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Richard Koo: a personal view of the macroeconomy

Financial markets rocked by "Obama shock"

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Last week the markets were roiled by the Obama administration's call for tougher regulation of financial institutions. Investors sold off stocks—particularly financial stocks—and bought the yen as a safe currency.

The proposed new regulations would mark an end to the long liberalization of the US financial sector. I think they are in line with the moves to increase taxes on financial institutions in the UK and France.

In Japan, meanwhile, attention has focused on the use of campaign funds by DPJ secretary general Ichiro Ozawa. As a result we have the unusual situation of both the prime minister and the party leader becoming embroiled in a funding scandal just over 100 days into the new administration.

*** Glass-Steagall turned corner in 1990s**

As Mr. Obama himself noted, former Fed chairman Paul Volcker is the figure behind the Administration's proposed new banking legislation. The proposal is even referred to as the Volcker plan.

Mr. Volcker has argued for some time that the operations of commercial banks and investment banks should be separated. It was said in the US not so long ago that as long as Mr. Volcker (he is currently 82 years old) is alive, the 1930s-era Glass-Steagall Act—which split up commercial and investment banks—would not be repealed.

But the 1990s saw a gradual rollback of the provisions of Glass-Steagall, and in 1999 the Act was finally repealed. I suspect Mr. Volcker was not happy to see this happen.

In what may or may not have been a coincidence, it was around the time that Glass-Steagall was repealed that the US moved towards a system of financial capitalism and its financial sector began a dramatic expansion. This phase continued until the housing bubble collapsed.

*** Two regulatory changes led to creation of large US banks**

It is difficult to say whether the current financial crisis could have been avoided had Glass-Steagall not been repealed. However, it is a fact that the relaxation of rules on inter-state banking, also a product of the 1990s, led to the creation of a number of massive banks that were "too big to fail."

While it may be difficult to imagine for readers in Japan or Europe, there existed until the early 1990s a wide variety of restrictions on interstate banking in the US. New York banks, for example, were prohibited from opening branches in California. The only institutions excepted from these rules were foreign banks and the First Interstate Bank, which had been engaged in such operations before the regulation was enacted.

Today no one thinks twice when they see Citibank branches in California or Bank of America branches in New York, but this would have been unthinkable 20 years ago.

These rules were relaxed in the 1990s because it was said that US banks, prohibited from engaging in interstate banking, were too small relative to their foreign rivals and were therefore unable to compete effectively in global financial markets. The US authorities essentially set out to create large, globally competitive banks.

*** Volker continually called for financial regulation reforms**

Both the repeal of Glass-Steagall and the liberalization of interstate banking occurred in the 1990s under the Clinton administration. During Mr. Clinton's second term it was Lawrence Summers, the current director of the National Economic Council, who served as Treasury secretary. And current Treasury secretary Timothy Geithner was engaged in various roles under Mr. Summers. In effect, this two-pronged drive towards the liberalization of the financial sector was spearheaded by the two men most responsible for economic policy under the Obama administration.

Mr. Volcker, who believes that the government should not easily allow the creation of massive banks or the expansion of banking operations, stood opposed to the two men within the Obama administration that were largely responsible for those changes—Messrs. Summers and Geithner. The two men were also not in favor of the tightening of financial regulation sought by Mr. Volcker.

Mr. Volcker therefore found himself on the policymaking sidelines for nearly a year, but nonetheless continued to argue in favor of this type of reform.

Mr. Volker also has a high standing in the US, reflecting his past achievements, the consistency of his arguments, and his sincerity. The general perception of him is a far cry from that of Alan Greenspan, his successor at the Fed who allowed the bubbles to grow.

*** Proposed legislation shifts course of liberalization and attempts to limit bank scale**

Many global observers felt that US attempts to tighten regulation while continuing along the path of financial liberalization were too lenient. Even the UK, whose economy is heavily dependent on the financial sector, levied a special tax on banks, as did France.

A handful of US financial institutions are also paying out massive bonuses again while ordinary households and small businesses face a credit crunch that appears to be worsening.

Given this backdrop, I suspect Mr. Obama decided it was no longer wise to continue supporting financial liberalization.

The administration also emphasized that it wants to limit the size of banks by capping deposits and other liabilities. These limits will probably take the form of a cap on the percentage of total deposits in the US that can be held by a single institution.

This clearly runs in the face of the trend towards the liberalization of interstate banking, which was effectively intended to create large banks.

The prevailing view today that no bank should be “too big to fail” probably prompted the move to cap total liabilities, in my view.

