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Bank of Japan

The Consequences of the Great Financial Crisis: Five Years On

Remarks at the Institute of International Finance (IIF) 30th Anniversary Annual Membership Meeting in Tokyo

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Introduction

This evening, I am honored to speak to you on the occasion of the dinner at the center of the 30th anniversary celebrations of the Institute of International Finance (IIF). I would like to thank Douglas Flint, Chairman of the Institute and Charles Dallara, the Managing Director for kindly extending this invitation.

Before I go any further, I wish to offer my heartfelt congratulations to the Institute of International Finance and its members, for the valuable role that they have played, over the last three decades, in organizing the international financial community. The Institute of International Finance was established in response to the Latin American Debt Crisis of the early 1980s. It is likely that nobody at the time probably expected the following 30 years to be marked by many more episodes of turbulence in the international financial markets. The 1980s were relatively quiet, but 1994 saw the return of troubles to Mexico. Just three years on, in 1997, we saw the Asian Financial Crisis unfold. This was followed by crises in Russia, Turkey, and Argentina after the turn of the century. In 2007 we saw the start of the Great Financial Crisis, which is still not resolved, especially on the European continent.

On each occasion, the Institute played an important role in the resolution of these crises. It has built up a reputation as the primary collective voice of private bankers. Of course, relations with the official community were not always smooth. For example, the Institute was initially quite critical of the Brady Plan when it was introduced in 1989. A report by the Institute at that time argued that the Plan had engendered a loss of discipline in the international financial system. Nonetheless, the industry consensus represented by the Institute was always an important input.

As the voice of the industry, the Institute has branched out into other areas. One such area is its active participation in the process of formulating rules and practices of the international financial system. Most recently, we have had a good working relationship during the Basel III reforms. Again, the official community may not always agree with every word of what the Institute says, but I can assure you that we are listening carefully. Today, I will just scratch the surface of all the good work that the Institute has undertaken, but this does not diminish the enormous value of what has been accomplished.

Five Years after the Great Financial Crisis

Now, let me move on to today's main topic, the Great Financial Crisis and its consequences.

It is now more than five years from the day -- August 9, 2007 -- when three hedge funds sponsored by BNP Paribas suspended redemptions, marking the beginning of the Great Financial Crisis. For all the efforts by the public and private sectors, global growth leaves much to be desired. But how have we fared from a broader perspective? I would like to offer you my views from three angles: crisis management, economic recovery after the crisis, and preventing a recurrence.

First of all, from the perspective of crisis management, we did succeed in averting a repeat of the Great Depression of the 1930s, and this can largely be attributed to the developed economies' decisive and concerted policy responses. From the perspective of central banks, monetary policy was eased on an unprecedented scale. Far more importantly, the proactive provision of emergency liquidity -- acting as the lender of last resort -- contributed significantly to preventing events from getting out of control. Furthermore, one should not underestimate the benefits of improvements in the plumbing of the markets, which were patiently pushed forward, in cooperation with the public sector, over the last 20 years. Examples of such efforts include ensuring delivery against payment in the securities markets, effecting real-time gross payment through central bank accounts, and dealing with the Herstatt Risk via Continuous Linked Settlement payment-against-payment scheme.

Turning to the state of the economy, as I have just noted, the global economy has not yet returned to a robust growth path. In fact, over the last five years, there were only occasional glimmers of hope. Nevertheless, in light of the experience of the bursting of the Japanese bubble, I had always been a little skeptical and suspected that those glimmers might just be false dawns. Output in the advanced economies has barely exceeded the levels before the crisis. It is inevitable that economic activity would stagnate while debt is being reduced, because economic agents would reduce expenditure in order to repay their debts.

In this regard, if I may deviate a bit, it is somewhat misleading to describe such a process as a "lost decade." These words connote that some output is gone forever, forgetting that there was actually a "bloated decade" preceding this period. We must instead keep in mind that recovery cannot begin in earnest until excess debt is worked off. Unless we come to terms with this fact, recovery could be endangered by the adoption of inopportune and inappropriate policies, driven by discontent among the general public, that could erode efficiency and destabilize the global economy. It is important, therefore, to avoid inflicting collateral damage from impatient policy choices following the acute phase of the Crisis.

Before moving on, let me comment briefly on the ongoing efforts to prevent a recurrence of the Crisis, where important advances are seen, for example, in strengthening bank capital rules, reforming OTC derivative markets, and holding systemically important financial institutions to account for the risks they take, reflecting the commitment made by the G-20 leaders at their meeting in Pittsburgh in the autumn of 2009. Nevertheless, we should not pretend that we can reach nirvana without encountering any crises, if we just continue refining and strengthening these arrangements.

