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The 18th International Financial Symposium

"Perspectives of the World Financial Crisis---Wither to go"

(The Abridged Edition)

Institute for International Monetary Affairs

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Preface

Institute for International Monetary Affairs and the Japan Center for Economic Research held a symposium on April 8, 2009, at the Auditorium of Japan Bankers Association, entitled as “Perspectives of the World Financial Crisis---Wither to Go”. We had Mr. Richard W. Fisher as a special guest who spoke on “The Economic Situation of the United States and the Federal Reserve’s Response”, touching the policy measures the U.S. Financial authorities have taken thus far and the prospect of the U.S. economy. He was joined in the panel discussion by Mr. Toyoo Gyohten, President of IIMA, and Ms. Yuri Okina, Research Director and Chief Senior Economist of the Japan Research Institute, Limited and Mr. Akira Kojima, Senior Fellow of JCER. They discussed a wide variety of themes ranging from the importance of micro economic policy and fostering entrepreneurs, to education, while proposing desirable financial and fiscal policy measures to overcome the current economic crisis.

This is a summarized record of the proceedings of the symposium. We sincerely hope this paper would help your business and academic considerations. （※）

June, 2009

Institute for International Monetary Affairs

（※）This paper is the English edition of the Japanese article from the monthly journal of JCER published in May 2009.

Profiles of the Panelists

Richard W. Fisher, President and CEO of the Federal Reserve Bank of Dallas

After graduated with honors from Harvard Univ., Mr. Fisher received an MBA from Stanford Univ. and started his career in Brown Brothers Harriman & Co. in 1975. From 1978 to 1979, he worked as an assistant to the Secretary of the Treasury during the Carter administration. In 1987 he created Fisher Capital Management and Fisher Ewing Partners. In 1997, he rejoined the government and served as deputy U.S. Trade Representative with the rank of ambassador until 2001. After working as vice chairman of Kissinger McLarty Associates, he assumed the office of the current position in 2005.

Yuri Okina, Research Director and Chief Senior Economist of the Japan Research Institute, Limited

Ms. Okina received both a B.S. in Economics and an MBA from Keio Univ. She entered the Bank of Japan in 1984. After joining Japan Research Institute (JRI) in 1994, she became chief senior economist in 2000 and research director in 2006. Concurrently she worked as a member of Industrial Revitalization Commission (IRCJ) during 2003-2007. She serves many other governmental committees including Financial System Council and Government Tax Council.

Toyoo Gyohten, President of the Institute for International Monetary Affairs

After graduated from the University of Tokyo, Mr. Gyohten joined the Ministry of Finance (MOF) in 1955 to become Vice Minister of Finance for International Affairs in 1986. After retirement from MOF in 1989, he taught as visiting professor at Harvard Univ. and Princeton Univ. He was chairman of the Bank of Tokyo, Ltd in 1992. Since 1995, he has been the president of IIMA and concurrently he serves as senior advisor of the Bank of Tokyo-Mitsubishi UFJ, Ltd. In 2008, he has been appointed as a special advisor to the Cabinet, as special envoy of the Prime Minister.

Akira Kojima, Special Advisor to the Japan Center for Economic Research

Mr. Kojima graduated from Waseda Univ. and studied at Manchester Univ. as a British Council Scholar. Serving for many years as an editor at NIKKEI both domestically and internationally, he became managing director and editor in chief in 2000, then senior managing director and editor in chief in 2003. In 2004 he became chairman of JCER. Since 2008, he has been in the current position and concurrently, serves as corporate adviser to NIKKEI.

1. Special Presentation

"The Economic Situation of the United States and the Federal Reserve's Response--Proactive beyond the conventional monetary policy"

Mr. Richard W. Fisher, President and CEO of the Federal Reserve Bank of Dallas

Today I have the honor of speaking to you in another capacity—as a representative of the central bank of the United States in my role as president of the Federal Reserve Bank of Dallas, one of the Federal Reserve's 12 operating banks. Each of the bank presidents participates in the Federal Open Market Committee (or FOMC), the body that sets monetary policy for the United States. The tradition of the Federal Reserve is that each member of the FOMC speaks only for him or herself. I shall adhere to that tradition today. The observations I will offer today are my own and should be interpreted as a view only from the Federal Reserve Bank of Dallas—nothing more.

The data from the United States are grim. Our economy contracted at an annual rate of 6.3 percent in the fourth quarter of last year. I expect that when the numbers are properly tallied, we will have contracted at a very similar rate in the quarter just ended.

