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COMMENTS ON "SUB-PRIME CRISIS - LESSONS FROM JAPAN'S FINANCIAL CRISIS"

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Comments on "Sub-prime Crisis-Lessons from Japan's Financial Crisis"

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Similarity in Origin(I)

1.Bursting Asset Price Bubble

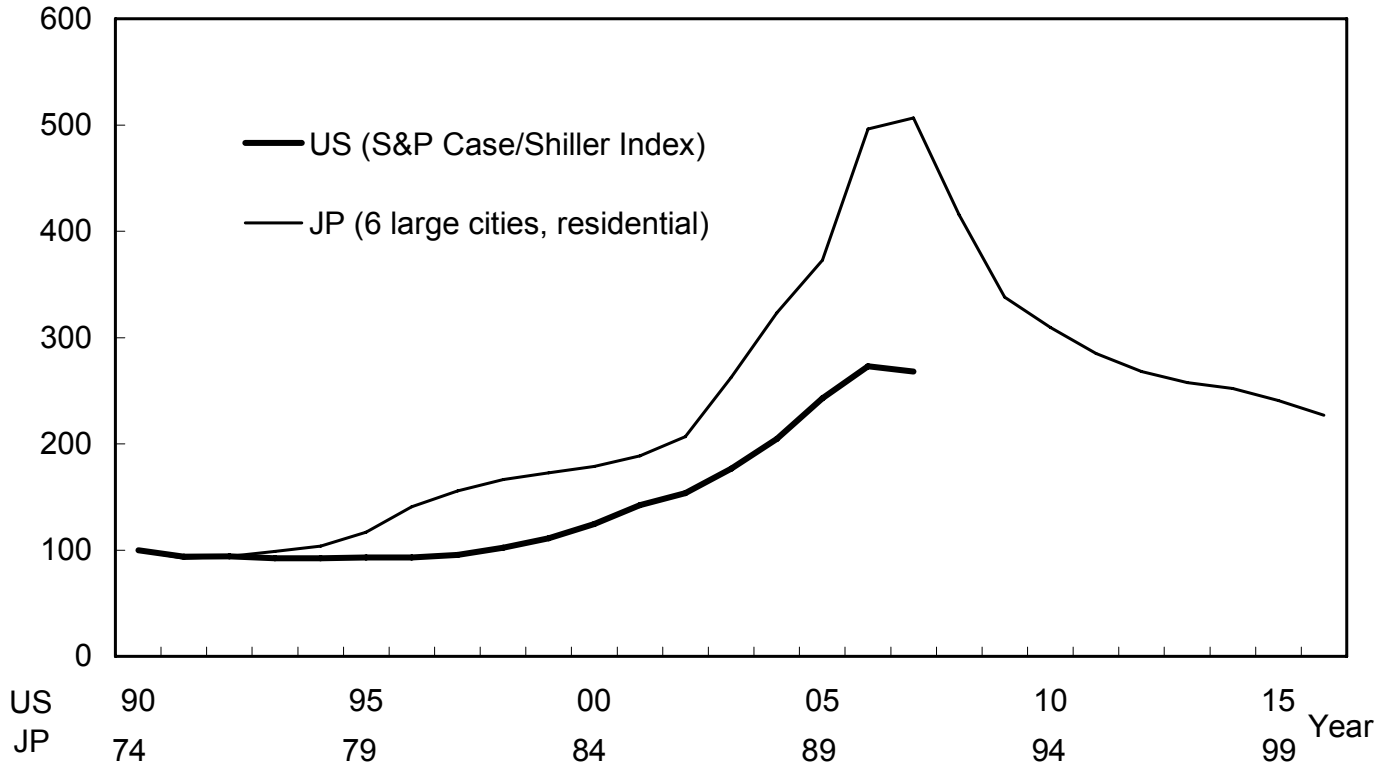
U.S.: Housing Price

Japan: Land Price and Equity Price

The size of increase in the U.S. housing price was about half of the land price rise in Japan. The increase in the real housing price after 1997 was 83%, which was enormously large by historical standards. Now it seems likely that the housing price will decline by about 30%. In real term it will become even larger.

