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

20-22 August, 2014

Tokuo Iwaisako
Hitotsubashi University and Ministry of Finance
JAPAN
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”
References