One important lesson of the Great Financial Crisis was that the stability of the financial system was more than the sum of well-regulated, well-supervised and well-managed institutions. The keyword is "macroprudence," which describes the additional policy perspectives that are necessary to achieving systemic stability. This concept is not a particularly new one. People were gradually becoming aware of it before the Crisis. The Crisis has shone a spotlight on its importance, and policy makers around the world have their work cut out for them in terms of enhancing the functioning of such policies.

In this regard, one critical issue that has become apparent is the role of the sovereign in ensuring financial stability. When the financial system is on the verge of a meltdown, as happened in 2008, only the sovereign can become the ultimate backstop. As a result, when the ability of the sovereign to provide support is in doubt, a vicious spiral develops between it and the financial system. The problem is becoming more acute, because the ever increasing burden of supporting the financial system under deepening globalization is on a potential collision course with the democratically governed sovereign state. The call

for "no more taxpayer bailouts" is perfectly understandable, given that the staggering bills for cleaning up after the collapse of a globally operating bank could easily overwhelm a nation's ability to raise taxes. The slow recovery of trust in financial institutions is making it difficult to come up with a sensible solution, because a bank that is not trusted by the market is more likely to need sovereign support under the slightest duress, and the lack of public trust will make it more difficult for the sovereign to strategically deploy the safety net. I hope that all of you gathered in the room today will think through these issues with me in the coming months.

The Relevance of the Japanese Experience

So, the global economy is in a difficult situation. Nevertheless, I do not believe that all is lost. The global economy can return to a path of stable growth and policy does have a part to play in the process. Let me elaborate my thinking in the remaining time, while keeping an eye on the collateral damages that could be inflicted, as I noted a few moments ago. The Japanese experiences gleaned over the years offer some valuable insights.

The Japanese economy returned to a path of relatively consistent growth after 2003. It was more than ten years after the initial signs of the bursting of the bubble became evident, but Japan enjoyed the longest post-war economic expansion. Three factors contributed significantly to that development. Firstly, a long process of deleveraging had ended. The amount of loans outstanding relative to GDP, which peaked around the beginning of the 1990s, finally returned to the levels seen in the mid-1980s by around 2003. Secondly, global growth remained at an elevated level for a long time, averaging around 5 percent annually from 2004 until the failure of Lehman Brothers in 2008. While this number was inflated by the unprecedented credit bubble, it was significantly higher than the 3 percent level of the 1990s. Lastly, the yen was generally weak. After appreciating slightly towards the end of 2003, the real effective exchange rate began a long descent until the middle of 2007, falling about 30 percent over that period. Contrary to popular perception, the yen was relatively strong when the Bank of Japan was embarking on and expanding quantitative easing, and accelerated its decline after the end of quantitative easing in March 2006. The divergence in interest rates -- the continuation of ultra-low rates in Japan and higher rates reflecting robust growth elsewhere -- encouraged the so-called yen-carry trades,

and contributed to the trend.

You might find these facts rather depressing. If the global economy were to take as long as Japan to de-lever, we might only be halfway through the process. Since most advanced economies are mired in low growth, strong external demand cannot be relied upon, considering the large share of advanced economies in the global economy. It is impossible to depreciate all currencies at once. That is why there is a lot of talk about the emerging economies becoming an engine of growth in the global economy. Conceptually, with their rapidly rising share of global output, emerging economies could pull the advanced economies out of the morass. The question is whether this is possible. The key is to enhance the growth potential of the global economy.

Here again, one might find a clue in Japan's experiences.

As you know, it was 48 years ago, in 1964, that the IMF-World Bank Meetings were last held in Tokyo. From April of that year, Japan acceded to Article VIII of Fund Articles, liberalizing current payments. The same month, Japan formally became a member of the OECD. The first Shinkansen bullet train, which was partly funded by the World Bank, began running between Tokyo and Osaka just a few weeks after the Meetings, in October. Japan was the emerging market of the day. Delegates to the Meetings were able to see firsthand the economic miracle that was unfolding. From 1956 to 1964, the Japanese economy grew at an annualized rate of 9.4 percent. In the following five years, it continued to speed along at double digits (10.2 percent, 1965 to 1969), and in 1968, Japan became the second largest economy in the West.

