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A L E R T

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## LESSONS FOR US FROM JAPAN'S BANKING CRISIS

Testimony for  
Congressional Oversight Panel  
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## **Key Lessons**

### **Differences in the Nature of the Crisis**

Japan's experience is mostly a lesson in mistakes to avoid. In addition, the banking crisis in Japan has very different roots from the American problem. In Japan, the root of the problem was in plain vanilla loans because too many nonfinancial companies were losing money. The banking crisis reflected a crisis in the real economy. Too many firms made products that were not worth what it cost to make them. The losses on bad debt added up to 20% of GDP. Behind every bad debt was a "bad borrower" that needed to be downsized or even liquidated. But, given the weakness of Japan's governmental social safety net, a person's current job at their current employer was the main social safety net. Fear of job losses and corporate failures made policymakers reluctant even to admit the problem, let alone solve it. It took Japan ten years before it seriously began to resolve the bad debt problem at the heart of the banking crisis. The effect was to stall growth. The presence of money-losing zombies willing to cut prices to the bone in order to survive made it difficult for healthier firms to sell at profitable prices. Because of the life support given to the zombies by the banks, most of the firms that ended up going under were often more efficient than those who were propped up due to political connections. To some degree, it was survival of the least fit.

In the US, the converse is true. It is not problems in the real economy that are causing a financial crisis, but a financial crisis that is causing problems in the real economy. Outside the auto sector, most US nonfinancial companies are in good shape. There are far more losses due to markdown of derivatives than from actual defaults on loans. But the "shadow banking system" of unregulated mortgages by nonbanks and derivatives has become dysfunctional. Its crisis is now causing a crisis in the real economy via a credit crunch. The debt problem of most nonfinancial companies and households is not the cause of America's crisis, but its result.

If Japan had acted in time and properly, it could have avoided a decade of stagnation, even though its myriad structural flaws would still have caused years of problems. There is no reason that America has to suffer a "lost decade." (For a more detailed discussion of the differences between the two crises, see the Appendix below after the charts, "The Japan Fallacy," an essay in the March/April *Foreign Affairs*.)

Even though the nature of the crises is different, there are some valuable lessons the US can learn from examining Japan.

### **Better To Do Too Much Than Too Little**

Japan spent years denying and delaying until the problem became much more intractable. In a crisis like this, it is much better to do too much than too little. Time is the enemy. If one step doesn't work, try another. The nature of the financial crisis is more complicated than in Japan and involved uncharted waters. But activism is much better than doing nothing out of fear of error.

### **The Truth Shall Set You Free**

There are many reasons why Japan took ten years to really begin solving its nonperforming loan crisis, why there were ten years of “denial, dithering and delay.” Part of it was a conscious cover-up by the Ministry of Finance and the banks, who believed that revealing the extent of bad loans would cause a crisis of confidence. Banks, under guidance from the MOF, literally cooked the books and, years later, some executives were indicted for this. Each time a bank failed, it was found that the official balance sheet was inaccurate. Beyond that, the policymakers and bank executives created a system that hid from themselves how bad it really was.

The US has done something similar by virtually outlawing the monitoring of derivatives. The total volume of Credit Default Swaps, a key factor in the crisis was unclear, as was counterparty risk because financial derivatives, unlike corn futures, are not traded on public exchanges. Capital markets are designed to handle calculable risk, but they cannot handle complete uncertainty as to volume and price. Even in cases where the underlying assets, e.g. commercial mortgages, have a fairly low default rate, commercial mortgage backed securities (CBMS) fell to 32% below book value in December, based purely on panic and uncertainty. We need regulations that let the shadow banking system come out of the shadows and quick action to create a market and a price, e.g. by government purchases of assets.

### **Financial Culprits Need To Face Criminal And Civil Penalties**

One reason it took Japan so long to inject government capital into the banks was because the voters felt the money would just go to bail out the banks, rather than themselves. In the US, as a result of the S&L crisis, hundreds of banker crooks went to prison; voters accepted a bailout because they were ultimately being bailed out. In Japan, though some bankers and officials were put on trial for fraud, few, if any, spent time in prison. The US needs to inject further large amounts of capital into the financial system. The public will not support such indispensable funds this if the purpose is to finance bonuses and \$30,000 commodes.

There are cases where, due to perverse executive compensation system, bank executives pressured loan offices to approve mortgages even when the officers warned of possible fraud. This brought in huge fees to the mortgage originators and bonuses to the execs who then unloaded the bad assets onto the pension funds of ordinary people via the route of securitization (see, for example, the *New York Times* of Dec. 28, 2008 for a detailed account of such shenanigans at Washington Mutual). Surely, peddling paper known to be dubious is worthy of criminal and civil investigation. If such actions do not, in fact, violate current law, then it is time for the Congress to improve the law.

### **Capital Injection Needed, But Must Have Upside For Taxpayers**

Another reason that Japan took so long to solve its NPL problem was that its banks were so thinly capitalized. The banks could not afford to write-down or write-off all the bad debt without becoming insolvent. At each point, the banks and policymakers decided that the pain of write-offs to the banks—as well as downsizing or liquidation of the borrowers—was greater than the

pain of further delay. So, they kept arguing that the banks didn't need the money; they could "grow out of the problem." The result was to extend the crisis and make the economy worse. The preservation of "zombie borrowers" turned marginal firms into sick ones. Eventually, around 1999, the government injected capital, but not enough and it did so via preferred shares that could eventually be turned into common shares if not paid back. The upside for taxpayers was limited. Moreover, for the next few years, the capital was used to preserve "zombie borrowers" through debt waivers and rescheduling, rather than getting the bad debt off the books. Not until 2002-03 did the Koizumi administration really push a serious reduction in NPLs through write-offs, and other measures. This was financed through covert means—virtually zero interest for depositors to finance interest rates for borrowers as low as 0.25% for 6% of borrowers and between 0.25% and 0.5% for another 6%. Plus, it was financed by real wages cuts. The result is low consumer income leading to low consumer spending and inordinate dependence on exports. That is why the global downturn is now hurting Japan so much worse than the US or Europe.

The US needs to inject enough capital so that banks and other financial intermediaries can get the toxic assets off their books. But there has to be an equity position that gives taxpayers an upside as these firms recover.

### **Separate Toxic Assets From Good Assets**

As long as the Japanese banks had so much toxic assets on their books, they found it hard to lend and investors were reluctant to provide more equity. Banks shifted their asset portfolio from loans to government bonds, which, among other things, limited the multiplier effect of monetary stimulus. (Most of the reason for the decline of bank loans was not a credit crunch but a lack of demand by borrowers). Once the toxic assets were removed, banks began to perform normally again.

In the US, removal of the toxic assets is absolutely necessary, especially because their size and value is so uncertain. This requires not only public capital injections but, in light of the disarray among derivatives, perhaps some market-making by the government through its own purchases. That had been one ingredient in the initial notion of TARP and now Fed efforts at backing securitization for certain types of loans.

### **Adjust Mark-to-Market Accounting**

Mark-to-market accounting, in principle a valuable rule, has become a pro-cyclical measure that exacerbates bubbles and deepens panics because of how it is applied. The biggest financial losses are coming not in loans taken out by household or business borrowers but in the shadow banking system. For example, by mid-December 2008, pure panic had pushed the value of AAA-rated commercial-mortgage-backed securities (CMBS) down to 68 percent of their face value, despite a commercial-mortgage delinquency rate of only one percent. That 32 percent loss has reverberated throughout the financial system due to mark-to-market accounting rules, which require securities to be valued at their current market price, even in markets where there is little trading and prices fluctuate wildly. As a result of these rules, all investors holding CMBS have had to write down their holdings by 32 percent, even if the underlying mortgages are being paid

on time. That, in turn, has led prices to decline even more and investors to write off more capital, further tightening the credit crunch. In another case, Merrill Lynch sold some rarely traded securities at 22 cents on the dollar to raise cash to avoid bankruptcy. Others had to go mark down their holdings to 22 cents also because the market was so thin. The rules are more mark-to-myth when there is no market. In October 2008, the International Monetary Fund predicted that this vicious cycle would cause \$1 trillion in mark-to-market losses, as much as seven percent of U.S. GDP. The estimate is higher now. As with monetary policy, mark-to-market rules need to be adjusted so that they are anti-cyclical.

### **Fiscal-Monetary Stimulus Is Absolutely Necessary But Not Sufficient**

There is a myth that Japan shows the uselessness of fiscal stimulus. Supposedly, Tokyo used massive stimulus and it accomplished nothing. The reality is that Japan applied fiscal stimulus in a very stop-go fashion. When Tokyo stepped on the fiscal gas, the Japanese economy did better. When it took its foot off the pedal or, worse yet, applied the brakes -- such as when it raised taxes in 1997 -- the economy faltered. Had Japan done nothing, it risked depression.