Unemployment is rising. We currently have roughly 13.2 million people without jobs, which equates to an unemployment rate of 8.5 percent. I expect the unemployment rate to continue rising to a level that could surpass 10 percent by year-end. Among other things, this has compounded the problem of the much-watched housing market. The most recent release of the Case-Shiller index reveals that home price declines accelerated in the 20 metropolitan districts tracked, falling 19 percent on a year-over-year basis for the three-month period ended in January. But the problem with our economy is more pervasive. The men and women who operate our businesses and create and sustain employment have assumed a defensive crouch. Confronted by dyspeptic financial markets, they are doing the best they can to preserve their margins by cutting costs, and running tight inventories, rationalizing supply lines, deferring all but the most necessary capital expenditures and, in general, avoiding risk. Not helping matters is the implosion of our export markets. The World Bank is predicting that the global economy will contract by 1.7 percent this year, and global trade by 6.1 percent.

Confidence lost in the U.S. market

One of our founding fathers, James Madison, considered by many to be the father of the American Constitution, wrote that "the circulation of confidence is better than the circulation of money." There is presently a palpable lack of circulating confidence in the business community in America.

In light of this, the Federal Reserve has assumed a dramatically proactive and highly innovative role in seeking to restore vibrancy in the credit markets while stemming economic decline. This is an unaccustomed thing for our central bank. Ordinarily, the men and women of the Federal Reserve are the most shy and modest of economic agents. But confronted with a dysfunctional financial market and an implosion in our economy, in rapid order we have undertaken a series of very visible and widely broadcast initiatives.

Over a period of a little more than a year, we:

—Initiated so-called swap lines with the central banks of 14 of our major trading partners, ranging from the Bank of Japan to the European Central Bank and the Bank of England to the Banco de México to the Monetary Authority of Singapore and the Korean Central Bank, to provide these foreign central banks with the capacity to deliver U.S. dollar funding to financial institutions in their jurisdictions. We also have put in place swap agreements with four of our counterparts—the Bank of Japan, the European Central Bank, the Bank of England and the Swiss National Bank—to enable the Federal Reserve to provide foreign currency liquidity to U.S. financial institutions;

—Undertook a major program to purchase commercial paper, a critical component of the financial system;

—Announced we stood ready to purchase up to $100 billion of the direct obligations of Fannie Mae, Freddie Mac and the Federal Home Loan Banks, then increased that sum to $200 billion;

And, in a series of steps, the FOMC reduced the fed funds rate to between zero and one-quarter of 1 percent.

All of this has meant expanding the Federal Reserve's balance sheet. As of today, the total footings of the Federal Reserve have expanded to roughly $2 trillion—more than a twofold increase from when we started in 2008. By being so proactive in straying from our usual business of holding plain vanilla, mostly short-term Treasuries as assets and by shifting policy away from simple titillation of the fed funds rate, we have raised a few eyebrows. But these are complex, trying times, and we are duty bound to apply every tool we can to clean up the mess that our financial system has become and get back on the track of sustainable economic growth with price stability.

This expansion of our balance sheet has given rise to concerns that we may be: 1) Planting the seeds of future inflation; 2) Setting the stage for a demise of the dollar; and 3) Placing the cherished independence of the Federal Reserve at risk.

Our assignment is to conduct monetary policy so as to engender sustainable, non-inflationary job growth. Presently, the risk is deflationary job destruction. We have undertaken measures to counter that risk. I consider inflation an evil spirit that rots the core of economic prosperity and must never be countenanced. But in this environment, inflation is unlikely to present a serious threat given the pervasive bias in the U.S. economy toward wage cuts and freezes, rising unemployment, the widespread loss in wealth.

The fate of the dollar depends on the willingness of others to continue purchasing dollar denominated debt. Over the past year since we began in earnest the process of using the new tools, the dollar has appreciated 17 percent against the euro and 29 percent against the British pound. Among the major currencies, the dollar has depreciated against only one currency, Japan's, and by 2.4 percent. If a Japanese investor had purchased a three-month U.S. Treasury bill in March of 2008 and rolled it over every three months until the end of this past month, the return would have been slim to none—about –1.4 percent. A Korean investor investing in the same manner would have earned a 42 percent return in won terms had he invested in three-month Treasury bills.

Attractiveness of the U.S. securities depends on the efficacy of its fiscal policies

Demand for Treasuries and other official paper of U.S. government issuers will be determined by their attractiveness relative to alternatives, and they may well be judged more, rather than less, attractive under most reasonable future scenarios. Moreover, both the fate of budget imbalances and the potential for total returns earned by investing in U.S. securities depend on the efficacy of the fiscal policies Congress has advanced. These policies are designed to jump-start the economy while laying the groundwork for permanent structural reform. If these policies don't jump-start the economy, then I am confident that the reaction within fixed-income markets will force those with the power to tax and spend, the Congress, to readjust their fiscal policies.

