

Comments on
Franklin Allen and Elena Carletti,
“Financial Regulation Going Forward”

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Outline

- (1) Origin of Global Financial Crisis of 2007-09
 - (2) Bubble in general
 - (3) Global Imbalances
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- I agree with most of the views and assertions of Allen-Carletti, but a few quibbles
 - I add a few points that would elaborate their points

(1) **Origin** of GFC: three views

- (1-1) Sup & Reg failure
 - (1-2) Loose monetary policy
 - (1-3) Global Imbalances and Asian central bank purchases of Treasuries
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- Allen-Carletti emphasize (1-2) and (1-3)
 - I think (1-1) is very important

Sup & Reg failure

- Overlooked—
 - Originate to distribute model
 - CDOs (false assumptions)
 - Conflict of interest, Credit rating companies (AAA negotiated)
 - Off-balance sheet conduits
 - Intra-firm management and accounting problem
 - Regulatory failure of examination
 - Investors' complacency (just trust AAA)
- Too big to fail
 - Investment banks, as opposed to deposit-taking institutions, were not supposed to be bailed out
 - No mechanism of orderly resolution (temporary nationalization)
 - Reg reform should have been done after Bear Stearns (March 2008)
- Question. Was there a political will? –see Ito (2009)

Loose Monetary Policy

- Interest rate was too low (to prevent possible deflation) in 2004-2006
 - “Off Track” –John Taylor
- The low interest rate encouraged risky investment, risky loans, etc
- Questions.
 - Low “teaser rates” are possible even at the higher interest rate
 - How much interest hike would have been needed to stop a bubble, already in process? Could cause a recession to stop a bubble—desirable?

Global Imbalances and the role of Asian central banks

- High demands for US Treasuries from Asian investors, esp. central banks; which depressed the interest rate
- Question
 - Even if Asians had not bought US treasuries, someone else might have—very deep market. How much differences would the change might have?

What ifs—search for a crucial factor

- **What if regulators did their jobs?** Tightening rules on securitization/CDO businesses and legislators introduced orderly resolution mechanism in time (without change in monetary policy and Asian central banks)?
 - Was excessive securitization stopped, so that subprime crisis prevented?
 - Were investment banks nationalized instead of bailed out?

What ifs—search for a crucial factor

- **What if monetary policy was tightened?**

Interest rate hike by 425bp in a few steps in 2004, instead of 17x0.25bp over two years (without changes in sup® and Asian central banks)?

- Could a housing bubble (subprime, vintage 2004-06) have been prevented?
- Could it not have produced a recession and deflation?

What ifs—search for a crucial factor

- **What if China appreciated 20%** in 2004-2006 (instead of 2005-2008) and **all Asian central banks intervened much less** in 2004-2006 (without changes in Sup&Reg)?
 - Did less capital inflows trigger higher interest rate in the US, which prevented the housing bubble?
 - Did the Federal Reserve not have lowered the interest rate anyway to make sure preventing deflation?

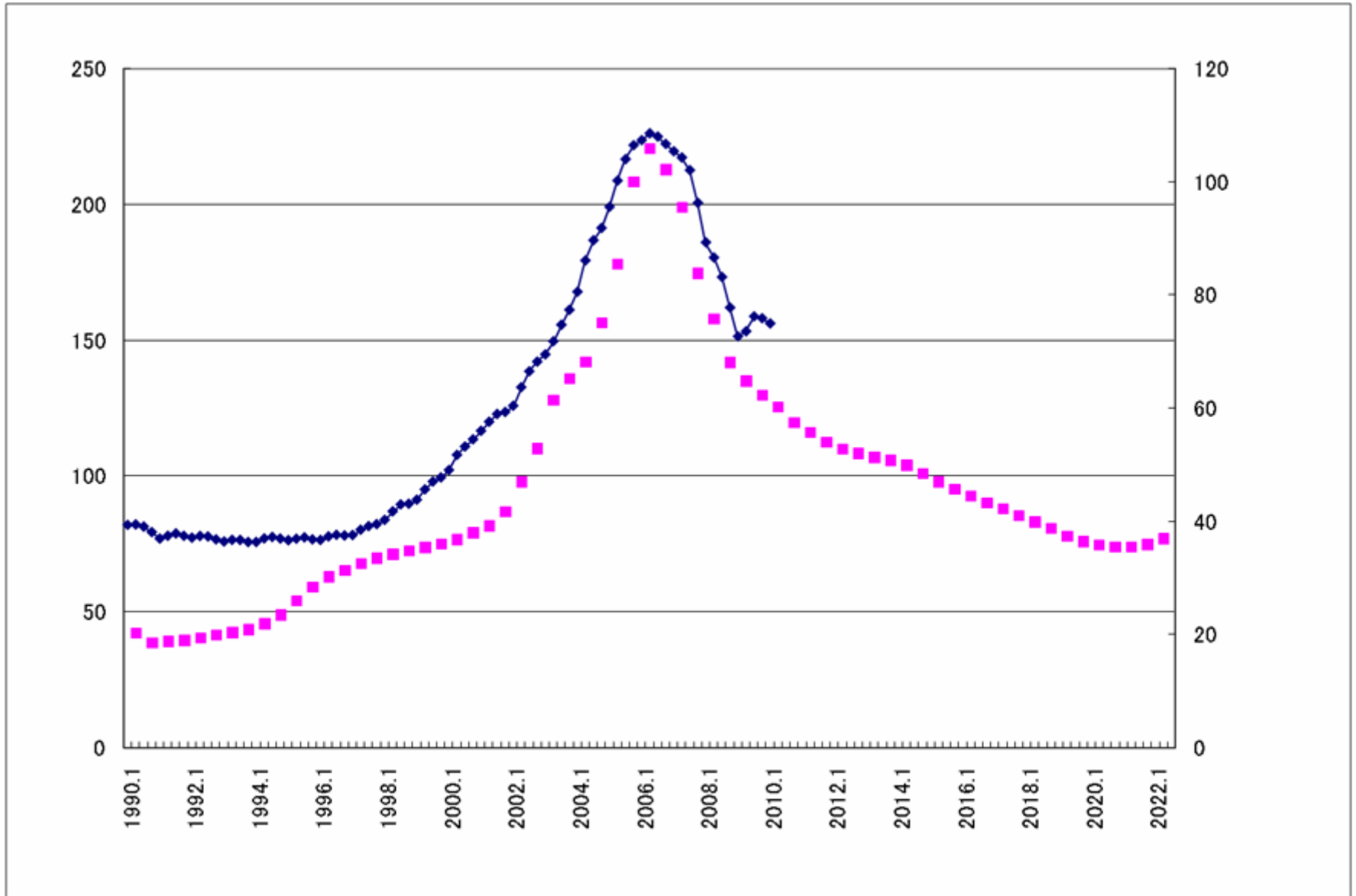
(2) Allen-Carletti: Bubble in the source