The Japanese land price declined by about 60% after bubble burst, and It took 15 years to reach the bottom.

Housing Price in the U. S. And Land Price in Japan



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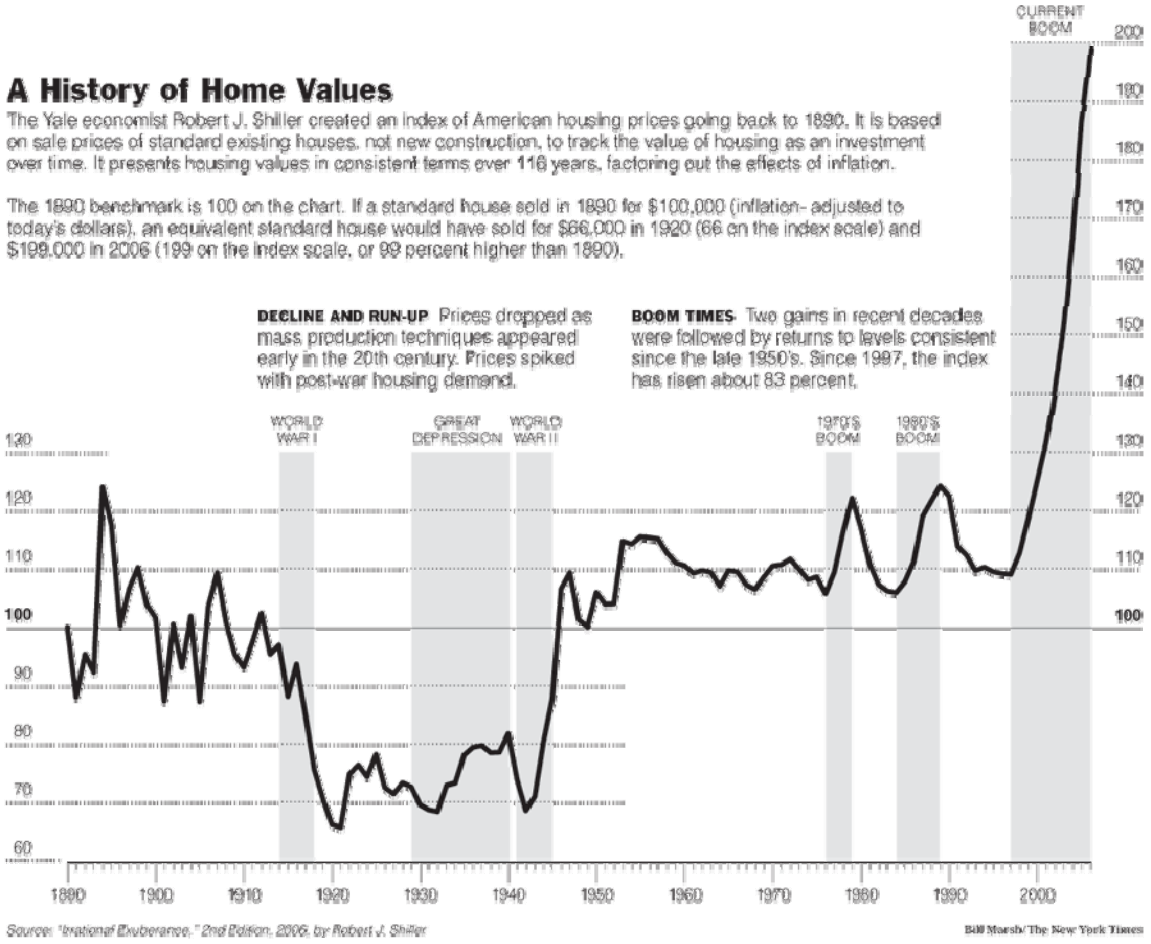
History of Real Housing Price



Similarity in Origin(II)