*** Sound settlement system at heart of Volcker’s position**

Mr. Volcker’s plan is based on the principle that the government must protect those banks—commercial banks—responsible for the settlement system. In fact, all of his ideas start from the idea of protecting the settlement system.

When I worked at the New York Fed during Mr. Volcker’s time as chairman, there were a number of events—including the Latin American debt crisis and the failure of Continental Illinois National Bank and Trust Company—that could easily have caused a financial system shock similar to that of the Lehman bankruptcy in 2008. But the problems were addressed with almost no damage to the real economy because of Mr. Volker’s efforts to maintain the settlement system using every means at his disposal.

The Latin American debt crisis was triggered when US banks, ignoring four years of warnings from the authorities, continued to lend ever-larger sums to dictators in Central and South America. The problems at Continental Illinois were the result of energy-related speculation.

Either crisis could easily have damaged the real economy while starting an endless blame game. But Mr. Volcker addressed them both with a focus on sustaining the settlement functions of the banking system. The Latin American debt crisis was dealt with over a period lasting more than a decade, while Continental Illinois was nationalized within 48 hours, leaving its settlement functions intact. Mr. Volcker succeeded in minimizing the impact on the real economy by flexibly applying a wide range of measures to fit the crisis.

I suspect Mr. Volcker's latest proposal comes from having repeatedly witnessed reckless behavior in the US financial sector and from his own unpleasant experiences in dealing with the consequences of such behavior. He probably came to the conclusion that the financial sector will always err on the side of excess, so we need to think about minimizing in advance the eventual cost of addressing the resulting problems.

*** Volker's plan will not solve everything...**

Of course the Volcker plan is no magic bullet. The proposed regulations center on deposit-taking banks, while the financial crisis was as serious as it was largely because of what happened at Lehman Brothers, an investment bank, and AIG, an insurer.

Some banks saw their balance sheets take a hit not because of problems at their investment banking divisions but rather because ordinary loans soured as the economy fell into recession. These kinds of problems will not be resolved by the Volcker plan.

That said, it is leverage that has allowed the US financial sector to expand to its current size over the last decade. Leverage requires willing lenders, and those have ultimately been deposit-taking banks.

I think Mr. Volcker believes that if we can change the behavior and culture of the banks at the center of the credit-creation mechanism, the financial capitalism resting on top of that structure can also be reined in.

*** Credit crisis can be overcome as long as settlement system remains healthy**

In the current crisis, the entire financial system—including the securitization markets—essentially shut down when the interbank market stopped functioning. The so-called "shadow banking system" functioned only because the banks were healthy. Once problems developed at the banks, the shadow institutions were unable to step in as a replacement. In fact, they found themselves in deep trouble as well.

AIG may have been an insurance company, but the reason why the authorities had to step in and rescue it was that so many US financial institutions had come to rely on the credit guarantees it provided. The rescue of AIG was in reality a rescue of US financial institutions.

The Volckerian view is probably that other financial problems can be dealt with as long as the banking system stays sound. If there are problems in the banks, the situation will only get worse, even if brokerages and other actors in the financial system remain healthy. It is therefore critical to maintain a sound banking system at the heart of the financial sector.

*** Volcker plan repeats history**

I anticipate heavy resistance to the Volcker plan from people making money by doing some of the things it seeks to stop.

But its enemies' record since the Glass-Steagall act was repealed in 1999 is far from commendable. They have created a number of bubbles and triggered the worst economic downturn since the Great Depression. For that reason, I think that some portion of Mr. Volcker's proposal will eventually become law despite the opposition.

The Glass-Steagall Act was created in response to the painful experiences of the Great Depression. Inasmuch as Mr. Volcker's plan to split investment banks and commercial banks is based on the same concept, I sense history repeating itself.

*** Debate should focus first on tightening rating agency regulations**

While splitting up investment banking and commercial banking functions may be important, I think the first focus of debate should be on tightening regulation of credit rating agencies. The current financial crisis could not have happened without the rating agencies assigning high credit ratings to subprime CDOs and other securitization products.

I think that the agencies' "cooperation" was essential to the irresponsible securitization that went on and that they shoulder much of the blame for the crisis.

This issue of rating agencies is a new problem that did not exist during the Great Depression of the 1930s. Prior to the Great Depression, US banks lent solely on the basis of collateral, as did Japanese banks until only a few years ago.

When that collateral lost much of its value during the Depression, lenders began to realize the limitations of collateral-based lending and to recognize the importance of credit checks and ratings. The painful lessons of the Great Depression therefore enhanced the social importance of credit ratings and the agencies that assigned them.