- “The basic problem that caused the crisis was that there was bubble in real estate in the U.S. and also in a number of other countries such as Spain and Ireland.”
- Causes
 - Too loose monetary policy, 2003-04
 - Question. Earlier than Taylor criticizing the rate in 2004-06.
 - “Lowering interest rates significantly below the current rate of house price appreciation thus created a profitable opportunity to buy property.”
 - Question. The interest rate above 10% !?

Comparison US vs. Japan

- Let me add Japanese experiences:
- Japan
 - bubble, 1985-90
 - and burst, 1990-2003
 - Banking crisis climax, November 1997
- US
 - Bubble, 2000-2006
 - And burst, 2006- ??
 - Banking crisis climax, September 2008
- Japan went through similar regrets and reform in the late 1990s.

Japanese Land price (16 yrs earlier) vs. Case-Shiller



Resolution mechanism

- I think that the resolution mechanism is the key, as Allen-Carletti also mentions it
- One aspect **Japan did better** than US
 - Japan introduced a **resolution mechanism** (Financial Reconstruction Law of 1998) within one year of the climax, and dealt with the subsequent failures in 1998
 - The was abolished but the related law was
 - Revised resolution mechanism remains on the book now
 - Deposit Insurance Law, Article 102
 - Article 102-1. Capital injection
 - Article 102-2. Liquidation
 - Article 102-3. Temporary nationalization
- One problem. How to resolve investment banks and “securities run” (as opposed to a bank run)

Bubble and burst, and financial system

- View (1):
 - Difficult to detect when a bubble starts as opposed to fundamentals. Bubble and burst is of capitalism nature
 - Important is to keep banks robust to a shock from bubble burst (increase core capital)
 - Resolution mechanism. Prevent moral hazard, while financial stability is maintained
 - Question. How much capital is enough; how to overcome too big to fail
- View (2):
 - Bubble itself should be prevented (no sure way to make banks robust)
 - Asset price stability should be in central banks' objective
 - Question. Three objectives (π (CPI), π (asset), y) and one instrument?

(3) Global Imbalances

- Origin of Global imbalances (Allen-Carletti view)
 - Asian crisis → self-insurance (fat reserves) → demand for US treasuries → low interest rate
 - Self-insurance is due to Asian countries' distrust of IMF. Allen-Carletti thinks IMF made mistakes and Asia has good reasons to be unhappy
 - Allen-Carletti's solution. Promote Asians in IMF and other IFIs.
 - No prospect to change

Prospects of Change

- I agree with their analysis, See Ito (2007)
- Comments:
 - IMF has NOT officially admitted that it had made mistakes
 - IMF has changed in practice
 - FCL is very much like lender-of-last-resort without conditionality
 - Difficult to differentiate “**solvency crisis**” that should come with conditionality and “**liquidity crisis**” that should be helped by FCL
 - Do you want to led to Greece without conditionality?
 - Asia now has Chiang Mai Initiative Multilateralized (CMI-M), which is like AMF and which is like European Stabilization Fund (recently proposed 750 billion Euro facility)

Asia is vindicated—many ideas and proposals denied in 1997-98

- Ban on short-selling
- Criticize credit rating agencies
- Criticize hedge funds
- Asian Monetary Fund
- Low interest rate and fiscal stimulus during the crisis
- Suspend mark-to-market
- Support the currency stability with massive intervention (large swap or LOLR)
- No premature foreclosure or a bulk sales of distressed assets

Concluding Remarks:

Yes, I agree most of Allen's points

- [Crisis prevention]
 - Detect early (model and common sense judgment)
 - Employ all measures, incl. macro prudential (LTV ratio; tax) as well as the interest rate (lean against), since the interest rate alone cannot do a job
- [Crisis management]
 - Legislate a resolution mechanism is the key
 - International coordination is important but difficult
- [Global Imbalances]
 - No chance of preventing it
 - Asian voice in international institutions should be strengthened—but the utilization of human capital is poor in Japan and most of Asia

References

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