As to the independence of the Federal Reserve, let me remind you that in 2013, we will celebrate our 100th anniversary as the central bank of the United States. We are an elder in this business. We seek to be worthy of the veneration traditionally given to an elder. To this end, we feel it necessary to guard our ongoing independence. We have recently agreed with the U.S. Treasury to an accord to work together to support the goals of preserving both monetary and financial stability. In this endeavor, it is the Federal Reserve's job to maintain monetary stability, while the Treasury will enable the Fed to sterilize the impacts of its lending and securities purchases on the supply of bank reserves.

In contemplating the future of the American economy and our ability to overcome our current financial predicament, I take great comfort in knowing that we have faced far tougher tasks and have always accomplished them. We never give up. And we always come roaring back stronger, leaner and more efficient than we were before. For 233 years, the people of the United States have demonstrated that they are masters of the process of creative destruction that the economist Joseph Schumpeter articulated as the key to success for any economy. I am confident that the innovative policies being pursued by the Federal Reserve will facilitate and, indeed, expedite the recovery process.

2. Panel discussion

<Panelists>

Toyoo Gyohten, President of the Institute for International Monetary Affairs

Richard Fisher, President and CEO of the Federal Reserve Bank of Dallas

Yuri Okina, Research Director and Chief Senior Economist of the Japan Research Institute, Limited

<Moderator>

Akira Kojima, Special Advisor to the Japan Center for Economic Research

Kojima

Currently the world economy is still in a state of dead of winter. What do you see the future hold for us?

Ms. Okina

As far as the responses to the present crisis are concerned, I think there had been differences in methodology applied for this current crisis and the previous ones. This reflects the fact that the financial system has recently undergone a major transformation. In the financial crises in 1980's and early 1990's, the banking sector was severely affected, but the other markets and the other sectors of the economy remained unaffected. On the other hand, securitization has evolved further since then and we saw a large number of new, globally active players entering the market. Today we have a very intricate financial system in the market. As a result, new ideas are required to counter the current crisis with regard to the monetary policy and prudential policy.

Successful intervention of the Fed

The U.S. Fed is taking a complete credit easing policy by which it tries to repair the various channels of financing in addition to the bank intermediation. Being prudent not to take credit risks, it intervened in the CP and ABS markets, and in the CP market the interest rate has already come down to bring the de facto credit easing effect. In the past, the central bank used to be the lender of last resort to the banking sector. In the current crisis, however, I think the central bank has really transformed its functions with adopting the unconventional measures. And I believe this also is a response to the fact that the financial system itself has undergone a major transformation.

I believe even the prudential policy has also changed. In the past, it largely focused on the management of the deteriorating banks, but in the current crisis, it was the non-bank institutions, especially investment banks, that aggravated the crisis and the government had to inject public fund even to such insurance companies as the AIG. Recently Geithner Plan was announced to deal with decoupling toxic assets, which I think was a major development. However, there was resentment among the people to the rescue of the AIG and others because of the bonuses paid to the executives of such institutions. In Japan we experienced similar problems in the past, because the Japanese people were against the injection of public money into banks. I wonder how the United States is going to resolve this issue going forward.

Both in Japan and the United States we have had quantitative easing policy. By comparison of the responses, however, the strategies behind the quantitative easing in Japan and in the United States were somewhat different. In the case of Japan, quantitative easing was primarily focused on the debit side of the central bank‘s balance sheet. Although this quantitative easing in Japan did have the impact of stabilizing the financial system, some say this really didn’t have the intended results as monetary policy. Now in the United States, you are primarily focusing on credit easing rather than quantitative easing as in the comments of Chairman Bernanke.

In the U. S., you are going to implement further injection of public money and decoupling of toxic assets. How do you think they will help to bring the economy and financial market to recovery? In Japan, we did inject public money and financial system was stabilized to a certain degree, but it took a very long period before economic growth was regenerated. Actually the growth was brought on by the growth in exports. At the same time, the corporate community pursued restructuring and introduced new money for the core sector of their business, which also contributed to the recovery. Now in the United States, it will be necessary that the companies like GM and Chrysler pursue the road for rebirth and this is going to be a very critical process.