As for monetary stimulus, initially the Bank of Japan kept interest rates high because it was still fighting the last battle, the 1980s bubble. It took until 1995 to bring overnight rates down to 0.5% and then another four years to bring them to 0.0%. A Federal Reserve study says that, had the BOJ acted quickly enough, it could have avoided deflation. But by 1995, it was too late. The problem was a miscalculation of how bad the problem was. The Fed says that, if it had been in charge and used its own forecasts of Japanese growth and inflation during 1991-95, it also would have been too tight.

On the other hand, fiscal-monetary stimulus is not enough. It is hard for them to have their normal potency when the financial system is broken.

Fiscal-monetary stimulus is indispensable for two reasons: it cuts off the vicious cycle of financial crisis leading to economic recession leading to more financial collapse and deeper recession, etc. Secondly, the necessary measures to cure the bad debt problem are inherently depressive in that they wipe out imputed wealth and income. A fiscal-monetary cushion is needed as an offset. Otherwise the recession will be too deep to be tolerable on either economic or political grounds and voters/politicians will choose Japan-style denial and delay. Trying to cure a financial crisis without fiscal-monetary cushion is like doing surgery without an anesthetic. In Japan, all too often, fiscal-monetary stimulus was used, not as anesthesia for surgery, but as heroin to dull the pain and avoid surgery. The notion was to pump up growth and the price of stocks and real estate so as to be able to bail out the zombie borrowers. So, Japan ended up in a false debate between those who wanted to build "bridges to nowhere" to prop up the "zombies," and those who opposed any sort of stimulus because they felt it would only be wasted.

### **Unconventional Central Banking Needed, Not Just Monetary Ease**

Japan tried all sorts of different types of monetary ease, from zero overnight interest rates to "quantitative easing." This put a floor underneath the economy, but did not restore growth. In the

US situation, there is a need to go beyond monetary ease, a need recognized by Fed chair Ben Bernanke, who has studied Japan's problems. For example, when panic hit the money market mutual funds, sparking withdrawals that hurt the commercial paper market, Bernanke put in a temporary guarantee and stopped the panic. Other measures have worked on panic-level spreads. Japan never went beyond conventional routes. Bernanke already has.

### **Regulatory-Institutional Changes**

At the root of Japan's banking crisis were a host of regulatory-institutional issues, including a "convoy system" under which no bank could be allowed to fail, the lack of genuine credit screening for loans, reliance on collateral which created a self-feeding spiral of loans and asset prices feeding each other, etc. Beyond that, there are much deeper problems in the capital, labor, and goods markets requiring much more fundamental reforms.

In the US, too, there are regulatory-institutional issues that could be solved much more easily than the more thorough-going flaws in Japan. One was the failure to apply to the nonbank mortgage originators the same prudential rules applied to banks, e.g. requirements for downpayments and documentation. A second was the refusal to regulate the derivatives market. The third is an executive compensation system that gives executives incentives to take outrageous risks with other people's money (heads I win; tails you lose). See the Appendix below for details.

### **A Story in Charts**

**Figure 1** shows that bank losses from Japan's NPL problem exploded from a negligible amount in 1993 to nearly 20% of GDP. Not until 2005 did big losses stop accumulating. **Figure 2** shows that, not until 2003, did the ratio of NPLs to total loans start declining—more than ten years after the onset of the crisis.

**Figure 3** shows that America's nonfinancial corporations do not suffer from huge amounts of excess debt, as is often stated. In fact, they own twice as much in financial assets as they owe in debt. This decade showed the highest such ratio going back a half-century. **Figure 4** shows that, by one measure (debt to net worth ratio), America's nonfinancial firms today are about five times better able to handle their debt load than were their Japanese counterparts at the beginning of the lost decade.

**Figure 5** shows that despite a record 16% drop in the value of household-owned assets since the third quarter of 2007, the average household still has net worth equal to nearly years worth of income. That is close to the average ratio of wealth to income that has prevailed for 50 years. The wealth destruction has been a correction of a bubble-fed high. Just as households adjusted to the dot.com bust, they should be able to adjust to this correction without a collapse of spending—as long as the job destruction is checked.

**Figure 6** shows that, while the delinquency rate (loans with interest more than one month late) has risen sharply for mortgages, the delinquency rate for other consumer loans and especially for

business loans remains low so far, especially considering the depths of the recession.

In **Figure 7** and **figure 8**, we can see that, unlike in Japan, US are rapidly getting the bad loans off their books. The ratio of loans being charged off as a share of delinquent loans is very high by historical standards.

Contrary to popular belief, the credit crunch in the US does not stem from banks refusing to make loans. As seen in **Figure 9**, the growth rate of outstanding loans has slowed, as it always does in recession, but at least so far, has slowed less than in the 2001 recession.

In **Figure 10**, we look at total private nonfinancial sector debt, deflated by the GDP deflator so as to be able to compare high inflation and low inflation periods. In 2008, debt stopped growing. So, while bank loans are still growing, other forms of debt are not. On the other hand, in some past recessions, e.g. 1975, debt actually fell. **Figure 11** looks just as nonfinancial business debt, so home mortgages are not included. There we see that credit outstanding is still growing; it was up 2.6% from the end of 2007 to the end of 2008.

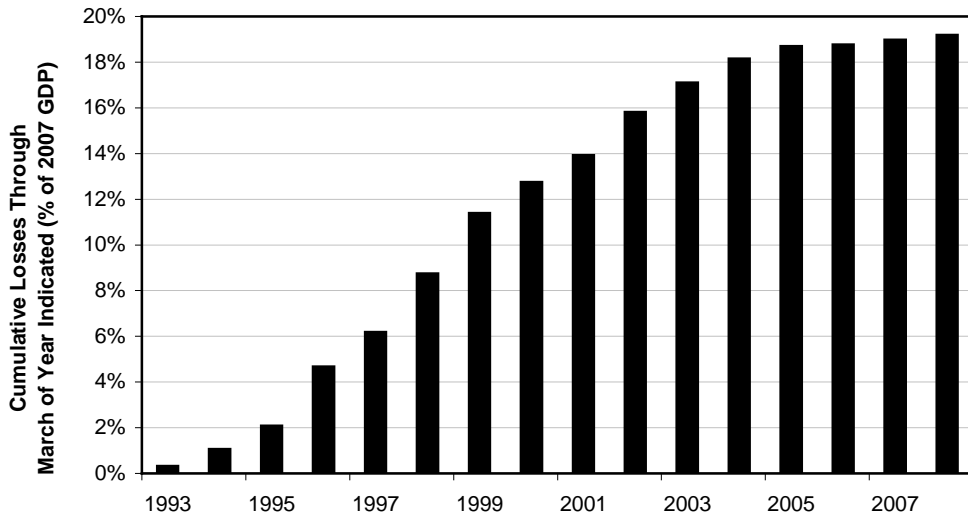
**Figure 12** tells us that bank loans (deflated by GDP deflator) were up 5.3% from the end of 2007 to the end of 2008, not much slower than in recent years. By contrast, we see in **Figure 13** that credit by issuers of ABS (Asset-backed securities) was down 12%. This is a problem since ABS issuers are now a significant (12%) share of the credit market. So, the credit crunch problem lies less in commercial banking than in the shadow banking system. In other words, banks cannot easily issue, say, a car loan, then securitize it and use the money to make yet another loan, so that the same dollar is used over and over again.

**Figure 14** shows that the ratio of bank net worth to assets has fallen in the current recession, as in past recessions, but is still at multi-year high. US Banks are in better position to write off bad assets than were their Japanese counterparts.

