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"Financial Turbulence and the Global Financial System"
A Pre-G8 Finance Ministers' Meeting Symposium

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

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Session 1: Sub-prime crisis – lessons from Japan's financial crisis

Comments by Paul Sheard, Managing Director/Global Chief Economist, Lehman Brothers

Look at three issues:
- differences b/w Japan and the US
- similarities
- lessons to be derived

Differences:

1) Nature of the bubble:
Japan: commercial real estate/equity market
US: residential housing/credit market

2) Size of the bubble
- Japan bigger in relative terms: absolute size perhaps similar (IMF estimate) but US economy more than twice size of Japan's and half losses fall outside of US

3) Nature of the financial system:
Japan: commercial banking system
- loans (asset side) and deposits (liability side)
- book value/not marked-to-market; not traded

US: capital markets
- originate-and-distribute, securitization model
- traded, mark-to-market system

4) Regulatory response
Japan: forbearance/slow workout/government-driven
US: regulatory pressure/quick workout/market-based

5) Expected duration:
Japan: 10-15 years from beginning to end
US: probably 2-3 years

Similarities:

Both are financial crises, so share certain common aspects; just highlight three:
1) evolve over time, periods of calm/relief rallies between string of crisis events often "migrating" around segments of the financial system
2) involve run for the exit by suppliers of short-term finance (Japan: bank depositors; US: short-term liquidity providers)
3) loss of trust/confidence in accounting values (Japan: NPLs; US: level-three assets), "monitors" (Japan: main banks/bank regulators; US: rating agencies/monolines/investment banks) and counterparties

<u>Lessons</u>:

1) Don't let problems fester: Quickly recognize and deal with asset impairment problems

2) Don't let need to prevent collapse in financial system stand in the way of 1)

3) Monetary policy works *through* the banking/financial system: when the problem is a broken banking/financial system itself, it is internally inconsistent to expect monetary policy alone to be able to fix it

4) Undertake multi-pronged, coordinated, aggressive policy response:
- i) expansionary macro policy (monetary and fiscal policy easing)
- ii) financial stabilization policy
- iii) surgical tailor-made policy

US scores highly on these expect 4)iii), where policies to head off looming foreclosure shock (Lehman Brothers mortgage strategy team estimate: foreclosures to rise from 400,000 in 2007 to 1.2 million in 2008 and 1.4 million in 2009) look inadequate.