

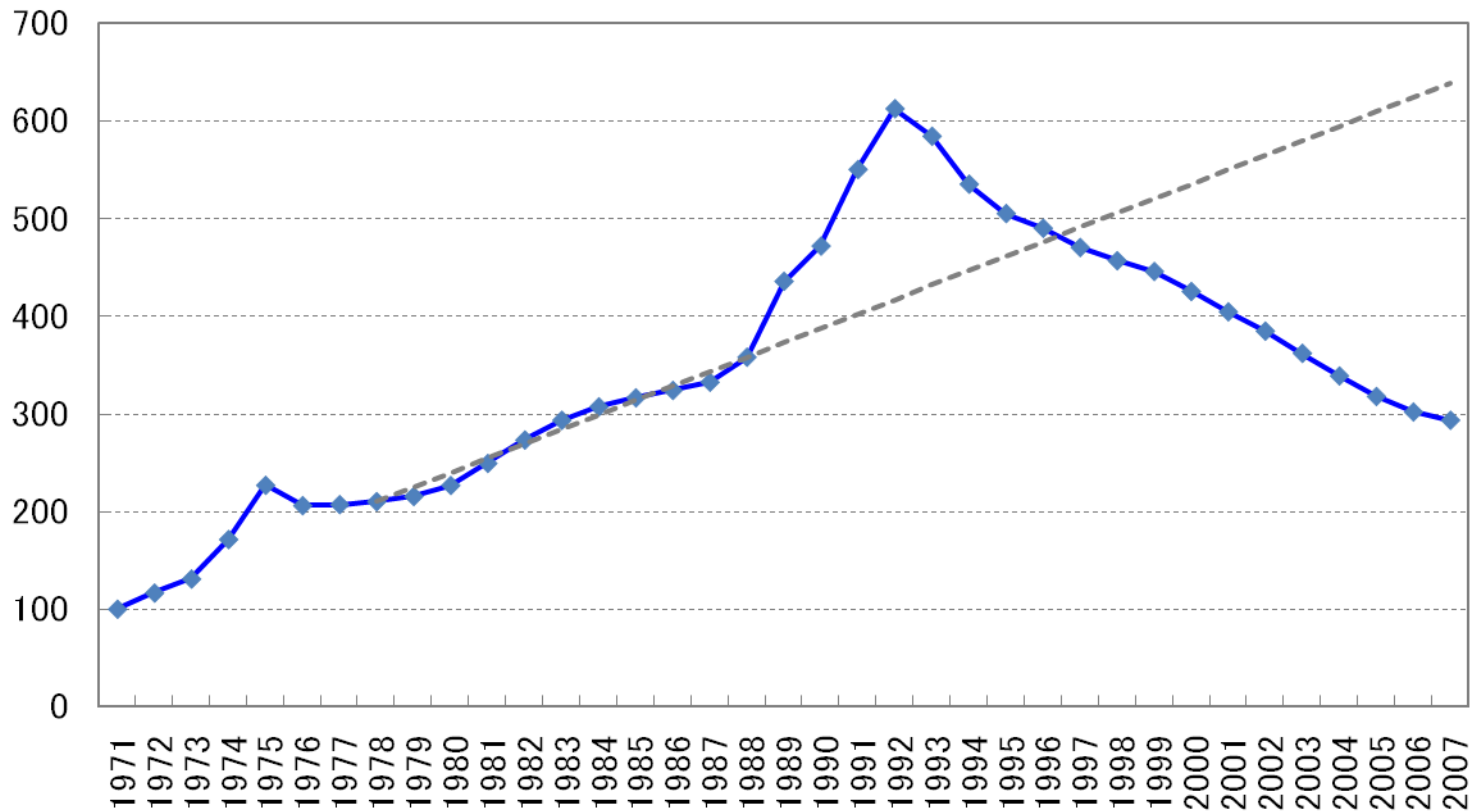
Post Crisis Financial Management

Why Bad Asset Disposition should be the policy objective?

