

# Newsletter



Institute for International Monetary Affairs

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## Where is the Financial Crisis Headed?<sup>1</sup>

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On this program in May of this year, I talked about the international financial instability and warned that there was no room for optimism. I am afraid that my dire prediction has come true. The unimaginably rapid deterioration of the global economic environment in the last five months is unprecedented in post-war history. The downward spiral gained momentum in September. It is almost beyond belief that after the collapse of Lehman Brothers, the five largest American investment banks all disappeared. The turmoil spread to other financial areas such as insurance, and to the financial markets of Europe such as in Britain. Financial markets became paralyzed from increasing unwillingness to lend. Stock values fell precipitously. In the last two weeks, the European and American authorities were panicked into applying any measures they could take in rapid succession from lowering of interest rates to buying bad assets, to guaranteeing deposits and using public money for recapitalization of financial institutions.

Why did it come to such a dire situation? I believe there are two reasons. One is that there was a complete lack of understanding around the world for the force by which deterioration of financial credibility could spread. Governmental authorities and financial institutions were not getting ahead of the problem, only chasing the problems as they developed. No one could predict what chain reaction the sub prime loan collapse

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<sup>1</sup> These comments were prepared for an appearance on the NHK program, "Shiten Ronten" aired on October 20th, 2008.

would create in an environment where securitized products, whose true values were not clear, were distributed around the world in huge quantities by financial institutions that were not fully under the supervision of any authority. In addition, the United States has a Republican administration, whose party is known for traditionally disliking government intervention, and which is in the final months of its term and lacking authority.

The second factor is the fearful fact that the financial crisis is spreading to the real economy as had been expected. Since the third quarter, the drop in household spending because of the fall in housing prices, in business profit and employment has become suddenly all too obvious. The serious concern that the American economy cannot avoid a recession is pouring icy water onto business confidence of the global economy.

What will happen to the global economy now? There is no question that the financial markets will thaw from paralysis thanks to the policies taken by governments such as purchasing bad assets or injecting public money, which are so-to-say emergency measures to stop the bleeding. However, the most important question is when the fall in American housing prices will hit the bottom. As long as the decline continues, the value of securitized products related to housing loans will deteriorate and the overall health of the financial industry will not recover. The consensus seems to be that housing prices will fall another 15%.

As for the slowdown of the real economy, historically it has been instigated by the FED's tight monetary policy. But this time, the cause is not the FED's policy but the collapse of the housing market, and that means that it will take longer for the real economy to recover. Judging from both the situation of the financial markets and the real economy, recession in the American economy will continue to the middle of next year and we will only see a real recovery in 2010.

Both financial crises and recession will come to an end at some point, but this time there is a difference in the extent of damage and the severity of the after effects. The significant characteristic of the current crisis is that the three historical and structural factors in the global economy are all in play.

The first is the relationship that existed in the global economic growth model. After World War II, the global economy developed atop the imbalances between the countries

that over-consume and have a current account deficit and those that over-save and have a current account surplus. The over-savers used to be developed countries such as Japan and Germany, but now, they are mostly developing countries such as China and oil producing countries. On the other hand, the only consistent over-spender has been the United States. This means that America's over-consumption had been supporting global economic growth. But the current crisis is forcing the United States to adjust this over-consumption. So what will happen to the American economy after the crisis? And can the over-savers expand domestic spending?

The second issue is how the nature of capitalism may change. The Reagan and Thatcher revolutions in the United States and Britain resulted in the global economy putting a high premium on the Anglo-Saxon model of deregulation, competition and markets. Since the end of the 20th century, the role of finance within economic activities grew excessively, supported by the globalization of the economy, the development of financial vehicles using IT and the excess in global liquidity. The securitized vehicles that became the hotbed of the current crisis were the product of such a development. There are now severe criticisms of inadequate risk management, a lack of financial supervision and the immorality of greed. Because of the large scale financial rescue measures, the balance sheet of the private sector has shrunk while those of governments and central banks have expanded exorbitantly. The flow of deregulation has turned in the opposite direction and voices demanding a larger role for government and re-regulating have become more prominent. Will the Anglo-Saxon type of capitalism be forced to retreat and the forces of protectionism, stricter regulation and populism gain momentum?

The third issue is the role of the dollar as the key global currency. Backed by the overwhelming power of the United States as the superpower, the dollar has been the only key currency in the global economy in the post-war world. But the ability of the United States to lead the world has diminished in recent years because of the Iraq war and other difficulties. In addition, the continuing increase in the current account deficit has resulted in the accumulation of trillions of foreign currency reserves in China and some oil producing countries. The value of the dollar and the financial situation of the United States will be highly affected by how these countries use such dollar assets. The latent concern for the dollar has been aggravated by the decrease in the strength of American financial institutions as a result of the current crisis. Will the dollar lose its position as the key currency? If so, what will the international monetary system look

like?

As you can see, the current crisis has some significant implications for the future of the global economy.

Fortunately, Japanese financial industry has not been hit as hard as those of the United States or Europe so far. The health of the financial system and the capital base of the institutions are relatively good and the yen is demonstrating stability. The reputation of the Japanese financial industry has advanced around the world and there are high expectations in South East Asia for Japan to play a leadership role.

The Japanese economy faces its own problems for the future: decreasing population, ageing society and fiscal problems, such as in dealing with the social welfare system. This means that it cannot expect high growth. If Japan wants to maintain its high standard of living under these conditions, the country must utilize the resources it has to secure earnings. In view of the competitiveness of its Asian neighbors, it is not possible to gain enough revenue just through the manufacturing sector. It becomes critical to strengthen the service sector, such as financing. The next few years, during which the financial sectors in Europe and the United States will be forced to make adjustments, provide an opportunity for Japan. Using the abundant capital capacity and high credibility, the government and the private sector should cooperate to lead the way in developing and strengthening the financial system in Asia and making full use of the business opportunities that would be created by such efforts.

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