GENERAL DISCUSSION
Panel on Experiences with the Crisis

Chair: Kevin M. Warsh

Mr. Warsh: I think one common thread among markets throughout the recent financial panic and the emerging recovery has been a change in the value of asset prices. So if I looked at the stock market performance for Asian countries from their March 9 [2009] lows until present [October 2009], the stock markets are up an average of about 95 percent. Now, they're still off their highs that preceded the crisis, but it's a remarkable move. Certainly the U.S. has also seen a remarkable increase in asset values, and my moderator prerogative question would be, how important is this increase in asset values to your perspectives on the return to more normal economic conditions? I'll make that the first question, but perhaps we can open it up here to a first group of questions.

Mr. Kashyap: I've got a question for Sato-san. Now that you're no longer an official, I don't know whether you can answer this question, but I found it inconsistent with good risk management practices that the Japanese institution that had committed to buy Morgan Stanley went ahead with that transaction at the pre-agreed price. I understand for policy coordination reasons it was incredibly valuable, but I think shareholders got ripped off and they should have renegotiated more. I'm wondering why the FSA (Financial Services Agency) stood by and, I'm sure, probably encouraged that transaction. But given the price at which that transaction was concluded, I never understood how it was consistent with the fiduciary duty that management has to shareholders, because the minute it was consummated there was a huge, huge loss. I think a U.S. institution would have walked away, and I don't know if the U.S. government could have compelled them to go ahead. I'd like to hear what you can say about that.

Mr. Warsh: Questions in the back?

Mr. Bery: This is to some extent similar to the question I asked Andrew Crockett yesterday. There was this great reflection after 1997 about the source of the Asia crisis and the responses to the crisis that led to a series of initiatives we haven't really talked about—the Asian bond market initiative and bilateral swap lines in the region, for example. The fact that these initiatives have not been mentioned at all, does that mean that agenda has been unsuccessful? Put more broadly, coming back to the point that Anne Krueger made yesterday, we're dealing with a highly successful bunch of countries in Asia which have now been badly affected by crisis twice in a decade. What does this do to the appetite for financial innovation? Certainly taking an Indian perspective, I think most Indian policymakers—Rakesh Mohan is here, he can contradict me—would basically say that if this is the price of being integrated, maybe we need to shop elsewhere. So, is there any kind of revulsion or reaction politically against financial integration? I mention that because Swee Keat talked about financial integration as being one of the things on the agenda. So what's the political climate on this issue when, as Sato-san indicates, in living memory you've had to go through two of these crises?

Mr. Warsh: Let's gather one more question in this round. Rakesh?

Mr. Mohan: Mr. Kim you described the huge increase in Korean banks' external short-term debt. Did the regulatory authorities not have a view about whether something bad or not good was happening during that time and whether some regulatory action should have been taken? Was there discussion about this or did it just happen without the regulator knowing what was going on?

Mr. Warsh: Perhaps we can get some quick answers to this round of questions.

Mr. Heng: I'll address the question about financial integration in the region. I think it is important for Asia to continue to pursue more integration, but there are a number of preconditions that you need. First and foremost is that the national authorities need to develop their own markets first, because only when you have a fairly deep internal market can integration proceed. In that regard you see efforts across different countries, certainly the bigger ones. China and India have been developing their financial markets as have the ASEAN countries. Now, there are also more regional efforts in bond market development and those efforts are ongoing. More recently there has been the Chiang Mai initiative to multilaterally pool reserves. But these are part of a broader effort that will take time and will evolve as real economy integration takes place. Real economy integration has become deeper through a series of trade agreements—within ASEAN, and ASEAN-China, ASEAN-Japan, ASEAN-Korea, ASEAN-India, ASEAN-Australia and New Zealand. All these agreements will bring the real economies in the region closer together.