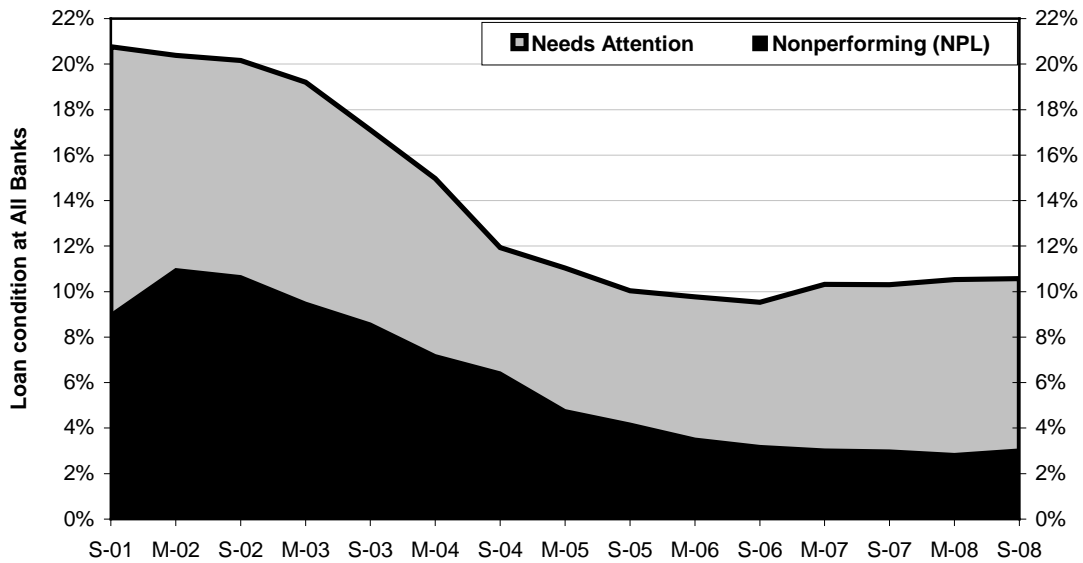
**Figure 15** shows that Japanese bank operating profits were so low that they were wiped out by credit costs for NPLs and the drop in stock prices. **Figure 16** shows that Japanese banks had a much thinner net worth cushion at the onset of the lost decade than do American banks today: 3-4% of liabilities for the Japanese banks vs. 10%-11% for US banks. Regulatory capital for internationally active Japanese banks was only 8-9% of risk-weighted assets at the onset of the lost decade (**Figure 17**) vs. 10-11% for the US banks. Plus much of the Japanese capital was deferred tax assets, holdings of company shares and other low-quality capital.

**Figure 18** and **Figure 19** show US commercial banking institutions (mostly via their holding companies) were massively increasing their equity issues even before TARP in order to cope with write-downs; the Japanese government did not start injecting capital until 1998-99 and private equity issues began in big way a couple years later.

**Figure 1: Japan's Losses on Nonperforming Loans Hit Nearly 20% of GDP**



**Figure 2: Problematic Loans Peak at Over 20% of All Loans in 2001**

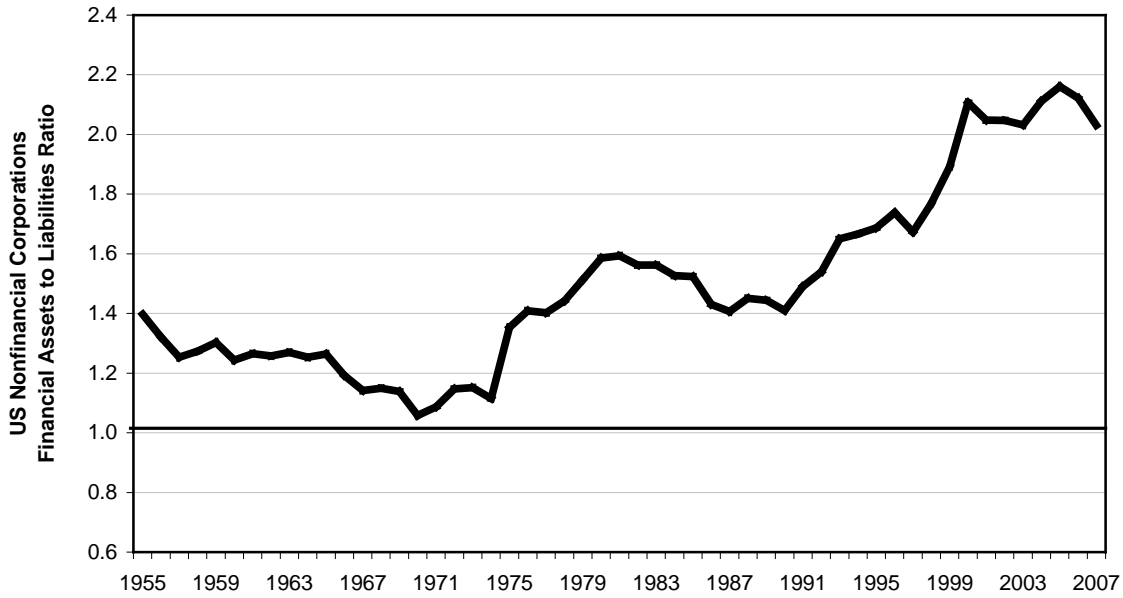


**Source:** Financial Services Agency

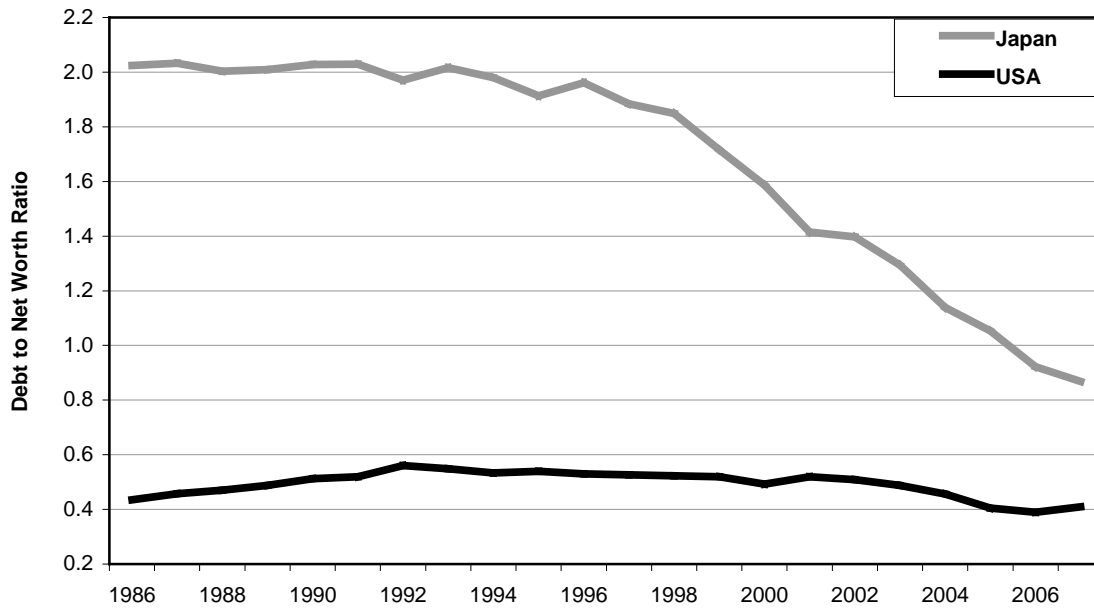
**Note:** Nonperforming loan equals loan three months in arrears (vs. US standard of one month) or loans where concessions have been made on interest and/or principle; "needs attention" loans not yet in arrears but at high risk of falling delinquent



