on what scale and at what speed fiscal consolidation efforts should be made. The international consensus is that stimulus measures should be continued through 2010 and that clear and credible plans should be developed to lower the ratio of government debt to GDP over the medium term. Within that context, European countries have generally put greater emphasis than the US on fiscal discipline, as evidenced by the Stability and Growth Pact. During a speech at Jackson Hole at the end of August, ECB President Jean-Claude Trichet pointed out that debt overhang, be it in the public or the private sector, has a seriously adverse impact on long-term growth, and strongly urged countries to pursue fiscal consolidation.

The Japanese government has taken the position that needed fiscal stimulus measures will be continued this fiscal year. At the same time, in order to achieve a “strong economy”, “robust public finances” and a “strong social security system” in an integrated manner over the medium term, it announced this July the “New Growth Strategy” that include enhancing collaboration with Asia and promoting the medical industry and science/technology and also adopted the “Medium-term Fiscal Framework” presenting specific targets and the “Fiscal Management Strategy” incorporating the pay-as-you-go principle.

Third, there is the issue of the specific steps to be taken in addressing the problems of financial regulation and supervision - the main topic of this Symposium. As I noted earlier, the many reforms being implemented in the wake of discussions thus far constitute a significant achievement.

It goes without saying that market functions should, primarily, be made most use of in the financial sector, but it is also a sector inherently requiring appropriate regulation and supervision due to the information asymmetry and its aspect as a public infrastructure. Measures are also essential in areas where incentives have been distorted through reward structures, etc. The experience of the latest crisis has prompted reconsideration about the idea that smooth transfers and allocation of funds and risks will be achieved intrinsically by relying on the market mechanism. In other words, the need for proper regulation and supervision has been reaffirmed. Reform efforts have been driven by the circumstances in which crisis directly and indirectly threatened the ordinary lives of the public and the management of companies and in which taxpayer money were mobilized in dealing with the crisis.

Although reforms continue to move ahead, the effects and impacts of regulations depend in great part on arrangements of the details and their implementation going forward. Failure to implement needed regulatory reforms in order to satisfy the individual interests of the industry is simply unacceptable, and such reforms must be steadily implemented. At the same
time, though, we must avoid generating unexpected adverse impacts on the stability of financial markets, financial intermediary functions and the macro-economy by implementing new regulations hastily or not paying sufficient attention to the composite effects of various reforms. Careful attention must also be paid to the possibility that strengthening regulations will generate risks in new areas that are not subject to regulation.

Fourth, in the context of regulations, the crisis has made clear the importance of so-called “macro-prudence”. In other words, there are times when the financial system as a whole builds up excessive leverage and risk even when the soundness of individual financial institutions does not appear to indicate any problem. The US has established a Financial Stability Oversight Council and the EU a European Systemic Risk Council in efforts to bolster macro-prudence. In Japan, the Financial System Council’s Roundtable Committee on Fundamental Issues proposed in a report released in December 2009 that appropriate cooperation be pursued between the Financial Services Agency, the Bank of Japan, the Ministry of Finance and other relevant organizations to enhance regulation/supervision in terms of macro-prudence. Incidentally, Japan’s Deposit Insurance Act modified after the financial crisis of the late 1990s provides for holding a Financial Crisis Response Council in times of crisis under the chairmanship of the Prime Minister, comprising the Chief Cabinet Secretary, the Minister for Financial Services, the Financial Services Agency Commissioner, the Minister of Finance and the Bank of Japan Governor.

The term macro-prudence can be used in a variety of senses, but central bank monetary policies that carefully consider economic fundamentals, including asset price and leverage levels, and seek to ensure the long-term stability of prices and of the financial system can be regarded as an important aspect.

Regarding macro-prudence, the IMF and the FSB are currently cooperating in studies of an international early warning system. I would like to note, however, that the implementation of an effective early warning system may entail a variety of difficult issues such as the choice of indicators to be employed, sensitivity of national authorities that ultimately serve functions of deposit insurance or lender-of-last-resort, and the possibility of sparking a crisis by issuing a warning.