2. Excessive provision of loans

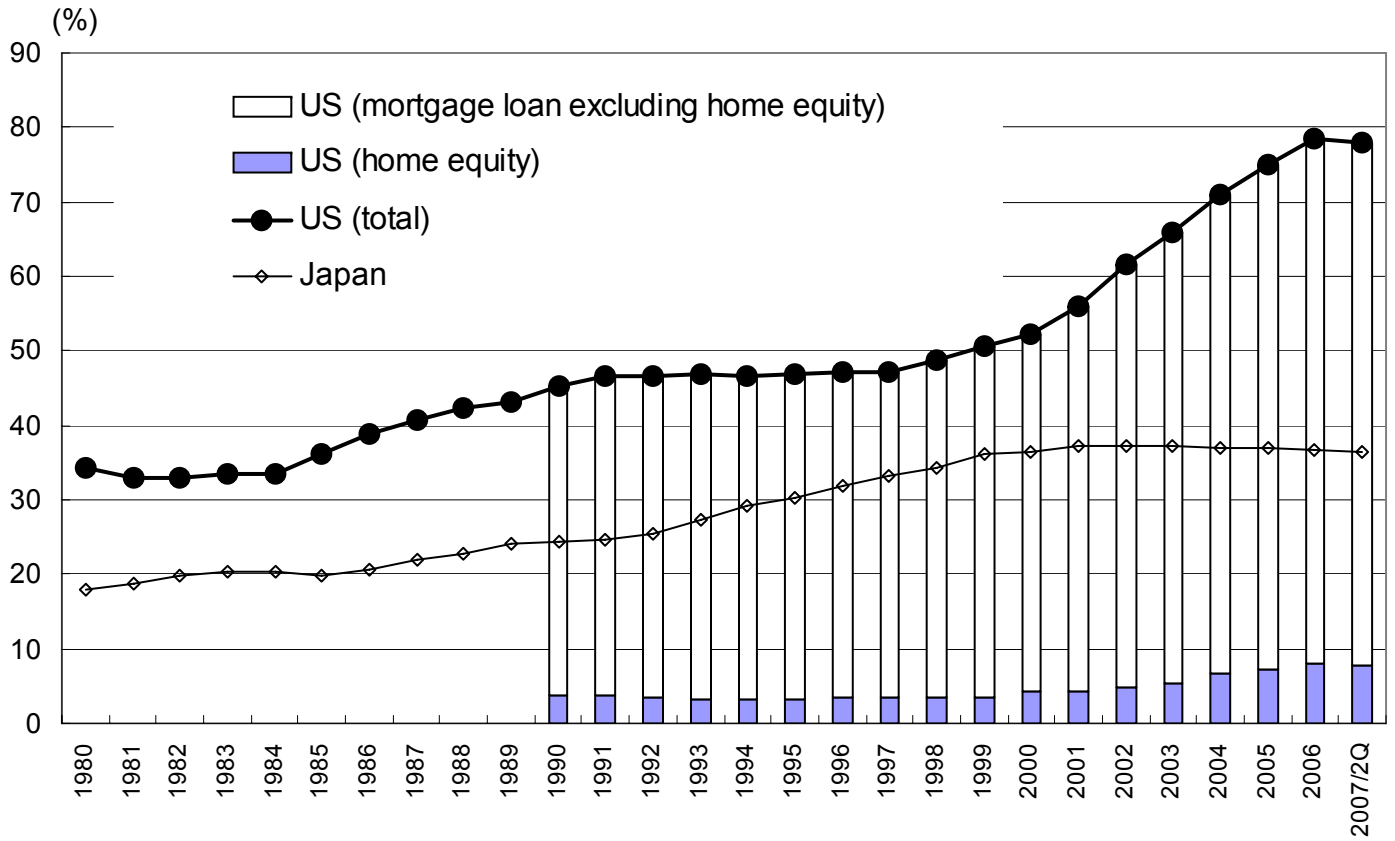
U.S.: mortgage loans

Japan: bank credit centering on real estate, construction and distribution sectors

The size of increase in the mortgage loans divided by U.S. nominal GDP above the historical trend was about half of the Japan's excessive provision of bank credit.

The U.S. nominal GDP is more than double that of Japan. This may imply that the potential loss associated with excessive loans will be about the same size in the two countries. In the case of Japan total loss incurred by financial institutions was about ¥100 trillion.