**Figure 3:**  
**US Nonfinancial Firms Own Twice as Much in Financial Assets As They Owe**

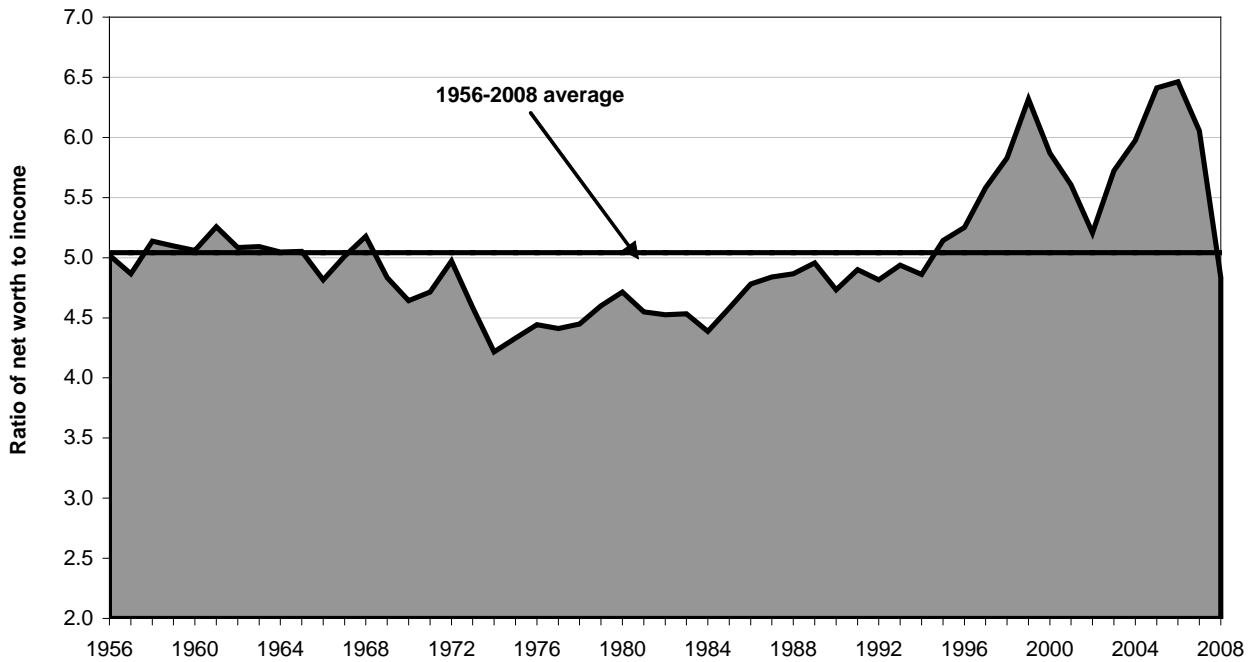


**Figure 4: US Firms In Much Better Shape Than Japanese Counterparts on Eve of Lost Decade**

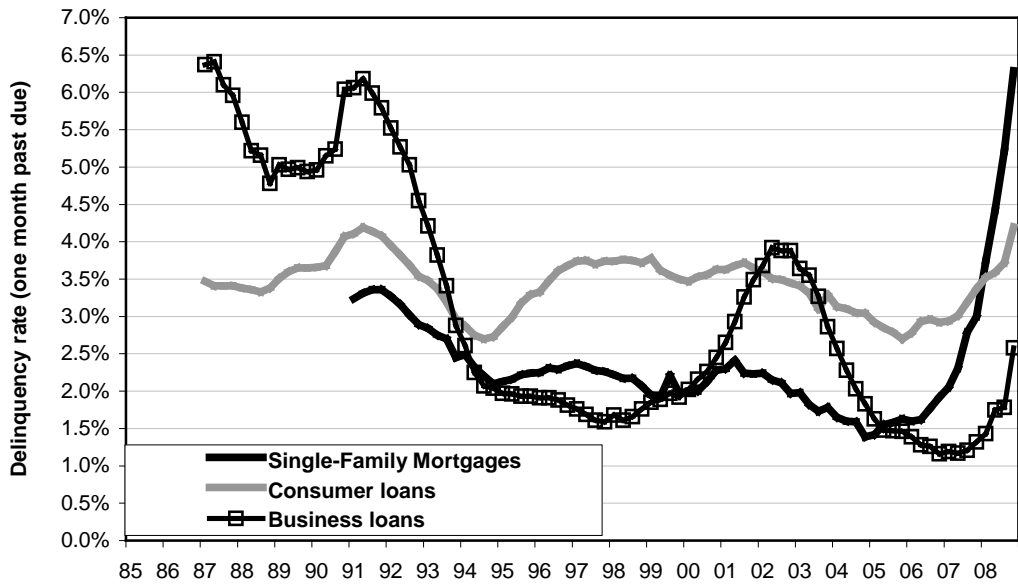


Source: US Federal Reserve and Japanese Ministry of Finance

**Figure 5: US Household Net Worth Back to Historic Levels: Five Years Worth of Income**



**Figure 6: US Delinquency Rate Still Low on Non-Mortgage Loans**



Source: US Federal Reserve

Figure 7: US Rapid Charge-Off Of NPLs . . .

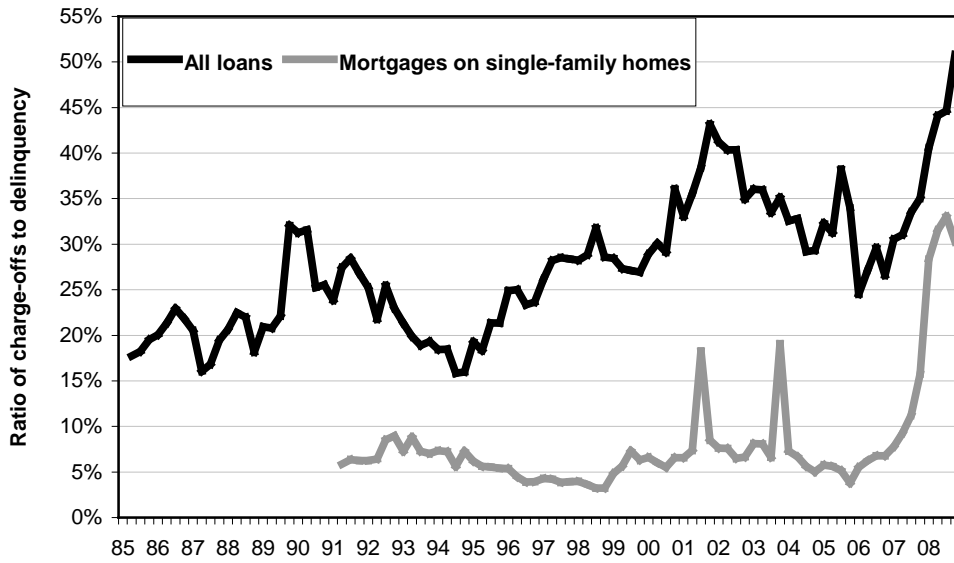
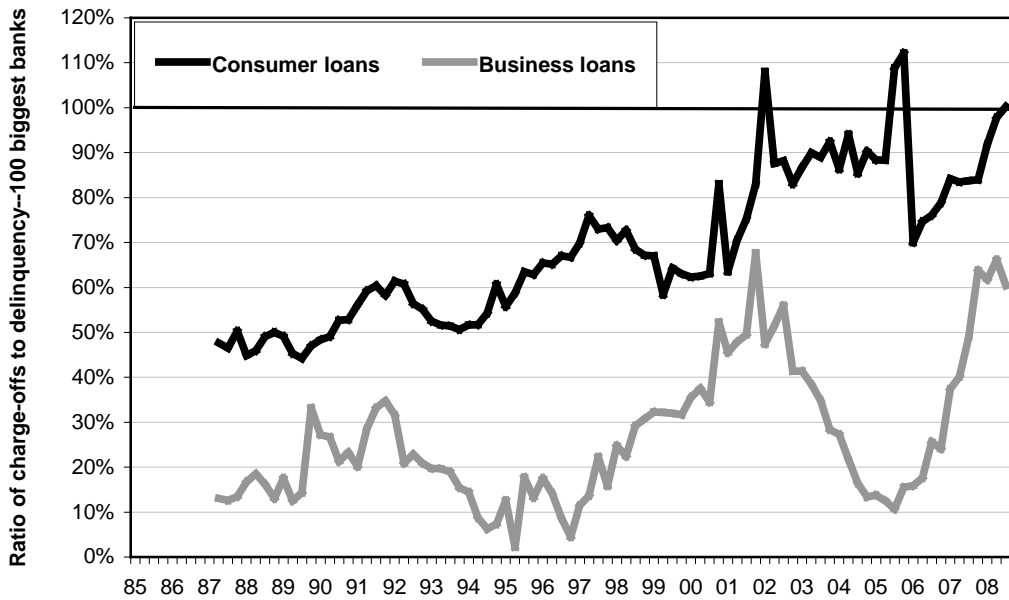
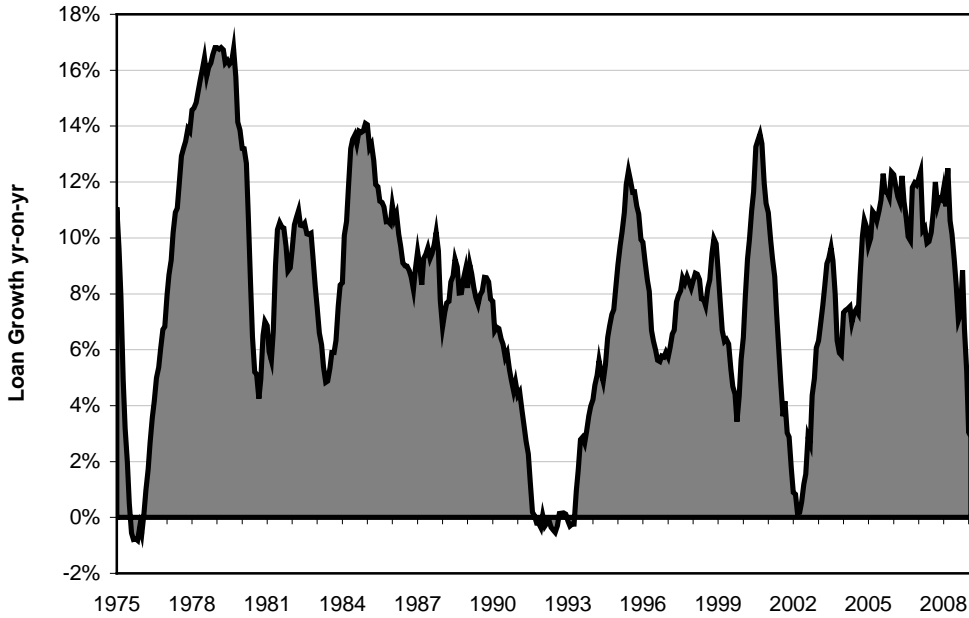