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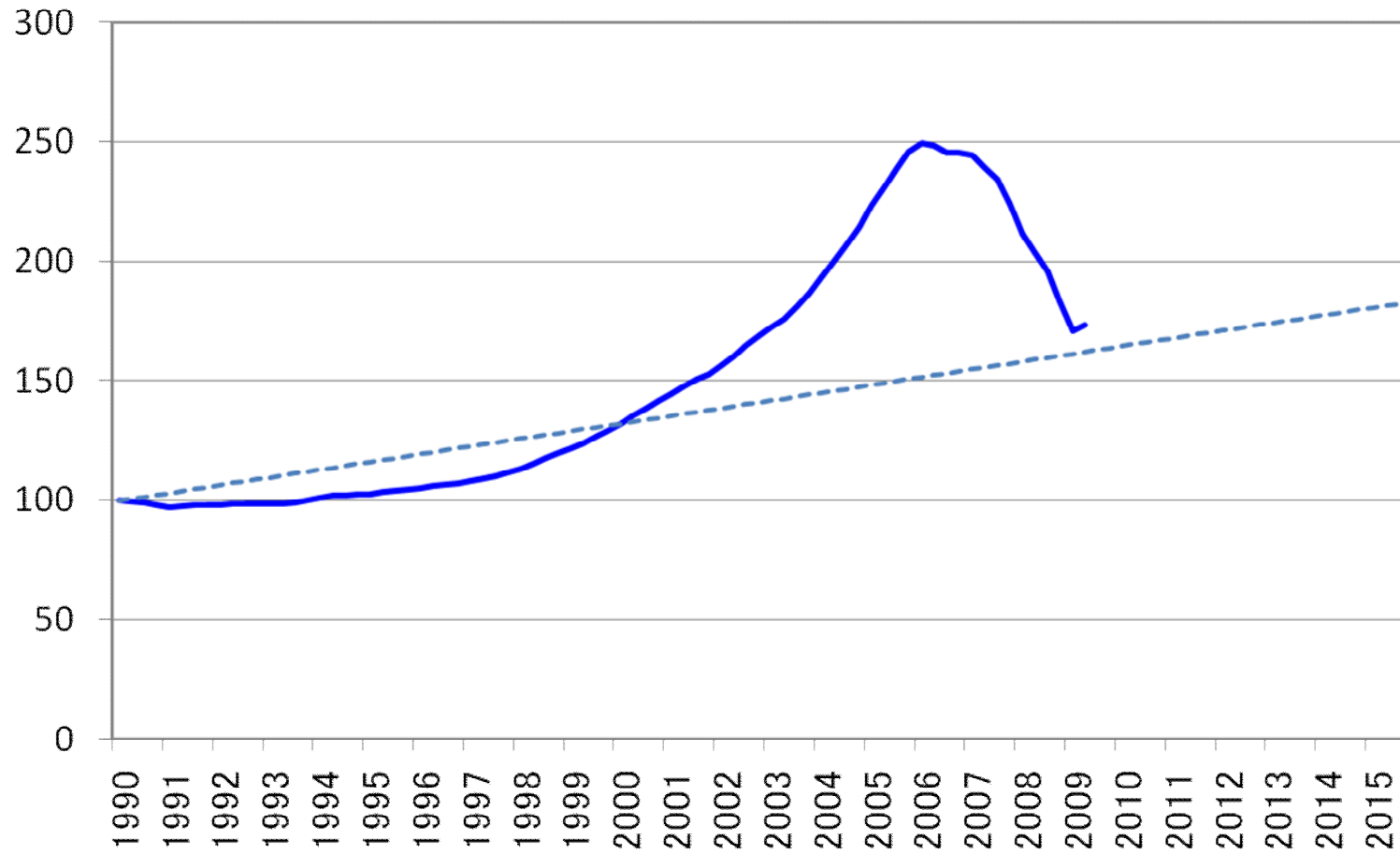
Japan's land price bubble

Official Land Price Index in Japan



Source: Ministry of Land, Infrastructure, Transport and Tourism.