SMEs generate a larger part of employment

Mr. Fisher

I think it's very important to remember that jobs are created in the United States by small businesswomen and men. There is obviously an enormous amount of attention paid to the restructuring of such monolithic large organizations as GM and so on, but future lies with comings we haven't even thought of yet. Who would have dreamed the Google or the Microsoft would be that size?

Only 11 percent of our economy versus, say 22 percent here in Japan, is manufacturing, only 5 percent is oil and gas and mining, and only 1 percent is agriculture. The rest is all high value-added services. Incidentally, in 2007, legal services provided two times as GDP contribution as the automobile industry. So, it is important to provide functioning markets that will enable small and medium sized businesswomen and men to create the new jobs that move us up the value added ladder that gives us comparative advantage in the global economy.

On the fiscal policy in relation with the monetary policy, we had a transition period between administrations where the only game in town was monetary policy. But from now on fiscal policy is critical to provide a spark in the economy and help for intermediate term and longer term the transition to a new economy. Although there are some concerns that deficit spending will get out of control, it is important that the fiscal policy provides the spark to the economic recovery.

As regards the difference between the Bank of Japan and the Federal Reserve in their approaches taken, the Bank of Japan initially focused on the right hand side of the balance sheet, while we have emphasized the left hand side of our balance sheet. We have intervened in the market and built up our different asset such as CPs with the consequence of providing liquidity. If you use an anatomical example, our patient was in the emergency room, in something of a coma, and since liquidity is the blood of capitalism, we provided the transfusion to keep the patient alive.

With regard to the decoupling of toxic assets by Geithner Plan, Secretary Geithner used to be President of New York Fed and certainly understands the importance of maintaining the independence of the Central Bank. None of his plans are perfect, but every one is an attempt to remove what is hindering a restoration of proactive lending policy by our credit institutions. Its objective again is to free up the credit system, particularly the banking system to lend once again. It aims the right direction.

In the present crisis, regulators, including the Federal Reserve, did not see a lot of this coming or did not understand it as sufficiently as we should have. It'll be corrected in the new regulatory structure that will likely be forthcoming. On the issue of bonuses paid to executives, I think we have to be very careful in the United States not to criminalize capitalism. If somebody has their hand out and ask for taxpayers' money, they will be subject to political exigencies and to political measurements. But my hope is that this will not be extended to those that are successful in creating something out of nothing.

Mr. Gyohten

It's not the first time that mortgage has caused a bubble, but one largest difference this time is that the background of such bubbles and their bursts was quite different from the past ones. We were not aware of the changes that had occurred in our environment and background. Environment has changed for one thing through globalization, and for another through big changes in the financial world. In the financial market, a greater range of products have been traded, and players have changed greatly in the meantime. Unfortunately, both of the public and private sectors were not able to grasp all the changes which were occurring, which led to a delay in responding to the crisis.

So what should we do at this juncture? I would say that the answer would be quite obvious. For the first thing, sufficient liquidity needs to be provided to the economy. Secondly, balance sheet has to be made more transparent, and has to be presented in a better way to show that toxic assets have been totally removed from it. Thirdly, someone, be it in the public sector or in the private sector, has to fill in the gap of the shortfall of the capital. So those three things, a kind of 3-part package answer, will be needed in order to tide over the current financial crisis.

In spring of 2007 when the crisis had surfaced, the initial responses taken by the U. S. authority unfortunately were insufficient in various different elements. I would say that the actions taken then were too little, too late. Also the policy target had been laid out in the wrong direction. But since the end of last year when the new administration took office, the policies taken were in the right directions. In providing liquidity, the FED and other agencies have been applied non-conventional tools to take a proactive approach.

On the removal of the toxic assets, we are watching whether Geithner Plan will be well functioning or not. And based on the outcome of the stress test the Treasury Department is now performing, the responses will be announced accordingly to fill the gap of capital. We already know the whereabouts of the problems in the United States vis-à-vis the financial crisis, and the direction for resolving those problems has been set clearly, and steps are now being taken. If I draw a baseball analogy, in terms of reality, maybe we are at the fourth or fifth inning of a baseball game.

In the current crisis, not only the financial market, but real economy needs to be considered. Although housing prices went down quite significantly, inviting defaults in mortgages and foreclosures of the houses, and further decline was likely in the housing market, the responses were not taken in good speed and sufficiently enough. Now this housing problem needs to be resolved by all means. Otherwise the financial market problem will not be solved, because the trigger of the crisis was the securitization of the mortgages. Bu in order to solve the problems completely, we will need more time and further effort as well as sizable amount of additional funds.