Figure 8: . . . Especially on Business and Consumer Loans



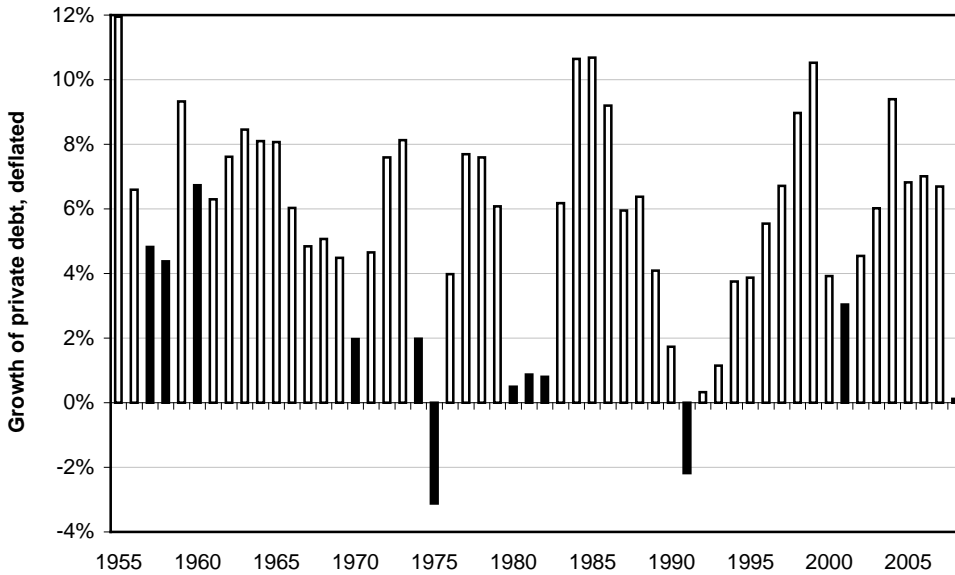
Source: US Federal Reserve

**Figure 9: US Bank Loan Year-on-Year Growth Slows No More Than In Typical Recession Fashion**



Source: Federal Reserve

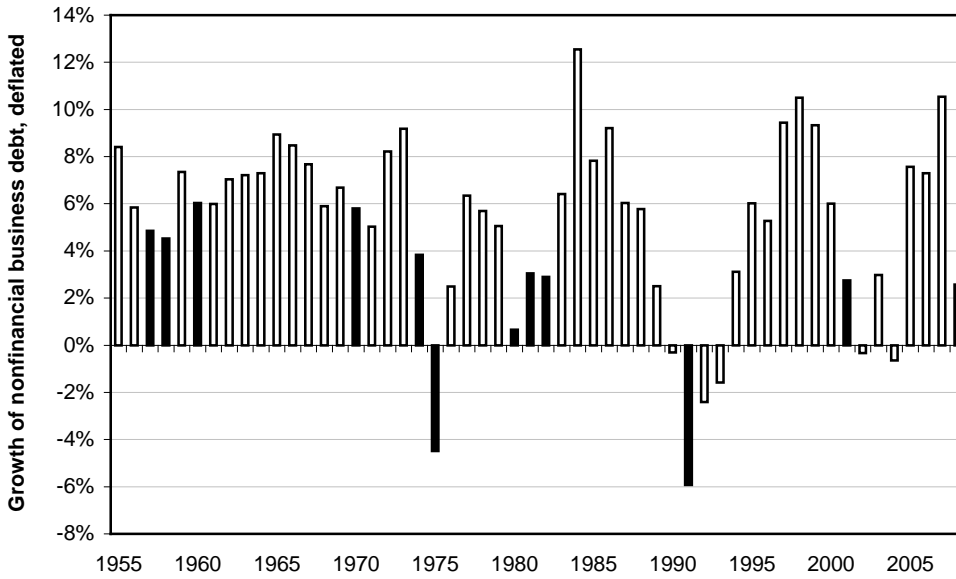
**Figure 10: US Private Debt Stops Growing in 2008; Fell in 1975 and 1991 (deflated)**



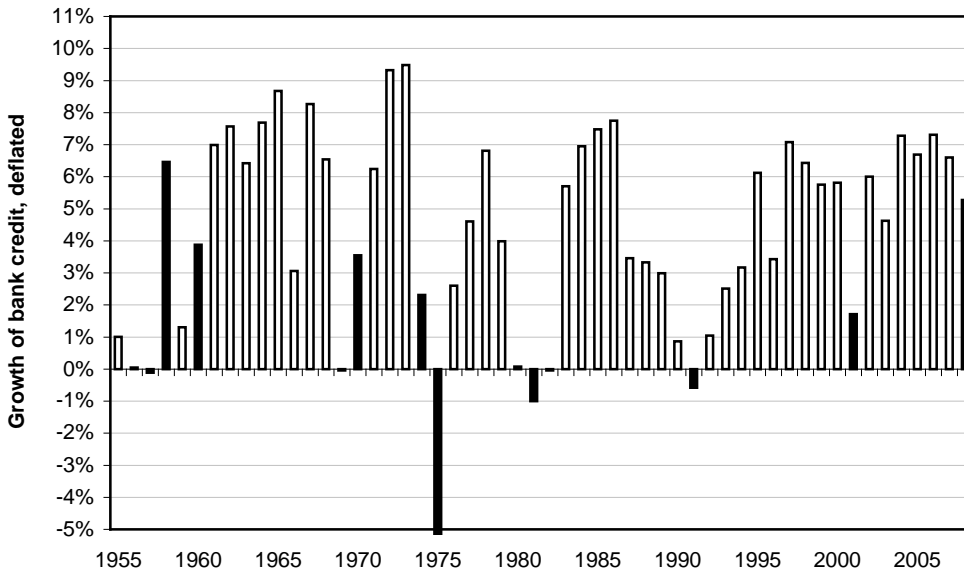
Source: Federal Reserve

Note: Deflated by GDP deflator so that inflation doesn't distort comparisons between high inflation and low inflation periods

**Figure 11: US Nonfinancial Business Debt Slows, But Doesn't Yet Fall As In Some Past Recessions**



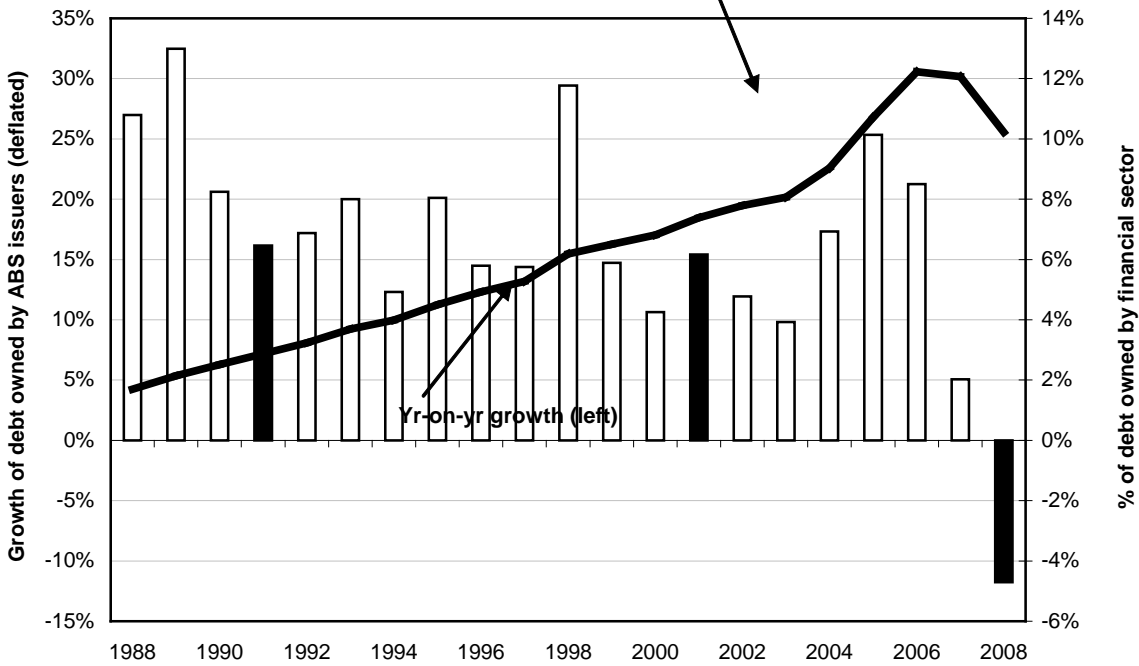
**Figure 12: US Banks Expand Credit 5% in 2008 . . .**