S&P Case-Shiller U.S. National Home Price Index

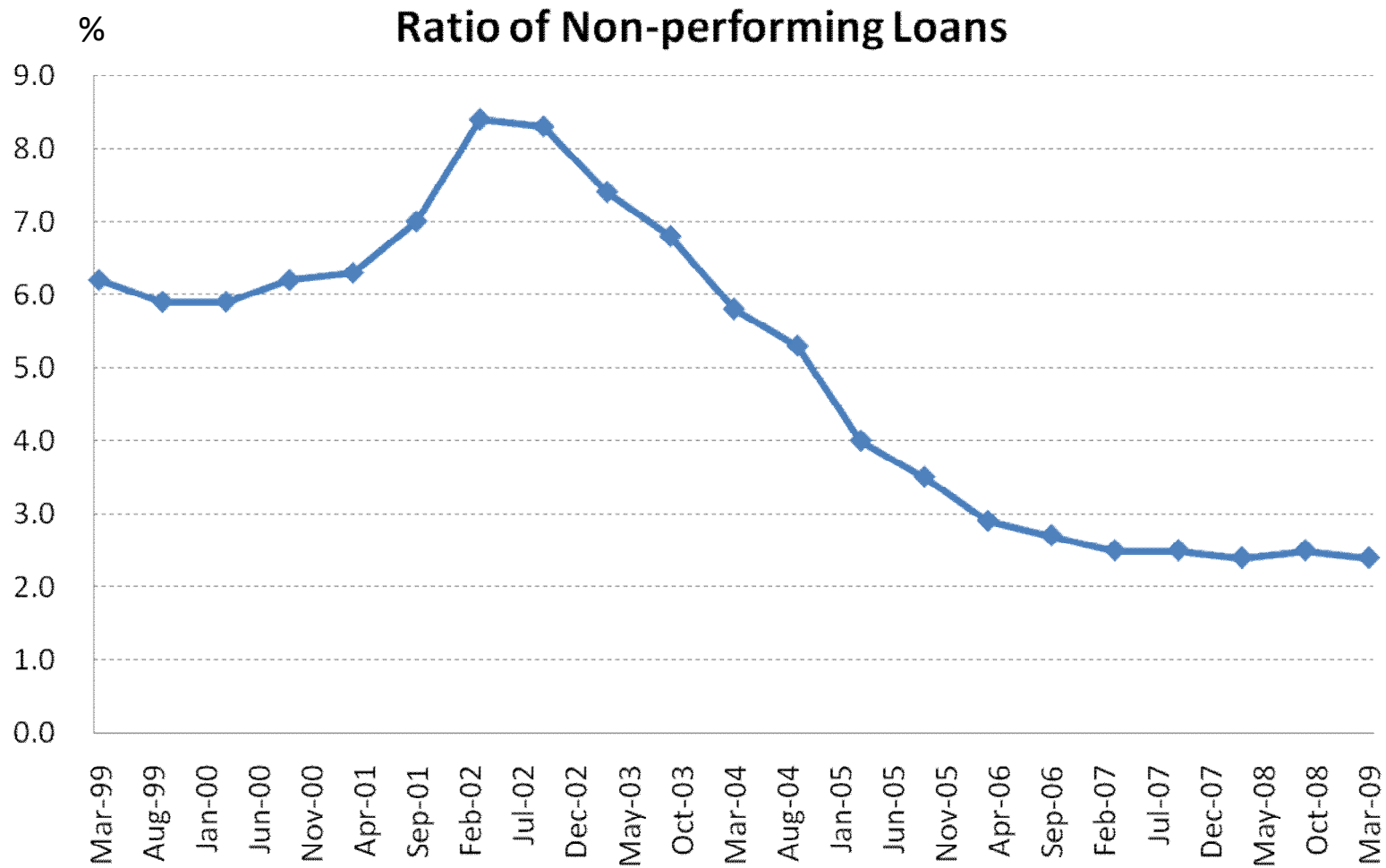


Source: S&P/ Case-Shiller Home Price Indices.

Nonperforming loans problem and protracted recession


■ Financial Crisis Management of Japan and US

JAPAN			US	
1991	Peak of Land Price	<i>Turning Point</i>	2006	Peak of Housing Price
1994	Failure of Tokyo Kyowa and Anzen Credit Cooperative	<i>Individual Arrangement</i>	March 2008	Bail-out of Bear Stearns
1995	Failure of Hyogo Bank and Kizu Credit Cooperative		July 2008	Failure of IndyMac Bancorp
1996	Public Injection to Jusen		7 September '08	2 GSEs became under US Government control
1997	Failure of Hokkaido Takushoku Bank and Yamaichi Securities		15 September	Failure of Lehman Brothers
1998	Nationalisation of Japan Long-Term Credit Bank and Credit Bank of Japan		16 September	AIG under Public Management
			25 September	Failure of Washington Mutual Bank
1993	Set up of Cooperative Credit Purchasing Company (CCPC)	<i>Purchase of Toxic Assets</i>	20 September	Announcement of Plan for Purchasing Toxic Assets
1999	Set up of the Resolution and Collection Corporation (RCC)			
2003	Set up of Industrial Revitalisation Corporation of Japan			
1998-99	Public Injection to Major Banks 9.3 Trillion Yen j	<i>Public Injection to Financial Institutions</i>	14 October	\$250 Billion were provided
June 2003	Public Injection to Resona Bank 1.96 Trillion Yen j		October 2008	Injection to 9 Major Banks (\$125 Billion)



Source: Financial Service Agency, Bank of Japan
<http://www.fsa.go.jp/status/npl/20090807/01.xls>

Why policy response was so slow?