The problem, as I pointed out, is that this has led to an extremely efficient cross-border network of production and trade in intermediate products, but not so much in final goods for intra-Asian consumption, which I think is what's needed going forward. But the development of the real sector and development of the capital markets and the banking sector will grow in tandem. It's not going to be a fast process—you need to take a longer-term view to look at progress, because if you take a short-term view, there isn't much that seems to be happening. But as efforts continue, I'm quite confident that we will see progress over a number of years.

Mr. Kim: When you compare the 1997 East Asian crisis to the current global financial crisis, in the 1997 crisis the problems started on the asset side of the banking sector balance sheet with nonperforming loans, but in this crisis the problems have accumulated on the liability side with debt problems. I would like to say that banks are doing their best now; but although they are very rational, their behavior has had negative side effects on the rest of the economy. So, you need to change the behavior of the banks. Simple rules and regulations or controls won't work, because there are many ways to circumvent them. In other words, you should find a solution to the problem of distorted incentive mechanisms in the rules and regulations, to lead banks to internalize these negative externalities caused by their own activities.

I also want to point out that there is another reason for the accumulation of short-term debt that can be called a winner's curse. In the shipping industry, for example, there were huge foreign exchange revenues that the firms wanted to hedge. The banks secured their positions with bridge financing. But that created a negative externality for the rest of the economy.

Mr. Sato: As regards the Mitsubishi UFJ Financial Group move to invest in Morgan Stanley, usually Japan FSA's basic position is to respect the decision of the financial entity itself and its own business judgment. Of course, if it seems to be an irrational investment, we would certainly examine it from the viewpoint of its effect on bank financial soundness. But I think, in truth, this investment was carried out on a fairly independent basis, making the best use of U.S. asset evaluators, law firms, and so on. So, we welcome such moves if they are based on rational and forward-looking considerations that enhance bank profitability and maintain financial soundness.

As regards innovation in the last few years, I feel that the word "innovation" can be rather ambiguous in meaning. For a typical competent aggressive investment banker, innovation could be a clever tool to evade rules-based regulation in a lawful and profit maximizing manner, while from the viewpoint of the regulator, such as the FSA, financial innovation may take the form of a new technology which enables more efficient and broad-based financial intermediation. For example, securitization, if it is used properly, could enable the banking sector to lend more to small and medium-size enterprises that would not have been lent to with ordinary lending practices. Innovation also allows the banking sector to provide new types of financial products with different risk and return profiles. This sort of innovation would be socially desirable. We can't stop innovation by regulation, but we should pay attention to the real effects of innovation, such as whether it is wrongly used simply to maximize short-term profits.

In the case of the originate-to-distribute business model, financial market players thought that they could eliminate the risks on the assets they bought by selling them immediately. This kind of moral hazard induced them to avoid real due diligence, which is indispensable in financial transactions. So, we have to be careful.

And with regard to financial integration, this is not something that we regulators can stop by policy. We have to live with financial integration and with innovation as well. So, as Sir Andrew Crockett noted, we have to live in a market-based world. In that environment, we must give our best efforts to bring about the best allocation of resources and the best provision of financial services from the social point of view.

Mr. Warsh: Thanks, Taka. Let's go back to round two of questions. We'll survey the group yet again. Start with Peter.

Mr. Hooper: A strong conclusion from the preceding discussion was the importance of developing effective resolution mechanisms. Could you comment briefly on how resolution has evolved since the previous crisis and how that may have affected the outcome this time?

Ms. Curran: You each have a unique perspective on the coordination between your country's regulatory authority and the monetary authority. I'm wondering if you could share your perspectives on the effectiveness of that coordination during the crisis and any lessons that you're bringing forward.

Mr. Kohns: A question to Mr. Sato. When you explain the differences between the past crisis and the current crisis, you stressed a lot that the current crisis is more of an exogenous shock. My question is that, given the size of this exogenous shock, one can imagine that the endogenous reaction of the banking sector to the shock is going to build up in the coming months. In particular, I can imagine that the share of nonperforming loans is likely to increase. What is your perspective on future bank lending and future burdens on bank balance sheets? Could this be an impediment to a stronger recovery as the credit supply is increasingly restricted when loans start to become nonperforming?