**Source:** Federal Reserve

**Note:** Deflated by GDP deflator so that inflation doesn't distort comparisons

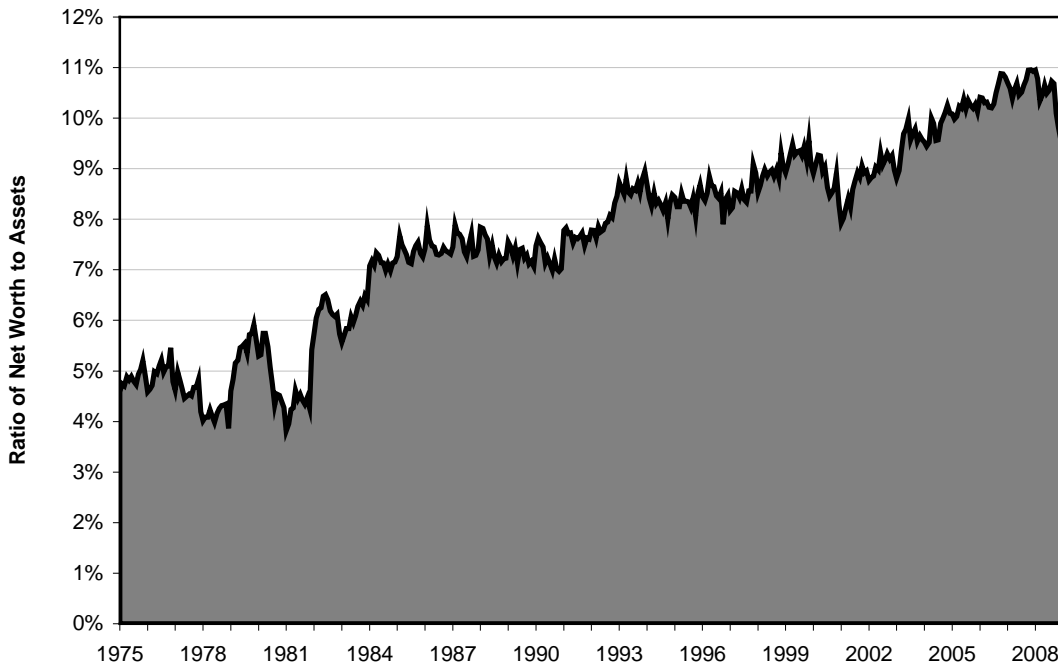
**Figure 13: . . . But Have Trouble Securitizing Loans**



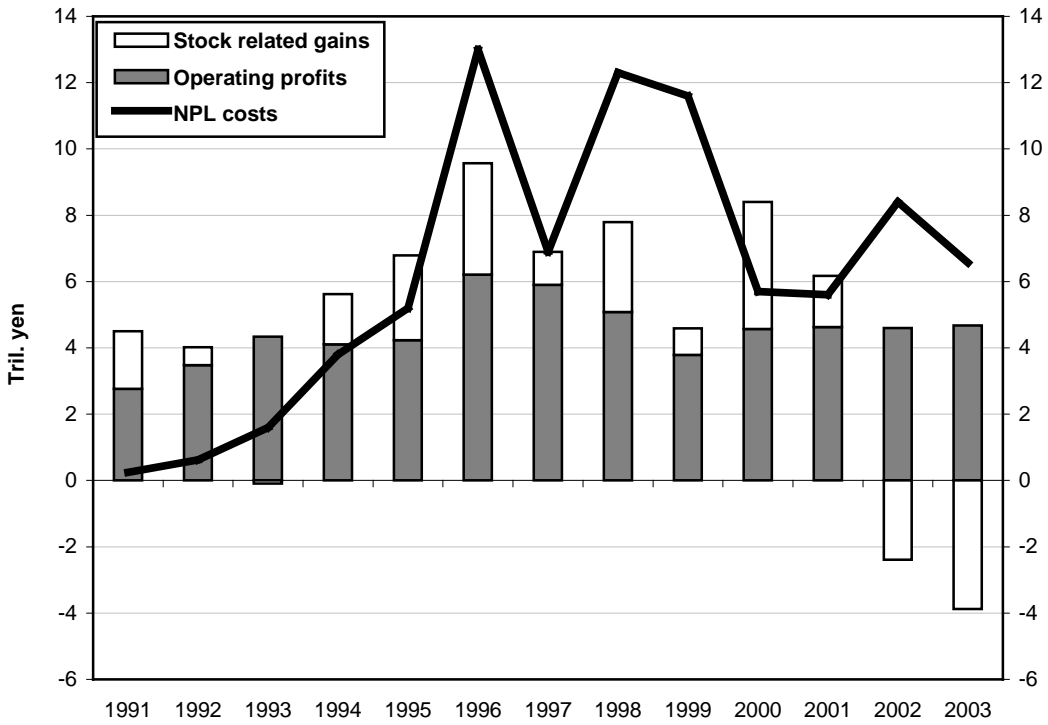
**Source:** Federal Reserve

**Note:** Deflated by GDP deflator so that inflation doesn't distort comparisons

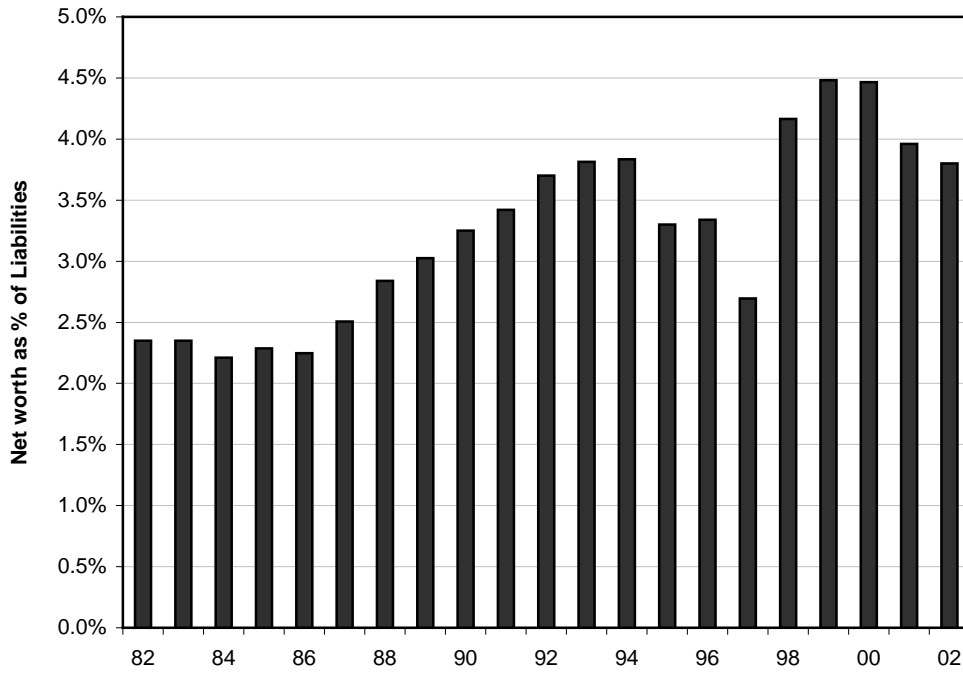
**Figure 14: US Bank Net Worth To Assets Falls, But Still At Multi-Decade High**



**Figure 15: Japanese Bank Profits Wiped Out By NPLs, Stock Losses**



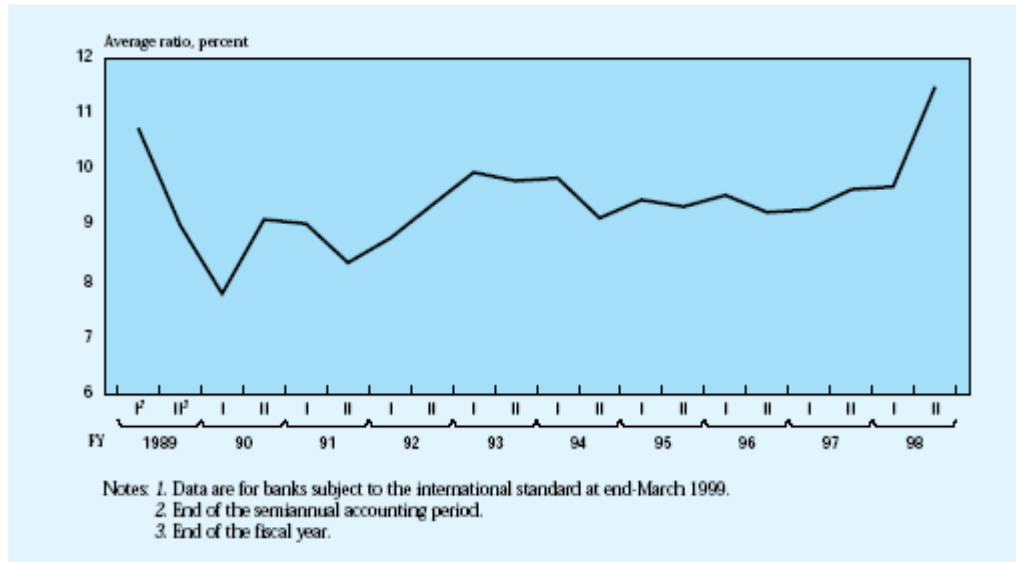
**Figure 16: Japanese Banks Thin Net Worth Cushion to Absorb Losses**