The reckless behavior of those same rating agencies was a key cause of the recent crisis, and I think we need more discussion on the kind of regulation needed to prevent this from happening again.

*** Rating agencies are supposed to serve as a brake on market excess**

The CDOs that triggered the crisis are so complex that it would take a team of a dozen mathematicians three weeks to analyze the risk characteristics of a single instrument. In my view, only institutions with teams of quantitative analysts on hand should be allowed to buy such products.

I think that products with risk characteristics requiring such sophisticated skills to analyze are not appropriate for ordinary investors and therefore should not be rated by the agencies. Assigning a rating to a product gives the impression that it is appropriate for general investors. Prohibiting the agencies from rating such products would prevent the kind of damage seen in the current crisis when rating agencies adopted looser rating standards in a bid to attract more business.

The agencies were originally intended to assure the quality of products traded on the capital markets and to serve as a brake on market excesses. In the current crisis, however, the brake cable snapped. To prevent this from happening again, I think it is essential that the authorities more tightly regulate credit rating agencies.

*** Is stock market drop entirely Obama’s fault?**

Although the “Obama shock” triggered a global decline in equity prices, I do not think the fall in share prices can be fully attributed to the Administration’s proposal for stronger regulation.

Stock markets around the world have rallied sharply since hitting bottom last spring, but the real economy has not seen a corresponding recovery.

Share prices have recovered to pre-Lehman levels by some measures, yet US industrial output remains stuck at 2002 levels, and capacity utilization is back at 1983 levels after a modest rally from an all-time low. Industrial production in Japan is still at 2002 levels and is down 19.8% from the February 2008 peak.

An identical phenomenon can be observed in Europe. The eurozone unemployment rate stands at 1998 levels, and industrial output, despite a modest recovery, remains at 1999 levels and is down 13.6% since the Lehman collapse.

Recent earnings reports from US banks also indicate that the household sector, the source of final demand in the economy, faces very difficult times. Personal consumption will clearly not be able to drive a US economic recovery as it so often did in the past.

All in all, I see little possibility of the real economy recovering to pre-Lehman levels in the near future.

*** Balance sheet recession continues even after panic is gone**

Both the Nikkei Average and the DJIA fell to the 6,000–7,000 range last spring in the wake of the panic sparked by the major policy mistake of allowing Lehman Brothers to fail. It was natural for share prices to rally once the panic had subsided. But the problems in private-sector balance sheets that existed prior to the Lehman collapse persist and will create a ceiling for share prices and the real economy.

Until recently, the stock market seemed likely to continue rising at the pace seen since last spring. But I think equities had clearly grown overextended and was not surprised that the rally finally hit a wall.

In my view, the "Obama shock" abruptly threw into relief something that people already perceived, albeit dimly. If US final demand cannot be expected to return to pre-Lehman levels anytime soon, current stock prices are simply too high.

*** Equity rally may have stumbled even without Obama shock**

From a policymaking perspective, it is not particularly difficult to resolve the panic created by a policy misstep (the Lehman bankruptcy) with an all-out policy mobilization (valued by some analysts at $9 trillion). But repairing private-sector balance sheets damaged by the collapse of the housing bubble will require an extended period of time and continuous government support, as Japan's example shows. It will not be easy.

In other words, we have only finished the "easy part"—easing the panic created by US authorities' policy mistakes—and are about to embark on the "hard part," which involves the real work of cleaning up balance sheets.

I therefore think the stock market rally may have stumbled even without the Obama shock.

*** Public support falls when governments implement correct policies during balance sheet recessions**

The decline in the Obama administration's public approval ratings was also expected. Japan's experience shows that making the right policy choices during a balance sheet recession will only cause support for the government to weaken, to the extent that those measures are successful in averting a crisis.

Left unchecked, a balance sheet recession will eventually lead to a deflationary spiral. But the general public is incapable of understanding the pain that that would entail without actually experiencing the spiral. The more fiscal stimulus provided by government to avoid a deflationary spiral, the more the public will come to the conclusion that the money was wasted, since the economy remains weak despite the heavy expenditures. The public does not realize that the economy would be far weaker without government support.

It is often said that the man who avoids a crisis is never proclaimed a hero. This was true of the LDP administrations in the 1990s, and it is the dilemma now faced by the Obama administration, which will almost certainly be criticized in the media in direct proportion to the amount of (essential) stimulus it provides.

