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Danger Posed by Shadow Banking Systems to the Global Financial System: Lessons from Japanese Experience

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Shadow banking and asset bubble

- Excess risk-taking by unregulated and unmonitored shadow banking activity creates asset bubbles.
- Collapse of asset bubble causes a dry up of liquidity and a sharp contraction of credit.
- Credit crunch causes a slow down of real economic activity, leading to a severe recession.

Japan’s “bubble economy” (1)

- Historical background
  - Catching-up stage of economic growth had ended by early 1980s.
  - This caused productivity growth slowdown, low equip investment, and lower corporate profits.
- Development of financial markets: banks lost best borrowers to bond and stock markets.
- Japan’s household saving rate was still high, but corporate demand for credit declined.

Japan’s “bubble economy” (2)

- In seeking new profit opportunities, banks had made many questionable lending decisions in late 1980s.
  - In particular, lending to real estate, construction, and resort businesses.
- Key to the “bubble economy” was Japan’s collateral lending practice.
  - Kiyotaki and Moore (1997)

Japan’s “bubble economy” (3)

- This resulted in a serious non-performing loan problems in 1990s, but credit crunch did not happen until fall of 1997.
- Forbearance (zombie) lending and misallocation of credit had been more serious problem.
  - Caballero, Hoshi, and Kashyap (2008)

US subprime bubble (1)

- Excess risk taking in mortgage lending market.
- Large mis- and overvaluation of MBS and CDS
  - Mostly, it was a result of overconfidence and ignorance, not a criminal act.
  - Some people were apparently aware of overvaluation: eg. John Paulson

US subprime bubble (3)

- Decline of home prices caused loss of values of ABSs linked to subprime mortgages.
- The shock spread quickly to other asset classes as entities based on short-term debt were unable to roll over the debt or faced withdrawals.
  - Repo market, the market for ABCP, and MMMFs.
- Large international spillover of the financial crisis.

Common features

- Monetary easing and very low interest rate.
- Other factors behind excess risk-taking
  - Excess supply of funding.
  - Loss of conventional and stable profit opportunities (Caballero, Farhi, and Gourinchas 2008).
    - Increased competition among financial institutions.
  - Emergence of new unknown asset class.

Differences

- Japan’s bubble economy
  - Commercial real estate bubble.
  - Banks’ problem: did not involve shadow banking
  - Funding came from domestic saving. There was a limited international spillovers.
- US subprime loan bubble
  - Housing price bubble.
  - Shadow banking system was main source.
  - International capital inflow sustained and fueled subprime bubble (Bernanke 2005; Rajan 2010).

Implications

- Same old story, same old mechanism.
  - This time is ***not*** different (Reinhart and Rogoff, 2009)
- However, bubble always reappear in different faces.
  - There will not be a single policy and/or regulatory solution.
    - Perhaps, except extremely tight monetary policy --- BIS view vs FED view.

Implications (continued)

- Shadow banking system arose because conventional banking system had become too heavily regulated and too transparent.
  - So that less and less profitable.
- Heavy regulation kills most important role of financial institutions/system, that is discovery and transmission of business information.
- Financial authorities cannot monitor and control everything. There will be always loop holes.

Next: China Syndrome?

- Current Chinese situation looks exactly like Japan’s experience in late 1980s.
- If so, eventual crash will be inevitable.
- Will it be corporate, household or local government non-performing loan problem?
- Will there be serious international spillovers?
  - Mainly through goods market?
  - Any serious financial propagation?

Government involvement

- Chinese banks are state owned or government-backed.
- So they are better regulated and better protected, they say.
- But, does government have incentive to monitor and regulate them appropriately?

Government involvement (continued)

- Semi public, semi private financial institutions always create problems.
  – Japan: Jusen (specialized housing loan companies) problem.
  – US: FannieMae and Freddie Mac
- Government discretions and indecisions
  – Japan: Government had avoided restructuring of non-performing loans at the beginning.
  – US: “Owning a home is the American dream”

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