Source: Bank of Japan

**Figure 17: Japanese Bank Regulatory Capital for Int'l Banks**

**Chart 11**  
Average Risk-Based Capital Adequacy Ratios of Internationally Active Banks, Consolidated Basis<sup>1</sup>

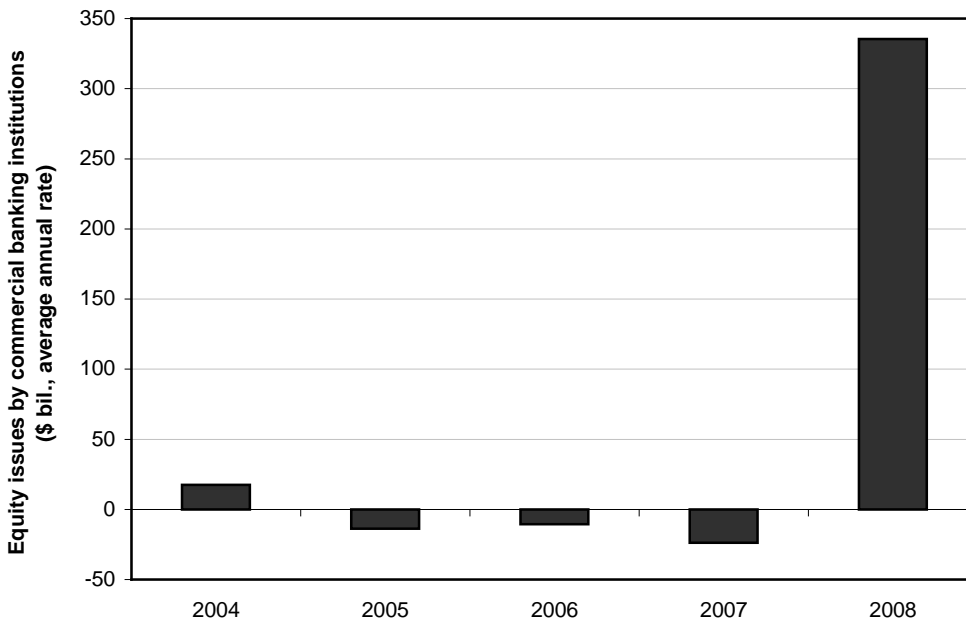


**Table 5**  
Consolidated Financial Statements

**Source:** Bank of Japan

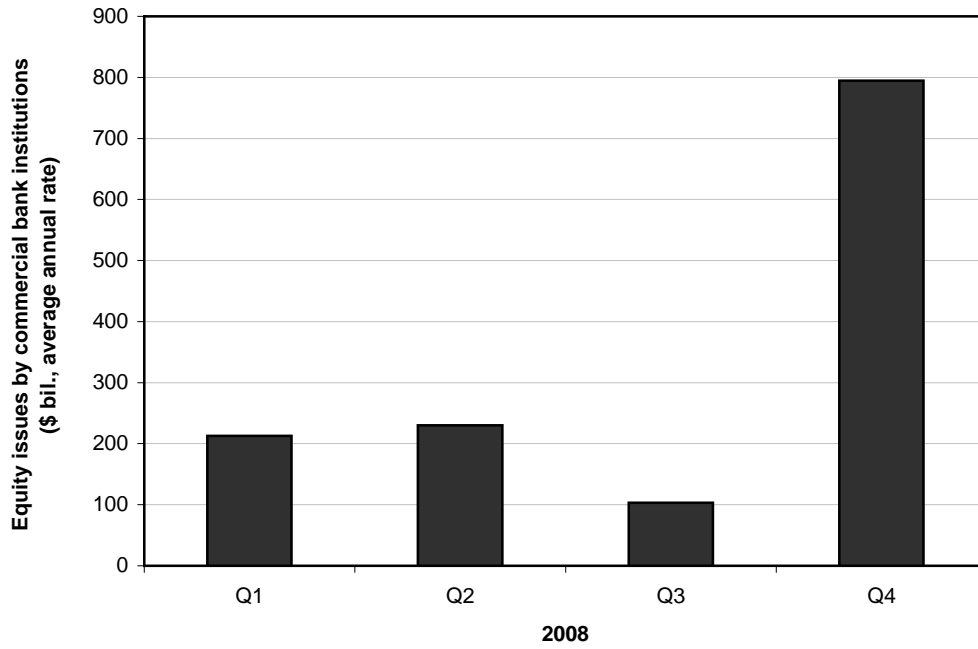
**Note:** Only applies to banks active in international markets; domestic banks had much lower ratios. Capital includes holdings of company stock, deferred tax assets and other low-quality capital. This risk-weighted ratio improved as banks moved their asset from company loans to government bonds.

**Figure 18: US Banks Up Equity Issuance in 2008 . . .**





**Figure 19: . . . Even in Jan-Sept. Before TARP Injection**



Source: Federal Reserve

## Appendix

### **The Japan Fallacy: Today's U.S. Financial Crisis Is Not Like Tokyo's "Lost Decade"**

By Richard Katz

From *Foreign Affairs*, March/April 2009 (foreignaffairs.org)

Summary: The financial crisis of 2008 need not usher in a replay of Japan's "lost decade" of the 1990s. The current crisis is the result of correctable policy mistakes rather than deep structural flaws in the economy.

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In periods of crisis, pundits and policymakers tend to scramble for historical analogies. This time, many have seized on Japan's notorious "lost decade," the decade of stagnation that followed a mammoth property bubble in the late 1980s. But this comparison is wrong. In Japan, the primary problem was pervasive dysfunction in the economy, which caused a banking crisis. In the United States, pervasive dysfunction in the financial sector has caused a deep recession in the economy as a whole. This financial dysfunction is not the result of structural flaws, as in Japan, but of grave policy mistakes. It is now being compounded by widespread investor panic.

The consequences of the 2008 U.S. financial crisis will be different from Japan's slump in the 1990s for three reasons: the cause of the current crisis is fundamentally different, its scope is far smaller, and the response of policymakers has been quicker and more effective.

Japan's malaise was woven into the very fabric of its political economy. The country has a thin social safety net, and so in order to protect jobs, weak domestic firms and industries were sheltered from competition by a host of regulations and collusion among companies. Ultimately, that system limited productivity and potential growth. The problem was compounded by built-in economic anorexia. Personal consumption lagged, not because people refused to spend but because the same structural flaws caused real household income to keep falling as a share of real GDP. To make up for the shortfall in demand, the government used low interest rates as a steroid to pump up business investment. The result was a mountain of money-losing capital stock and bad debt.

Japan's crisis pervaded virtually its entire corporate world. In sector after sector, debt levels and excess capacity ballooned and profitability remained low. White-elephant projects, from office buildings to auto plants, were built on borrowed money under the assumption that if times got tough, the government and banks would bail out the debtors. But the banks were too poorly capitalized to write off bad loans. And for every bad loan, there was a bad borrower whose products were not worth the cost to make them. The cumulative total of bank losses on bad debt between 1993 and 2005 added up to nearly 20 percent of GDP.

Policy mistakes -- from Japan's mismanaged fiscal and monetary policy to the government's failure to address the loan crisis -- made a bad situation even worse. But even if policymakers had done everything right, Japan's economy still would have stagnated until Tokyo addressed its more fundamental flaws.

## DEREGULATION NATION

The United States' subprime mortgage fiasco of 2007-8, in contrast, was primarily the result of discrete, correctable mistakes brought on by ideological excess and the power of financial-industry lobbyists rather than intractable structural problems.

The first mistake was the U.S. government's refusal to regulate subprime mortgages. Traditional banking regulations forbid banks from lending to people with no down payment or proof that they can repay a loan. However, no such rule applied to nonbank lenders, even after they became the country's biggest mortgage originators. That left new mortgage institutions with little incentive to ensure that their loans could be repaid; no sooner had they issued these so-called liar loans than they resold them to investment banks for a profit. The investment banks then sliced and diced the loans into securities embossed with AAA ratings despite the dubious creditworthiness of the original borrowers. A single statistic makes clear how damaging this lack of regulation was: by the third quarter of 2008, 22 percent of subprime, adjustable-rate mortgages were in foreclosure; by contrast, the foreclosure rate for prime, fixed-rate mortgages - - 60 percent of all mortgages -- was still less than one percent.