*** Obama administration must explain economic sickness to voters ASAP**

In Japan's case, however, it took 5 to 6 years from the collapse of the bubble for people (including myself) to recognize that the recession was very different from those described in economics textbooks. The economic wound festered throughout this period because the government did not respond with the right kind of medicine.

In contrast, the US and UK today can adopt the right policies simply by following Japan's example. Mr. Obama's $787bn fiscal stimulus actually owes much to Japan, including the strong warnings and advice offered by former prime minister Taro Aso to President Obama.

Unfortunately, Messrs. Obama, Summers, and Geithner have yet to explain to the public how this recession differs from ordinary recessions and why fiscal stimulus is needed.

Japan's experience shows that it is extremely difficult in a democracy for the government to persist in providing fiscal stimulus without explaining why it is necessary. It is like trying to give a patient an expensive treatment for pneumonia without first explaining to her that she is suffering from pneumonia and not merely a bad cold. It was perhaps because of the lack of sufficient explanation that the Democrats experienced an unexpected loss in last week's special Senate election in Massachusetts.

It may be difficult for Mr. Obama to tell voters one year after he was elected that, in fact, we are dealing with a different kind of economic sickness. But the longer the Administration waits, the further its approval ratings will fall.

*** US authorities have been flexible on bad loan write-offs even while tightening regulation**

While announcing what would appear to be tough new regulations for the banks, the US authorities have substantially eased the rules on bad loan write-offs and are moving to prevent the recent plunge in commercial real estate prices from causing further damage at US banks.

Nationwide commercial real estate prices have fallen 43% from the 2007 peak on average. Many properties are now worth less than the outstanding balance on the loans secured by them, preventing banks from rolling over the loans. The sharp drop in property values also means that the loan-to-value (LTV) ratio on all real estate-related loans has probably exceeded an appropriate level.

If US banks start refusing to roll over existing loans or tighten the criteria for extending new loans because LTVs are too high, they could trigger a wave of commercial real estate-related defaults. That, in turn, could inflict fatal damage on a banking sector already weakened by problems in residential mortgages.

Many of the loans issued during the bubble are due for refinancing between late-2009 and 2011. Consequently, there is no time to waste for either the authorities or the banks themselves. If lenders refuse to roll over these loans, the US could experience another Lehman shock.

*** Approach has shifted from quick bad loan disposals to more gradual process**

The authorities have responded by changing their position. If the bank can make a case that the price of a given property has fallen excessively, the authorities will not intervene if the bank decides to roll over the loan. In other words, they will not treat it as a nonperforming loan.

Even if the outstanding loan balance exceeds recent estimates of the property’s market value, the bank may be allowed to roll over the loan if, for example, the owner has long-term contracts with good tenants and rents do not appear likely to fall substantially from current levels.

This implies a major shift from the traditional stance of US authorities, which was to demand that banks write off impaired loans as quickly as possible. It also represents a change in the stance of Treasury secretary Geithner, who originally argued that the US would not experience the kind of drawn-out recession seen in Japan did because it would deal with its banking problems quickly.

The pronounced weakness in the commercial real estate market has forced US authorities to abandon their traditional preference for quick write-offs. Instead, they will encourage US banks to roll over loans (even effectively nonperforming loans) and thereby prevent the crisis from surfacing. This suggests that the banks will be allowed to clean up their problems over time by funding write-offs with earnings.

*** Drawn-out disposal process represents most practical option**

This change of approach suggests that, one year into the new administration, US financial authorities are finally facing reality. This is an extremely favorable development. I visited Washington several times last year, and each time I emphasized that when the banking sector faces large problems and when taxpayers refuse to pay for the cleanup, the only answer for the authorities is to “put time on their side.” Rushing ahead to repair bank balance sheets will only aggravate the situation.

Many in the US initially responded to my arguments by saying that Japan had simply been lazy—the US authorities, on the other hand, would quickly clean up the mess and put the economy back on track towards recovery. They had not realized that nonperforming loans should be written off quickly only when they are small relative to the broader financial system.

When the problems are larger in scale—ie when they are systemic in nature—the only answer is to do things slowly.

Like myself, Mr. Volcker also believed that given the magnitude of the problem the only answer was to put time on our side and write off the loans gradually. He was also ignored initially. Although I do not know how big a role Mr. Volcker played in relaxing the rules on commercial real estate lending, this is precisely the approach he took in dealing with the 1982 Latin American debt crisis, another systemic crisis.

The decision by US authorities to place first priority on enabling the smooth refinancing of existing loans, thereby discouraging banks from rushing to foreclose on properties (as required under the rules), implies that they have finally adopted a realistic approach to dealing with the situation.