Specifically, could you elaborate a bit on the outlook and future burdens on the banking sector in Japan?

Mr. Warsh: Let's go to the front and then we'll take one more question in the back and see if we can't get those answered by the panel.

Mr. Ito: Question to Mr. Kim. You mentioned the many regional arrangements growing in Asia, but when you were pressed for dollar liquidity Korea went to the Federal Reserve for a swap line. I understand you didn't go to the IMF because of your experience 10 years ago. But you could have drawn on the Bank of Japan swap, or utilized the CMI (Chiang Mai Initiative) arrangements. I don't think that a bilateral swap with the BOJ would have triggered the IMF linkage clause. So while there were some other opportunities available to obtain funding, you chose to go to the Federal Reserve. What was the reason for that?

Mr. Warsh: I think we have room for one more question in this round. David.

Mr. Hale: Actually I have two questions for Mr. Kim. Would you ever consider having a currency swap with China someday, which now has massive foreign exchange reserves? Mr. Heng Swee Keat, just a question on the issue of asset markets. Many fund managers believe that we're now headed into a period of asset bubbles in East Asia. The most explicit example of this would be Hong Kong, which has a very direct monetary link to the United States through its currency board. Their monetary base has gone up 145 percent in the last year, the stock market's boomed, and there's been a huge increase in the last few months in property values. Do you fear the same could now happen to Singapore and Malaysia and other countries in the region because of the low interest rates here, capital outflows, and the desire of Asian central banks to restrain exchange rate appreciation by accumulating further large increases in their foreign exchange reserves?

Mr. Warsh: All right, that completes the questions for this round. Who among the panelists wants to go first? Swee Keat, should we start with you again? Maybe you can speak to the asset price question that David raised. So, to what extent are the asset price increases that we see in Singapore and across the region being taken into account in the conduct of policy, and to what extent is that either a headwind or a risk as you think about policy going forward?

Mr. Heng: I will address both questions. One is our experience with coordination during the crisis. In the case of the MAS (Monetary Authority of Singapore), we're quite unique because we're both a central bank and the regulator of banking, insurance, and capital markets. I think putting everything under one roof has its hazards, but during the crisis we found it to be extremely useful for a number of reasons. One was that it gave us a fairly good view of what was happening everywhere and an understanding of the interlinkages across different sectors of the financial markets. Before Lehman collapsed, we had intensified our monitoring. When the collapse happened the stresses were extreme, but we were able to coordinate policies across different functions. Even though Lehman had only a small operation in Singapore, there were large effects across different sectors. And when AIG got into trouble, when Fortis Bank was in trouble, and so on, we found that our very extensive relationships with both central banks as well as regulators across the globe were extremely helpful. We were in contact with other regulators and central banks constantly, particularly since Asian markets open first each day. I think it worked well, and right now, in terms of the discussion about macroprudential supervision, we have an internal financial stability group that pools information from various sources and we meet regularly to monitor what is happening across the different markets and how different developments interact with each other. There were many things that surprised us in the course of doing that, such as how the interaction across sectors was so extensive.

On the issue of the rebound in asset markets in the region, regulators and central banks in the region are paying a lot of attention because liquidity conditions are extremely accommodative. We need to watch how conditions develop. In our case, because we are also a regulator, we have additional tools and don't think that we should use monetary policy in a blunt way because monetary policy has to respond to current and future real economic conditions. We need to keep a very clear focus on using monetary policy to anchor inflation expectations and to make sure that we don't use it for more than it can deliver. We also have a range of macroprudential tools and we have used them. In fact, just three weeks ago, we ended a scheme which allowed banks to absorb the interest on property loans. The use of macroprudential tools is not unique to Singapore. For example, across Asia loan-to-value ratios for mortgages have been lowered. These are simple tools to limit leverage so that it does not damage the banking system. We will have to continue to watch developments very carefully and be prepared with a range of responses.