4. The international financial system in future

There are also several lessons learned from the recent crisis in the area of international finance. Looking back, in the early 1970s, we saw the collapse of the Bretton Woods System, a fixed exchange rate regime which sought exchange rate stability and the policy independence of national governments while restricting cross-border movements of capital. Since then, the free movement of capital came to be actively promoted instead of just permitted. In addition, nations subsequently undertook financial deregulation. The idea that ensuring the free cross-border movement of capital and allowing as much freedom and innovation as possible for financial activities in each financial sector are in and of themselves “virtues” that bring about an efficient allocation of resources and that should be promoted, may be considered a remote cause of this crisis.
After this crisis, it has been argued that we must be prepared for more frequent financial crises in a world in which large sums of money move instantaneously across borders. Recalling the bubble in Japan in the latter half of the 1980s and the subsequent bursting of that bubble, the Asian currency crisis that began in 1997, this international financial crisis sparked by the 2007 subprime loan problem, and the recent difficulties faced by Greece and the euro, I find certain commonalities: (1) important institutional changes had been made beforehand; (2) activity in the financial sector had increased in the midst of strong exchange rates, stable prices, and an easy monetary environment; (3) a sense of euphoria had convinced many that these favorable conditions would never end; (4) this conviction led to a disregard for risk; and, (5) macro imbalances such as excessive rises in asset prices and current account deficits expanded shortly before the crises.

Regarding institutional changes constituting remote causes of the crises, in the case of Japan, financial deregulation facilitated corporate fund-raising through bond-issuance and banks had to turn to real estate financing as a new business, that induced excessive lending and eventually to building up of the bubble. In the run-up to the Asian crisis, capital accounts were liberalized while de facto dollar pegs were maintained, and people borrowed from foreign countries and invested in domestic real estate markets with little regard for exchange rate and term risks (relying on short-term dollar-denominated loans). Behind the financial crisis triggered by the subprime loan problem in the US was the acceleration of financial innovation after the 1999 removal of restrictions on cross-ownership between banks and securities firms (Gramm-Leach-Bliley Act) and regulatory arbitrage exploiting remaining regulatory gaps through the use of off-balance transactions, etc. The most important institutional change that became a remote cause of the problems in Greece and other euro-zone countries was the introduction of the euro as a common currency; this produced the environment in which there is no need to care about exchange rate risk and overconfidence in the stability of national economies. With the benefit of hindsight, such environment spurred on an unsustainable influx of money.

On the other hand, it goes without saying that financial innovations and the free cross-border movement of funds have generated the benefits of an efficient allocation of resources for demanders and suppliers of funds, corporations and households, boosting growth in many countries. Representative examples of this can be seen in the rapid growth of venture companies and emerging market economies. In any case, returning to fixed exchange rates, constraints on capital movement, and regulations on financial activities resembling those in place until the 1970s is neither practical nor appropriate. While making maximum use of the lessons of this crisis, it is crucial that greater efforts be made to pursue sound macroeconomic policies and to ensure appropriate financial regulation/supervision, that vigilant monitoring of the signs of new crises be maintained, and that international collaboration to prepare for a crisis, if any, be enhanced.

One topic which has gathered renewed attention is the international monetary system of the future. More specifically, there is an argument that use of the US dollar, which is subject to US domestic policy, as the world’s key currency is problematic. Some observers suggest increased use of SDRs, artificial reserve assets created by the IMF. This renewed attention stems from the fact that the recent crisis began in the US, the issuer of the key currency,
which raised concern about confidence in US policy, even if only temporarily. It has become apparent, however, that the euro, up until now considered the nearest in stature to the US dollar as a key currency, faces a number of its own limitations, not least among them being that each country has its own separate government bond market. Although the utilization of SDRs merits further consideration, the very nature of SDRs makes them not so much a currency. Instead, SDR can be regarded as a credit line without conditionality through which national authorities accommodate each other with foreign currency reserves. I would like to remind you that the US dollar enjoys the “network externality,” whereby benefits arise through use by other participants, and also strong “inertia” of keeping using it. Although neighboring countries may choose to make more frequent use of the euro, the yen, the yuan, etc., it is difficult to imagine the emergence of a currency that could stand on par with the US dollar as a key currency in the foreseeable future.

5. Conclusion

One lesson drawn from the current crisis is the renewed awareness of the critical role of the governments of sovereign states as a final backstop for economic and financial stability. Governments pursue macroeconomic policies to prop up the deteriorating real economy and take measures to support the financial sector. Governments have unique capacity to mobilize taxpayer funds based on democratic processes, and enforce financial regulations and other rules by enacting laws. Just as there are government failures (macroeconomic policy mistakes, overregulation, and various inefficiencies), so too are there market failures and market excesses.

As the role of the governments is larger, it is all the more important to develop appropriate ways in which the government and the private sector can fulfill their respective roles and find the channels through which the actual circumstances and wisdom of the private sector can be properly reflected in government policies. More broadly, I believe there are two fundamental challenges for a democratic regime of any country that is exposed to flooding of instantaneous and miscellaneous information. One challenge is how to respect the sober findings of experts in the public and private sectors while adequately taking in public opinion in order to produce genuinely sound policies. Another is how citizens can support the political leaders whom citizens have themselves selected and who must make difficult policy decisions.