There were plenty of warnings. In 1994, a bipartisan coalition in Congress passed the Home Ownership and Equity Protection Act, which enabled the Federal Reserve to force all mortgage lenders to follow traditional banking standards. But Federal Reserve Chair Alan Greenspan refused to use these powers, claiming that the financial markets were self-correcting. When Democrats and Republicans in the next Congress tried to require that the Fed enforce these rules, House Majority Leader Tom DeLay (R-Tex.) quashed the effort.

The second policy blunder was the U.S. government's failure to regulate the compensation of chief executive officers (CEOs) -- a system that in its current form gives executives incentives to take outrageous risks with other people's money. When CEOs are paid primarily in stock options, as is the case today at many firms, they suffer little punishment for failure. If CEOs gamble big with the company's money and succeed, they can gain hundreds of millions of dollars in bonuses; if their gambling fails, they do not suffer losses, just a smaller reward. Even CEOs who have caused their firms to collapse, such as Merrill Lynch's Stan O'Neal, have still walked away with enormous severance packages. This system is a critical factor in the behavior that led to today's crisis. Studies show that extraordinary losses are much more common at firms where the majority of CEO compensation comes from stock options, rather than cash or outright stock.

The third error was the virtual non-regulation of the derivatives market. Derivatives should serve as a kind of insurance to lessen risk. Corn futures, for example, stabilize farmers' incomes, inducing them to plant more, which gives consumers more food at cheaper prices. Today's financial derivatives often turn the insurance principle on its head, causing shocks to be

amplified and transforming derivatives into what the investor Warren Buffett has called "financial weapons of mass destruction." If an investor buys a share of General Electric from Merrill Lynch, that share retains its value even if Merrill goes bankrupt. But unlike corn futures or stocks, most financial derivatives are traded not on exchanges but in bilateral deals. If an investor's trading partner (counterparty) fails, the investor takes the loss. The collapse of the investment bank Lehman Brothers caused the insurance company AIG to lose big in so-called credit default swaps, undermining trust in all counterparties and causing a run on the entire derivatives and securitization markets. Rather than frightened depositors banging on bank doors, the result was investors furiously clicking away at their keyboards as their money disappeared. In the end, the impact was the same: perfectly solid companies suddenly found themselves unable to issue commercial paper, and creditworthy homeowners found it hard to get car or student loans. It took an intervention by the Federal Reserve to forestall a more serious meltdown.

This run on the shadow banking system is the real cause of the severe post-September credit crunch that transformed a mild recession into something far worse. Banks have actually increased their extension of credit by six percent since September, but they are having a hard time securitizing those loans in the capital markets. That means that they can no longer use the proceeds to make further loans, which would allow them to use the initial dollar over and over again.

If powerful financial lobbyists waving the banner of faith in markets had not thwarted commonsense regulation, much of this would never have occurred. Democratic and Republican policymakers alike, from Treasury Secretaries Robert Rubin and Lawrence Summers to Federal Reserve Chair Greenspan, blocked attempts at reform in 1998. Then, in 2000, Senator Phil Gramm (R-Tex.) went so far as to virtually outlaw the monitoring and regulation of many types of derivatives by initiating the Commodity Futures Modernization Act. Just as deposit insurance now prevents massive runs on banks, the regulation of derivatives could have made this crisis less severe.

## A TALE OF TWO BUBBLES

The scope of the Japanese crisis and the scope of the U.S. crisis are also fundamentally different. From 1981 to 1991, commercial land prices in Japan's six biggest cities rose by 500 percent. The subsequent bust brought prices down to a level well below that of 1981; as of 2007, they were still 83 percent below the 1991 peak. In the United States, the real estate bubble was not as inflated, and the bust has been less severe. From 1996 through the 2006 peak, housing prices in the 20 biggest U.S. cities rose by 200 percent. Most forecasters think prices will drop by 30-40 percent from the peak levels before bottoming out in 2009 or 2010. No one is suggesting that prices will fall below the level of 1996.

Most of the United States' nonfinancial corporations are still healthy. Whereas the debt of Japanese corporations was several times their net worth, in the United States, corporate debt amounts to only half of companies' net worth, the same level that has prevailed for decades. The ratio of nonperforming loans among nonfinancial companies is only 1.6 percent, and productivity growth remains solid.

In October 2008, the International Monetary Fund's Global Financial Stability Report predicted that the losses on all U.S.-originated unsecuritized loans (including home mortgages) would amount to \$425 billion, about three percent of U.S. GDP. This estimate will likely rise, but even then it would not come close to the 20 percent ratio that Japan experienced.

The biggest financial losses are coming not in loans taken out by household or business borrowers but in the shadow banking system. Because of the leverage inherent in financial derivatives -- which are designed so that a one percent hike in real estate prices can create a much larger gain in asset-backed securities -- a small loss in the value of the underlying assets can be multiplied several times over. Far more significant is the psychological factor: by mid-December 2008, pure panic had pushed the value of AAA-rated commercial-mortgage-backed securities (CMBS) down to 68 percent of their face value, despite a commercial-mortgage delinquency rate of only one percent.

That 32 percent loss has reverberated throughout the financial system due to mark-to-market accounting rules, which require securities to be valued at their current market price, even in markets where there is little trading and prices fluctuate wildly. As a result of these rules, all investors holding CMBS have had to write down their holdings by 32 percent, even if the underlying mortgages are being paid on time. That, in turn, has led prices to decline even more and investors to write off more capital, further tightening the credit crunch.

The International Monetary Fund predicts that this vicious cycle will cause \$1 trillion in mark-to-market losses, as much as seven percent of U.S. GDP. If this is correct, most financial losses suffered since the onset of the crisis will have come not from genuine defaults in the real economy but from problems generated within the shadow banking system. Applying normally beneficial mark-to-market rules in today's abnormal markets without any adjustment is doing more harm than good. By the time the economy recovers and those marked-down securities are marked back up, the credit crunch will have led to a host of corporate bankruptcies, millions of layoffs, and countless families losing their homes.

## A PROGRAM OF ACTION

The Japanese and U.S. crises differ in many ways, but the starkest contrast is in the response of policymakers. Denial, dithering, and delay were the hallmarks in Tokyo. It took the Bank of Japan nearly nine years to bring the overnight interest rate from its 1991 peak of eight percent down to zero. The U.S. Federal Reserve did that within 16 months of declaring a financial emergency, which it did in August 2007. It has also applied all sorts of unconventional measures to keep credit from drying up.

It took Tokyo eight years to use public money to recapitalize the banks; Washington began to do so in less than a year. Worse yet, Tokyo used government money to help the banks keep lending to insolvent borrowers; U.S. banks have been rapidly writing off their bad debt. Although Tokyo did eventually apply many fiscal stimulus measures, it did so too late and too erratically to have a sufficient impact. The U.S. government, by contrast, has already applied fiscal stimulus, and the Obama administration is proposing a multiyear program totaling as much

as five to six percent of U.S. GDP. When it comes to crisis management, it is far better to do too much than too little.

Policymakers can draw many lessons from this comparison. First, the current U.S. crisis - like the Asian financial crisis of 1997-98 -- has proved that even an economy with sound fundamentals can be thrashed when financial markets go haywire. However, the Asian crisis provides a more promising message: once financial markets are calmed and policy mistakes are reversed, economies recover.

Second, whereas Japan needed a thorough overhaul of its political and economic institutions and practices, a process that continues today, the United States simply needs aggressive reform of its financial architecture and CEO compensation system. President Barack Obama clearly understands the need for better regulation, and there is reason to hope that his economic advisers, many of whom are alumni of the Clinton administration, have learned from their mistakes. In October, former Treasury Secretary Summers, now director of the National Economic Council, wrote in the *Financial Times*, "The pendulum will swing -- and should swing -- towards an enhanced role for government in saving the market system from its excesses and inadequacies."

Third, fiscal policy works, but only in connection with other measures. Many commentators believe that Japan's lost decade proves the uselessness of fiscal stimulus. They are wrong. When Tokyo stepped on the fiscal gas, the Japanese economy did better. When it took its foot off the pedal or, worse yet, applied the brakes -- such as when it raised taxes in 1997 -- the economy faltered. Equally important, it is hard for fiscal and monetary stimuli to be effective when the financial system is broken.

Finally, markets only work when undergirded by proper regulatory institutions that enforce genuine checks and balances on corporate executives, corporate boards, financiers, accountants, rating agencies, and regulators. Better rules make it safe to have freer markets.

There is, of course, one way in which the United States' crisis is much worse than Japan's: its global ripple effects. Getting through today's recession will be neither quick nor easy. But there is absolutely no need for fatalism or talk of an upcoming "lost decade" in the United States. The first step is to recognize, as Obama has repeatedly stressed, that this crisis is not a once-in-a-century unforeseeable disaster. Bad policies created this mess. Better policies can fix it.