Finally I would like to hear the views of President Fisher on what will become of the balance of power in the global economy after the crisis. Earlier President Fisher was confident in saying to us that the American style of society or market capitalism has a good capability to renew itself and produce new things. I strongly hope that would indeed be the case but I still have some suspicion about what is likely to be the case as far as the global balance of power is concerned.

Protectionism should absolutely be avoided

Mr. Fisher

I don't like to refer to which inning we are in in baseball games. I will remind you, however, if my memory is correct, that the longest professional baseball game played in the United States was 39 innings long, and it ended in a tie.

Mr. Gyohten raised several things of what we need to do. One way to answer that is, to say what we need not to do. Let me remind you of the Long Depression in Europe which lasted for 26 years. It was caused because Otto von Bismarck, the Chancellor of Germany took the initiative to close off the German markets according to the demands of the German farmers and the then makers of manufactured goods and the French responded with a protectionist act. So my answer to your question is, as we struggle to provide a restoration of the credit system, the one thing we cannot afford to do is protectionism, and I mean this not in words, but in action.

With regard to the financial system, I don't think people can say that the Federal Reserve was slow to react. We were the first out of the gate. And I listed for you the different actions that we took. Now, we are beginning to see some healthy signs, some stirring of what are called green shoots. One has to take faith in the basic human instinct of all societies, whether they are Anglo-American or other, to improve their living standards and to figure out regimes that make that possible. On the power balance, I think the balance of power will either stay or shift to those that are the masters of creative destruction.

Mr. Kojima

I would like to focus on the global imbalance issue. Ever since 1970's, the U. S. has accumulated debt and made excessive consumption because the U.S. Dollar had enjoyed a privileged status as key currency of the world. The U.S. has been borrowing the dollar-denominated debts without foreign exchange risk, and was able to continue to accumulate the debt. And we may say that caused a loss of self-discipline on the part of the U.S.

When we compare the lost decade or lost 15 years for Japan with the present case of the U.S., we find crucial differences. Japan was able to grow by the expansion of export but at the same time there was an adjustment in employment; companies reduced regular employment and increased lower-waged non-regular workers' employment, which enabled them to suppress the total wage cost which contributed to the improvement of the quality of the balance sheet for the Japanese companies.

But on the other hand, the balance sheet of the household had deteriorated. The total income of a household decreased, every year since 1998 through 2005. In that process the Japanese savings rate of the household decreased from 16 percent to 2 to 3 percent. So at the expense of the household balance sheet, the corporate balance sheet got improved as well as the financial institutions' balance sheet. But in case of the United States, it is the balance sheet of the household that needs to be improved. The household still have a huge debt vis-à-vis the GDP. If you look at the consumption, it increased from 60 percent of 15 years ago to 70 percent because household consumption had been financed by debt. How do they pay it back? In the income environment which is getting worse for the American people right now, they have to cut on spending. The U.S. economy used to be the spender of last resort for the world, but now spending need to be persistently reduced in order to improve the balance sheet of the household in the United States. That process has just begun, and it seems to me that the process will continue for a substantially long time to come. What do you think about this?

I have a last question about the dollar. I'm not talking about the value of the dollar, or how much it would go up or go down. The dollar denominated securities are still relatively attractive and drawing funds, but the short term strength of the dollar at this time may have been driven by just a short time factor. The American financial market is still frozen and not functioning well. The dollar supply within the U.S. market is not enough so that financial institutions are going abroad to sell their assets and buy the dollar at the overseas market. If that is the case, then maybe it's just a short-term factor that supports the strength of the dollar and once market gets normalized, this picture will change drastically. At the same time, in the adjustment process of the global imbalance, I am afraid that the dollar would not maintain its strength, and become weaker over a long period of time. What do you think of my prediction as one of the views to understand the present situation?

Mr. Fisher

No central bank official and no Finance Ministry official should ever comment on the direction of currencies.

On the issue of household consumption, households are harboring the resources as much as possible by increasing their savings and therefore spending less. Until confidences are rebuilt, and people forget the past, the growth path would not be on the same slope that we had before.

Putting these two things together in terms of confidence in our future and our currency, my personal opinion is that it's a function of how quickly and sustainably we restore economic growth, how well we do it without impairing price stability. And it is our job and your job to make our home countries attractive in a world where we are not going to have an equivalent of Esperanto in a language, that is, one single currency. And the currencies and the countries that will do the best in attracting investment will be those that are for the best possible returns.

As to what might make our country attractive, I think the single most important thing is to provide high quality education of our higher educational institutions. They are where ideas come from. And this is where we deploy those savings in the long run. And I would hope we would invest those savings in people to improve the capital plant which is the only thing that drives us into the future in a high value added society.

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