- Too much dependence on fiscal stimulus policy
- No hot money from abroad
- Current account surplus in Japan
( Current account deficit in U.S.)
- No recognition of the social cost due to external diseconomy of bad-debt mess

Bad assets and recessions

- My conjecture is that “bad assets hidden in the financial sector hinder economic growth”
 - Bad assets destroy inside money (= Bad assets disrupt the payment system)
 - Disappearance of money disrupts economic transactions
 - Output declines and unemployment increases
- Deflation is also a consequence of a protracted bad asset problem
 - Disappearance of money causes deflation.
- We may need “A Bad-Asset Theory of Financial Crisis”

A Bad-Asset Theory of Financial Crisis (1/3)

- Hidden bad assets destroy inside money through information asymmetry (the Market for Lemons, Akerlof 1970)
 - Money = Media of exchange in economic transactions = a public good
 - Inside money = short-term debts of financial institutions (e.g., deposit money, repo)
 - The value of inside money is guaranteed by the assets of the financial institutions
 - Emergence of bad assets = Severe information asymmetry about asset quality

A Bad-Asset Theory of Financial Crisis (2/3)

- Market participants cannot distinguish good assets from bad assets
- Confidence in the value of assets breaks down completely (The Lemon Problem)
- Run on short-term debt (= equivalent to Bank Runs in the 1930s)
- Money disappears (= Disappearance of a public good = Externality)

A Bad-Asset Theory of Financial Crisis (3/3)

- Malfunction in financial intermediation (= Liquidity shortage)
- Economic transactions are disrupted
- Output declines and unemployment increases
- Shortage of inside money causes deflation

Why a Bad Assets Problem causes a persistent recession?

- Bad assets problem = the lemon problem = disappearance of a public good due to information asymmetry = External diseconomy
- Banks cannot internalize the social cost of bad assets
- Banks have no proper incentive to reveal bad assets
- Hidden bad assets continue to exist for years
- Information asymmetry continues for years
- Economic disruption continues for years

Why is policy intervention necessary?

- Bad assets problem = the lemon problem = disappearance of a public good due to information asymmetry = severe externality
- Banks do not internalize the social cost of the lemon problem
- Banks do not have proper incentive to reveal and dispose of bad assets
- Government intervention is necessary

Implication from the bad-asset theory

- Bad-asset disposals are effective for both recession and deflation
- Government intervention is necessary to accelerate the bad-asset dispositions

■ Public funds injected were 47 trillion yen, of which 10 trillion were lost

第2-3-18表 日本の金融危機時の主な対応策

公的資金の投入約47兆円のうち、国民負担は約10兆円

(2009年3月末、億円)

	投入実績等	回収等累計額等
預金保険機構による投入 (注1)	472,042	328,356
不良債権買取	97,775	97,196
資本注入	125,484	108,147
破綻処理 (預金保護等)	188,673	74,357 (注2)
その他 (銀行国有化等)	60,110	48,656
日本銀行による株式買取	20,180	
小計	492,222	328,356
中小企業への特別信用保証	289,436	(注3)
産業再生機構への政府保証	100,000	(注4)
合計	881,658	

Practical lessons on bad assets

- Rehabilitation of the borrowers is crucial
 - Not just numbers on bank balance sheets
- Need a turnaround of failed businesses and households
- Not macroeconomic policy but microeconomic approach
- AMC, asset management companies, that rehabilitate bad assets and bad companies
 - IRCJ, RCC in Japan
 - RTC in the U.S. Great Depression

Policy intervention to accelerate disposal of bad assets

- Stringent asset assessment of banks by regulators (“Stress test”)
- Stress tests should be repeated
- Stringent bank accounting rules
- A large amount of public funds for capital injections should be prepared
- Policy for rehabilitation of borrowers
(Establishing public organizations that manage the rehabilitation processes may be crucial)

Toward a new monetary policy rule

- Unexpected Increase in Bad Assets causes Unexpected Decrease in (Inside) Money
 - Central Bank should increase money supply in response to emergence of bad assets
- Monetary policy should respond to d (the bad asset ratio of banks).
- Taylor Rule can be augmented:

$$i = \bar{i} + \alpha(\pi - \bar{\pi}) + \beta x - \gamma d$$

Conclusion

- Bad assets cause severe externality.
(Malfunction of financial intermediary,
disappearance of inside money)
- Policy intervention to accelerate the disposal
of bad assets is justified
- Monetary and fiscal policies are just
painkillers