Housing Loans・GDP Ratios



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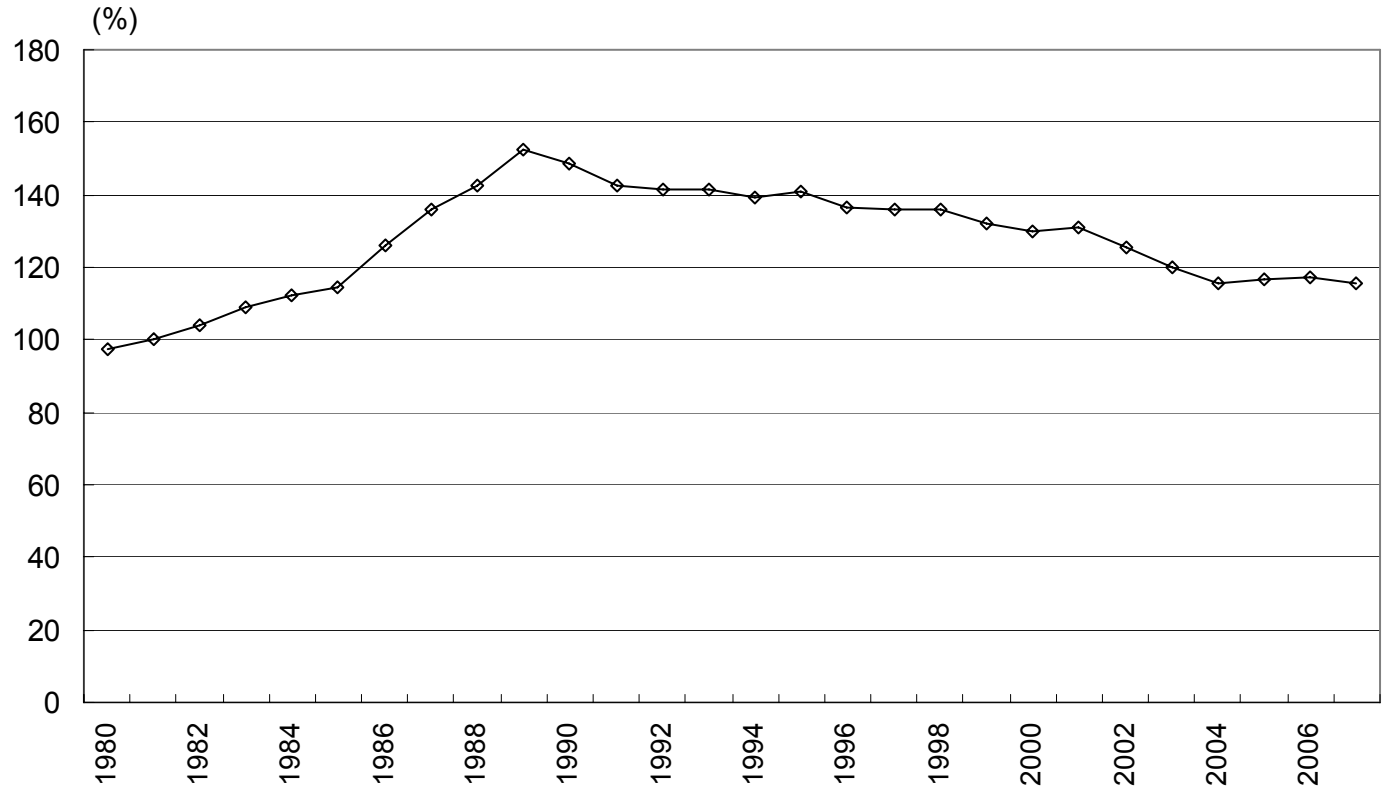
Bank Lending・ GDP Ratio（Japan）



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Difference in Spreading Risks(I)

1.Risk Distribution

U.S.: wide spreading risk through securitization and off- balance transaction via SIVs, SIV-lites and ABCP conduits led to the increasing loss incurred by banks

-maturity gap: the asset side consists of long maturity assets such as ABS,CDOs and CDS, while the liability side is financed by ABCP(90 days maturity on average) exposed to funding liquidity risk in the “shadow banking system”

-regulatory and ratings arbitrage: Basel I required no charge on reputational credit line. A-rate products are transformed into AAA-rated products in collaboration between the issuers of CDOs and rating agencies.

