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Has the International Financial Instability turned the Corner?[1]

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It has been nine months since the subprime crisis erupted in the United States. During these months, a drastic fall in the value of related securities caused financial institutions around the world, especially those in the United States and Europe, to suffer losses amounting to tens of trillions of yen (hundreds of billions of dollars), forcing them to strengthen their capital. House prices are still falling and the industry is experiencing a severe blow. Moreover, those individuals who increased their loans on the assumption that their houses would only gain in value are now faced with a sharp drop in their assets, which in turn forces them to decrease their spending. Consumer spending accounts for 70% of the American economy and its fall is beginning to have a strong negative impact on employment and capital investment. The US economy is rapidly slowing down and since the fourth quarter of 2007, it is hovering at zero growth.

The Federal Reserve System is desperately trying to prevent a credit contraction in financial markets and lowered the short-term interest rate from 5.25% to 2.0% in rapid steps as well as pumping large amount of capital into markets in collaboration with the central banks in Europe. The government gave a tax rebate worth $150 billion, equivalent to 0.8% of GDP in a desperate attempt to avoid a recession. But the impact of all these measures is expected to become effective only in the summer or after.

Although it is the US and European economies that are directly hit by the subprime crisis, countries that depend on exports for their economic growth, such as Japan and China, are feeling the impact of slower economic growth and a drop in imports of the affected countries.

[1] These comments were prepared for an appearance on the NHK program, “Shiten Ronten” aired on May 12, 2008.

The other factor that is inflicting deep anguish on the global economy is the sharp rise in prices of oil, natural gas, various primary commodities and food. A wide range of factors, such as supply, demand and distribution, are contributing to the rise in prices. But at the same time, I am sure that part of the huge amount of liquidity that was provided mainly by the US and Europe to calm the subprime turmoil has turned speculative, encouraged by the weak dollar and has flowed into international commodities markets and is thus contributing to the rise in prices. The rise in prices of primary commodities brings about, on one hand, a global inflation and, on the other, stagnation through higher cost and decrease in real income and brings the global economy into stagflation, a combination of inflation and stagnation. The lack of food and its higher costs would inflict a severe blow on the low income population around the world.

As you can see, the global economy is facing insurmountable problems since last summer. However, incredible though it may seem, optimistic views on the future of the economy are expressed mainly by market players in the US since around last month. These views are that the subprime crisis has hit the bottom and the markets will now move toward stability, and the economy will move towards recovery in the second half of this year. Reflecting such optimistic views, the stock market, after hitting the bottom in March, has regained quite markedly. But can we believe such optimistic views? We would all hope so but we must review the logic cautiously.

There are several bases to the optimistic views. First, although prices of the securitized financial products plummeted, they seem to have hit the bottom. The loss in value that was brought about in the process has been more or less dealt with, and many financial institutions are actively strengthening their capital. Bankruptcy of Bear Stearns, a major investment bank, in March was a huge shock. But it served as a catharsis, washing away the worst. The second reason is the expectation that various unprecedented drastic measures which were taken in the financial and fiscal areas should be kicking in. The third is the confidence that American industries other than housing are stable. Farming and energy sectors are prospering and the export industries are supported by the weak dollar and high economic growth in the newly developing countries. The view is that the bounce back in the stock market reflects these factors. The fact that GDP of the first quarter of this year showed an annual growth rate of 0.6% even though many had predicted a negative growth is quoted to support the optimism. According to this trend of thinking, the second quarter may show a small negative but the second half of this year should show recovery.

Such optimistic views are not without reason, but arguments cautioning against such optimism should be heard as well.

The cautious view says that the confusion in financial markets caused by the subprime loan crisis has not yet touched bottom and there is a great danger that stagnation of American economy will last for a long time. This view is the complete opposite of the optimistic view. The logic behind the caution is as follows; there are 80 million houses in the United States, out of which 55 million are held as collateral for housing loans. In the American housing loan system, there are many cases where only the house for which the mortgage is provided is used as collateral. When market value of the houses drops below the amount of debt, there will be those who escape their debt by abandoning their houses. House prices are currently dropping at the rate of 13% a year and there are already 4 million houses for which the market prices are below the owners' debts. This number is expected to continue to increase rapidly and there are estimates that say the figure will be 12 million by next spring. An increase of abandoned houses means an increase of dead stock in the housing market. This would imply that the slump in the housing sector in the United States is extremely severe and would seriously affect the whole economy. Employment is already down for four consecutive months since the beginning of this year, which is a bad omen. Though GDP of the first quarter was plus 0.6%, American economy could be said to be in recession already since the real GDP was in negative if the increase in stocks had been taken into account. The rapid economic growth of China, India and other newly developing countries is already slowing down and it will become difficult for American exports to increase.

Such a downturn of the economy would undoubtedly increase the amount of non-performing loans. The subprime loan crisis occurred in financial markets and depressed the real economy through the housing market. This was the initial impact. But now there is a further development where the worsening of the real economy is boomeranging to hit financial markets again through an increase of general non-performing loans. The problems cannot be solved by dealing with appraisal losses and capital injection. If we consider the danger of inflation which was touched on before, conducting financial and fiscal policies would be extremely tricky in the future.

When comparing the optimistic and cautious views, I personally think that the cautious view seems more realistic. In other words, I do not think that the difficulties American economy is facing in both the real economy and financial markets are over.

This means that the rest of the world, including Japan, must be prepared for the risk that such difficulties will be transferred to other economies. The losses suffered by Japanese financial institutions in relation to subprime loans increased gradually and are close to 2 trillion yen. It would be difficult to avoid the decrease in profits because of the increase in non-performing loans especially in American markets. The effect of slowdown of the global economy is slowly and surely evident on domestic economy.

On the other hand, it is true that the damage that Japan suffered is relatively small compared to other developed countries. So we should take the opportunity to move even one step ahead to deal with the mid to long-term problems that this crisis has revealed. That is the biggest homework for Japan at this point.

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