Mr. Warsh: Thank you. Kyungsoo, similar questions to you on policy coordination and asset prices, and also on your use of swap lines.

Mr. Kim: There is coordination between the Korean FSS (Financial Supervisory Service), the Ministry of Finance, and the Bank of Korea. We do have coordination on a regular and also irregular basis and very recently imposed debt-to-income limits when the authorities became concerned about asset price bubbles, especially in the real estate market. And in order to limit bank balance sheet problems, the government announced it will impose, revise, and update rules and regulations which will take effect very soon. Meanwhile, it was difficult to consider a swap line with the IMF due to strong concerns that receiving financial support from the IMF might have an adverse effect on the market credibility of the Korean economy.

Mr. Sato: In regards to Japan's bank resolution mechanism, I think there have been some clear elements of improvement since the late 1990s. One improvement is that the central purpose of bank resolution is now to preserve the stability of the financial system itself, not to protect individual banks, their managers, or their shareholders. This notion is well shared nowadays between government departments including the central bank. So this is progress.

The second improvement is that objective standards for triggering the beginning of the resolution mechanism have been made clearer. We introduced American-type prompt corrective action procedures based on a bank's capital ratio. As the capital ratio goes down, we give warnings to the bank to take remedial actions, but if this can't be carried out successfully, then it goes into insolvency. With this clear standard, now we hesitate less to go into bank resolution, and this helps avoid situations in the past where we tended to forebear resolution for fear of side effects. The manner of resolution is now clearly stipulated as well. We can send a government-designated new manager to a problem bank immediately and shift the overall capabilities to that new manager. With regard to the use of public money, we had a very harsh experience in the 1990s and this is a very touchy issue politically. We introduced a framework in which, when there is no real threat to the stability of the financial system as a whole and when it is simply an idiosyncratic phenomenon without much systemic significance, then problem banks go into ordinary resolution in which the shareholders and depositors have to share the burden of losses. So, these kinds of overall guidelines are much clearer than before; that's progress.

In regards to the future prospects of Japanese banks, it is true that the current stress represents a kind of exogenous shock for Japanese banks. But their exposure to toxic assets has been rather limited, so their losses on these assets should be limited as well. Now, the risks for Japanese banks are twofold. One is rising credit costs due to the deterioration in the real economy. But so far the rise in credit costs has not been so strong, and it has been managed by banks with ordinary revenue. However, if the world economy doesn't pick up quickly, then Japan's real economy could continue to stagnate and would be reflected in higher credit costs for Japanese banks. Another risk stems from Japanese banks' rather large exposure to equity price changes. We have a framework introduced several years ago in which Japanese banks have to include their holdings of equity shares within their Tier 1 capital. Now equities are roughly 50 percent of their Tier 1 capital, but the banks incurred substantial losses from the sharp decline in share prices worldwide recently. So the Japanese FSA is encouraging them to improve the risk management of their shareholdings. If they want to maintain the present level of shareholdings, then they should try to increase their capital. And if they do not intend to raise additional capital, then they should reducetheir shareholdings. These kinds of discussions are ongoing. I personally don't like outright regulation. So, for the time being we will let Japanese banks make their own decisions.

Mr. Warsh: Thank you, Taka. Swee Keat, the final comment on swaps.

Mr. Heng: Let me make a quick clarification on Singapore's swap facility with the Federal Reserve. The swap with the Fed is a central bank to central bank arrangement, and we can use these funds only to help banks ease funding liquidity in U.S. dollar markets. Singapore has entered into a swap agreement with the U.S. Federal Reserve because we are a very major U.S. dollar funding center. We did that as a purely precautionary measure. We see that the action taken by the Fed with the ECB, the Bank of Japan, and others was very important in restoring stability and confidence in U.S. dollar funding. But we cannot use it for government expenditures. In contrast, the swap line with the IMF and the bilateral swap agreement can be used to manage balance of payment problems. So, these are completely different creatures.

Mr. Warsh: Thank you very much, Swee Keat, Kyungsoo, Taka. I think it's been a very useful panel.