–liquidity risk was disregarded

-banks’ concern was only “pipeline risk”(no incentive for monitoring and due diligence)

Japan: concentration on private banks’ balance sheet

Difference in Spreading Risks(II)

2. Problems of Information Asymmetry

U.S.: parade of moral hazard(lack of supervision on mortgage lenders), adverse selection (lemon market on collateral) and agency problem(fund managers and investors) at various stages of processing the securitized products; excessive reliance on rating agencies and the Monoline as a provider of insurance). They tend to aggravate the underestimation of risks.

Japan: moral hazard in bank lending

Response by Banks

1. Disclosure and Capital Enhancements

U.S.: quick disclosure and capital enhancements, although there remain the issues:

- as to whether the latitude for the treatment on complex products is allowed to adopt the assessment based on the "mark-to-model", instead of "mark-to-market" , when the market liquidity is under stress(for instance, assets identified as the level 3 of the accounting rule157 is increasing).
- as to whether the reliance on the SWF can be sustained($38 billion from November to mid-January). The sound recovery with stable value of dollar is essential to maintain the capital inflow to the U.S..

Japan: slow and opaque disclosure tended to delay the capital enhancements . Yet,

- this time the early implementation of the Basel II (March 2008) seems to have reduced the risk exposure of the Japanese banks from the sub-prime and credit problem.

Policy Response(I)

1. Monetary action: Liquidity Provision

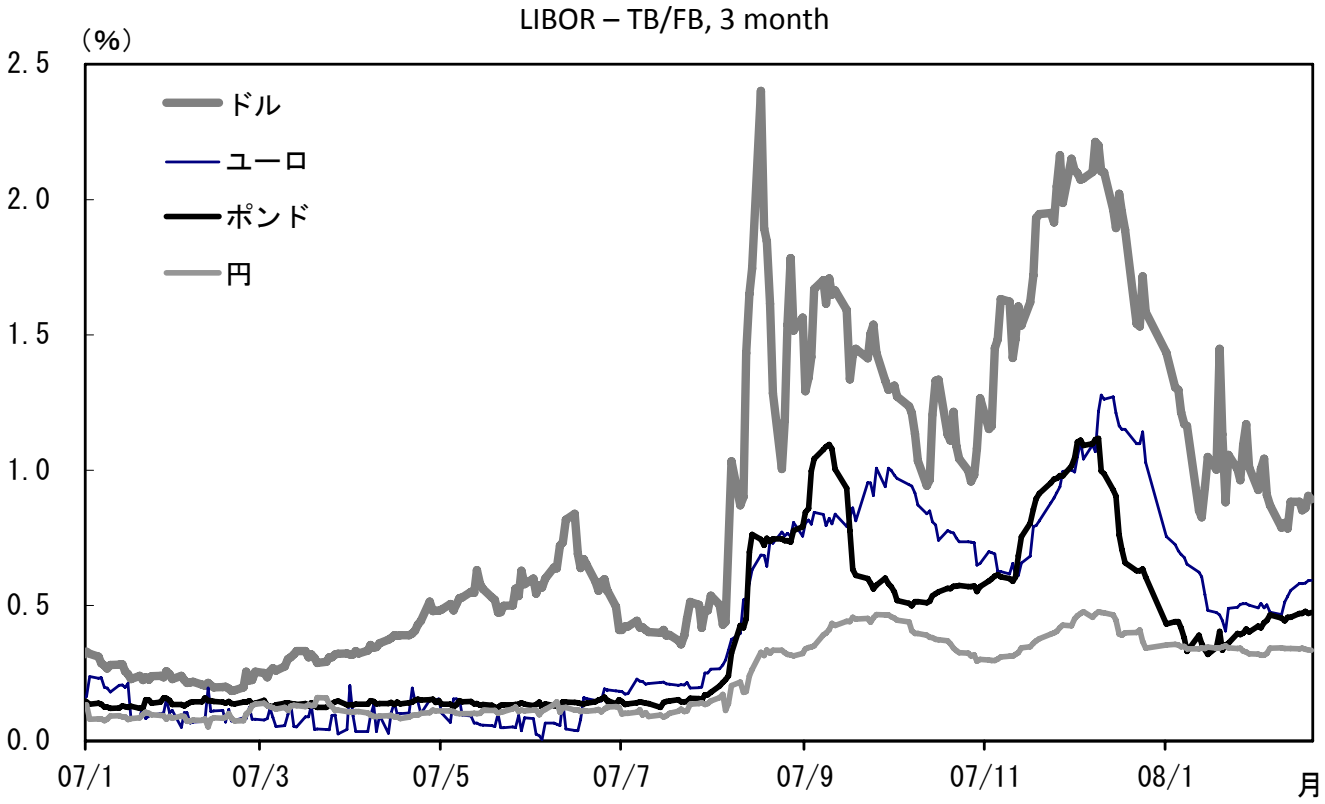
U.S. : massive liquidity provision with longer maturity through newly introduced facilities such as the TAF, the TSLF, the PDCF and the Swap arrangement with the ECB and the SNB. Yet,