It remains to be seen how many US banks will take advantage of the new guidelines, but given the substantial benefits of doing so I think that many will. This should help cushion the decline in commercial real estate prices and lower the probability of falling real estate prices triggering another financial crisis, in my view.

*** Reduced likelihood of selling climax**

The authorities' change in stance has also largely eliminated the possibility of a sudden selling climax that would bring a true bottom in prices.

It appears that a handful of "hyenas" were awaiting just such an event. But with financing extremely difficult to obtain in the current environment, it is difficult to anticipate just how far prices might fall. Such a decline would further weaken bank balance sheets, making it impossible for many people wanting to purchase real estate to obtain financing.

The implications of a selling climax are utterly different when (1) potential buyers are able to obtain financing, as was the case during the cleanup of the savings and loan crisis of 1989, and when (2) most banks are experiencing severe bad debt problems and there is a severe nationwide credit crunch. In the former case, a selling climax can mark the beginning of a new bull market, but in the latter case it represents a one-way ticket to a depression. It would appear that the US authorities have finally recognized this.

I have previously argued that two policies must be implemented to leave the US economy on a firm footing: (1) sustained fiscal stimulus until the private sector completes the deleveraging process; and (2) a gradual, pragmatic program for the disposal of banks' bad loans. The recent changes to the guidelines for commercial real estate loans (often dubbed "pretend and extend") suggest that the second may actually be implemented, and to that extent I think are a positive development.

Recent moves by the US authorities—the use of strict new regulatory proposals to reduce moral hazard complemented by the flexible application of bad loan disposal rules in light of actual conditions—are something straight out of Mr. Volcker's playbook and suggest that the Obama administration is finally beginning to utilize his experience.

*** Potential damage to DPJ government from Ozawa scandal**

Turning to domestic affairs, Mr. Ozawa's political funding scandal has the potential to inflict serious damage on the DPJ administration if it drags on much longer. The DPJ secretary general was responsible for mapping out the DPJ's election win last year, and the administration could fall apart without a strongman like him.

Before Mr. Ozawa took charge of the party, the DPJ had always been positioned to the left of the LDP on the political spectrum, and the only argument it had against the LDP was to claim that the LDP's structural reforms were insufficient, and that they would do more if elected.

Moreover, the LDP's original support base—conservative voters—had no choice but to vote for the LDP, even when leaders began shifting the party's center of gravity to the left (ie towards structural reforms). And the further the LDP moved to the left, the more DPJ voters it was able to attract. Former Prime Minister Junichiro Koizumi took full advantage of this strategy in the 2005 general election and won a landslide victory.

Mr. Ozawa realized what Mr. Koizumi had done, and as soon as he became leader of the DPJ shortly after the 2005 defeat, he began making the rounds of the LDP's traditional supporters—small businesses and farm villages outside the major cities—and tried to convince them that it was the DPJ that had their best interests at heart.

Mr. Ozawa effectively repositioned the DPJ to the right of the LDP, a strategy that paid off in the party's 2007 upper house election victory. Conservative voters who had been ill treated by the LDP under Mr. Koizumi began voting for the DPJ in droves.

Despite the shock of losing to the DPJ in the rural districts that were the party's traditional support base, LDP officials remained locked in an internal battle between the (pro-structural reform) Koizumi faction and the "U-turn" faction, whose members argued for a return to conservatism. This conflict set the stage for last year's landslide election win by the DPJ.

The victory was possible because Mr. Ozawa recognized that Mr. Koizumi's easy victory in 2005 concealed heavy discontent among conservative voters. He then utilized his strong leadership skills to reposition the party to the right of the LDP.

*** Ozawa departure could paralyze government**

Viewed from another perspective, it is only the presence of a strong, aggressive leader like Mr. Ozawa that has kept the DPJ together. Party members run a wider gamut from left to right than in the LDP, and their ability to work together to win the last two elections was largely attributable to Mr. Ozawa's strong, if not ruthless, leadership.

I find Mr. Ozawa's masterful skill in designing election strategies is reminiscent of Karl Rove during the Bush administration. Their aggressive, take-no-prisoners approaches to politics are also quite similar.

If Mr. Ozawa were to be forced out, it could become even more difficult for the DPJ administration to make decisions. That would be a cause for concern given the diplomatic and economic challenges facing Japan today. Making a wrong decision can harm the country, but so can making no decision at all.

Richard Koo's next article is scheduled for release on 16 February 2010.

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