Today, China is growing at a breakneck speed, just like Japan did back then. The annualized growth rate over the last 20 years (1992 to 2011) is 10.5 percent, which is in line with the growth seen during Japan's miracle years. The question is: how many more years can this continue? While one should be wary of drawing simple analogies, living standards in China -- for example estimates of per capita PPP GDP -- are now about the same as Japan in 1964. Meanwhile, at market prices China has surpassed Japan's 1964 GDP in 1999.

In the case of Japan, double-digit growth continued for 15 years, between 1956 and 1970, and after a sharp downturn in economic activity in 1971, trend growth became gradually lower. In retrospect, this was inevitable. From the perspective of population and labor supply, the suppression of wages reflecting the movement of the labor force from the countryside to the cities ended in the first half of the 1960s. The share of the working-age population (aged 15 to 64) reached its peak in 1969. Meanwhile, the working-age population itself began to decline in absolute terms since 1996. The end of these two types of demographic bonuses should have been one of the main determinants of the inflection in trend growth.

Having said this, I must note that it is most difficult to concurrently monitor such a change. An economy does not grow in a straight line. It could slow down significantly once every few years, even if average growth over a decade ultimately turns out to be in the double digits. Notwithstanding such difficulties, macroeconomic policy must adapt, or else, the economy will suffer. During the 1970s and 1980s, Japan's economic performance was generally better than that of other advanced economies, but the two decades were punctuated by a period of high and persistent inflation in the first half of the 1970s, and the 1980s ended in the infamous bubble. While the causes of these developments are complex, macroeconomic policies and business decisions that did not sufficiently take account of declining potential growth were certainly contributing factors. Despite the difficulties, policy makers must ensure that the economy would only suffer minimal disruption in the transition from high growth to medium or lower growth.

Towards a Global Perspective of Policy

What, then, lies ahead of us in terms of economic policy?

In the abstract, the key issue is to conduct individual national policies with an eye on the sustainability and stability of the global economic system as a whole. Looking at the advanced economies, short-term interest rates are virtually zero and long-term rates are at historically low levels. Central bank balance sheets have expanded to a level unimaginable before the Crisis. There is little room for further decline in interest rates,

which is the traditional channel for monetary policy stimulus. At the same time, fiscal policy is largely constrained because of deteriorating public finances. In such a situation, where options for stimulating the economy via domestic channels are limited, it is understandable that the prevailing policy discussion tends to focus on the exchange rate or demand from the emerging or resource-producing economies.

From the perspective of the emerging or resource-producing economies, this puts them in an awkward situation. Many of these economies have adopted fixed or quasi-fixed exchange rate systems, with the result that monetary easing by the advanced economies would feed directly into their economies. Every policy decision is reasonable by itself, but the aggregate effects or the cross-border spillovers might point towards a global easing bias. These unintended consequences may have parallels with the environment that gave rise to the great credit bubble of the 2000s.

In order to avoid any misunderstanding, I am neither saying that inflation is imminent nor that a credit bubble is now brewing at the global level because of central bank actions. Nevertheless, too narrow a view on policy could result in the collateral damages that I noted earlier this evening. With the deepening of globalization, no responsible policy maker could now dismiss the cross-border spillovers and feedbacks of their policies. Central banks are buying time, judging that the benefits of easing -- such as alleviating the pains of deleveraging -- would outweigh the costs. The time must be used wisely, because monetary policy cannot replace structural policies undertaken by governments, as well as deleveraging of the economy.

Concluding Remarks

In the 1980s, when we had to resolve a crisis, we almost literally locked you up in a smoke-filled back room and told you that you would not be able to leave until you came up with a workable plan. This is no longer the case. First of all, nobody is allowed to smoke indoors these days. More substantively, structural changes in the international financial system -- for example, the shifting of international financing from bank loans to negotiable securities -- and the resulting diversity of stakeholders is making it more difficult to form a consensus on any issue.

A global policy perspective, which I have floated today, has become necessary and at the same time more difficult to adopt because of these changes. In order for this to happen, central banks must accept a longer time-frame, at least as long as the entire business cycle. Financial cycles, which could be much longer, are also important. Markets are often short-sighted, but financing of the economy was, still is and will ever be a long-term business. If financial institutions uphold this principle, policy makers can continue working with you. As it has done over the last 30 years, I do hope that the Institute will continue evolving in order to make further contributions to the international financial community.

Lastly, I would like to congratulate and thank, once again, the Institute for its contributions to the international financial community over the last 30 years. Thank you very much for your attention.