- there is the balance sheet constraint of the FED because the bank reserve is unchanged. There are three solutions such as the zero rate, the corridor scheme and TB provision by the Treasury.
- Krugman interpreted the FED action as “pawnbroker of last resort” similar to sterilized intervention
- the Black Swan(=the highly unusual events) is still alive on money market : large Libor-OIS spread represents default and liquidity risk because of the counterparty credit risk.

Japan: liquidity provision under the quantitative easing policy which worked to calm down the financial unrest and played the complementary role to the expectation channel effect in controlling market interest rates(as exemplified by lower forward rate due to the liquidity effect with increase in targeted bank reserves).

- liquidity provision accompanied by selling operation of the BOJ bill and government bonds at zero interest rate

TED Spread



（注）ポンドのFB/TBは、3か月物レポレートで代用。

（出所）Bloomberg

Policy Response(II)

2. Monetary action: Loan provision in emergency

U.S.: loan ($29 billion)provided to Bear Sterns (more precisely, the SPC managed by the fund) through the JP Morgan based on the Article 13-3 of the Federal Reserve Act. This may be interpreted as the combination of the Swedish "bad bank" and the Japanese special loan.

-the action was taken based on the recognition of being "too interconnected to be allowed to suddenly fail"(the network and gridlock effect) , not "too big to fail".

Japan: special loan provided to the Yamaichi securities company through the Fuji Bank.

Policy Response(III)

3. Monetary action : Policy rate after bubble burst

U.S.: “timely” cut in policy rate from 5.25% to 2%, yet

- the housing loan rates have not responded to lower policy rate and the credit conditions were tightened.

- the sole use of “optimal response” by the FED seems to be not sufficient to avoid recession and terminate the financial market turmoil.

Japan: delayed action which eventually led to the zero bound on policy rate.

Policy Response(IV)

4.Fiscal actions

U.S.: measures to contain the sharp rise in foreclosure such as:

-the “FHA Secure”(the guarantee by the FHA in refinancing good quality loans)

- tax cut in good timing, although the effect may be only temporary(Q2 and Q3)

-the proposal to cut the debt and refinance ($300 billion) or the “negative equity certificates”(the Office of Thrift Supervision) or the Brady Bond.

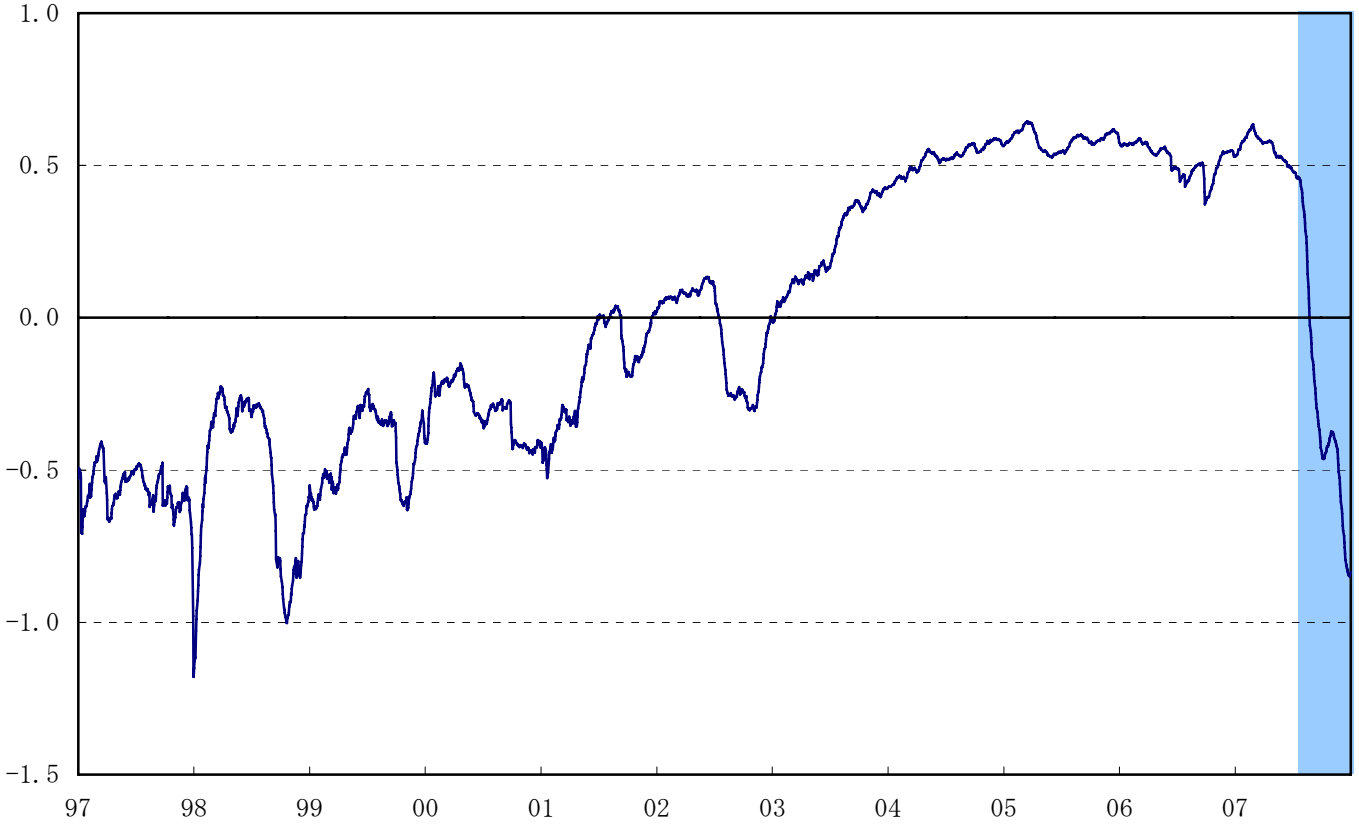
Japan: massive increase in public investment and capital injection amounting to ¥12 trillion with purchase of NPL’s amounting to ¥7 trillion, in addition to the compensation for loss and deposit protection (¥20 trillion).

Conclusion

1. It is important to strengthen the transparency on the balance sheets of financial institutions. Opaque financial statements may not only enhance the perception of counterparty credit risk, but also delay the adoption of timely response by banks and policy.
2. It is also important to strengthen the risk management by financial institutions, notably with respect to funding and market liquidity risks: the size of balance sheets including off-balance sheet activity matters.

   -ample “funding liquidity “ (awash with liquidity) dried up suddenly due to the change in “market liquidity”.
3. Timely monetary action with ample provision of liquidity is needed, yet the consequence of lax monetary policy on global financial market cannot be neglected.
4. Fiscal actions should be focused on the key area to remedy the root cause of problems.

Global Market Liquidity



為替・株式・クレジット・短期金融市場の流動性指標（ビット・アスク・スプレッド、リターン・トゥ・ボリューム＜価格変動の絶対値を取引高で除した指標＞等）をそれぞれ標準化したうえで、それらを単純平均して指数化。計測の方法は、BOE（2007）Financial Stability Reportと、ECB（2007）Financial Stability Reviewを参考にしている。

日本銀行「金融市場レポート」