Financial Crises and Financial System: Possibility of Fundamental Reforms

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1. Financial crises have happened repeatedly

1997-2002: Japanese financial crisis after the bubble economy of 1980s
Real estate and stock market bubbles in the second half of 1980s

2008-2009: Global financial crisis after the bankruptcy of Lehman Brothers
Excessive securitization of sub-prime mortgage loans and excessive risk taking by some financial institutions

2010-present: Sovereign and banking crisis in the Euro area
Excessive government debt of some of the member countries
Excessive intra-euro area balance of payment imbalances

2012-?: Possible sovereign debt crises in Japan and/or USA
Excessive use of fiscal policy under post-financial-crisis stagnation

2. Common causes of financial crises

In the past, a financial crisis is often caused by speculative bubbles in real estate and stocks. These bubbles are often generated by the following three factors:
(1) Excessively easy monetary policy,
(2) Financial deregulations and financial innovations, and
(3) Regulatory distortions favoring investment in certain assets such as land or sovereign bonds.

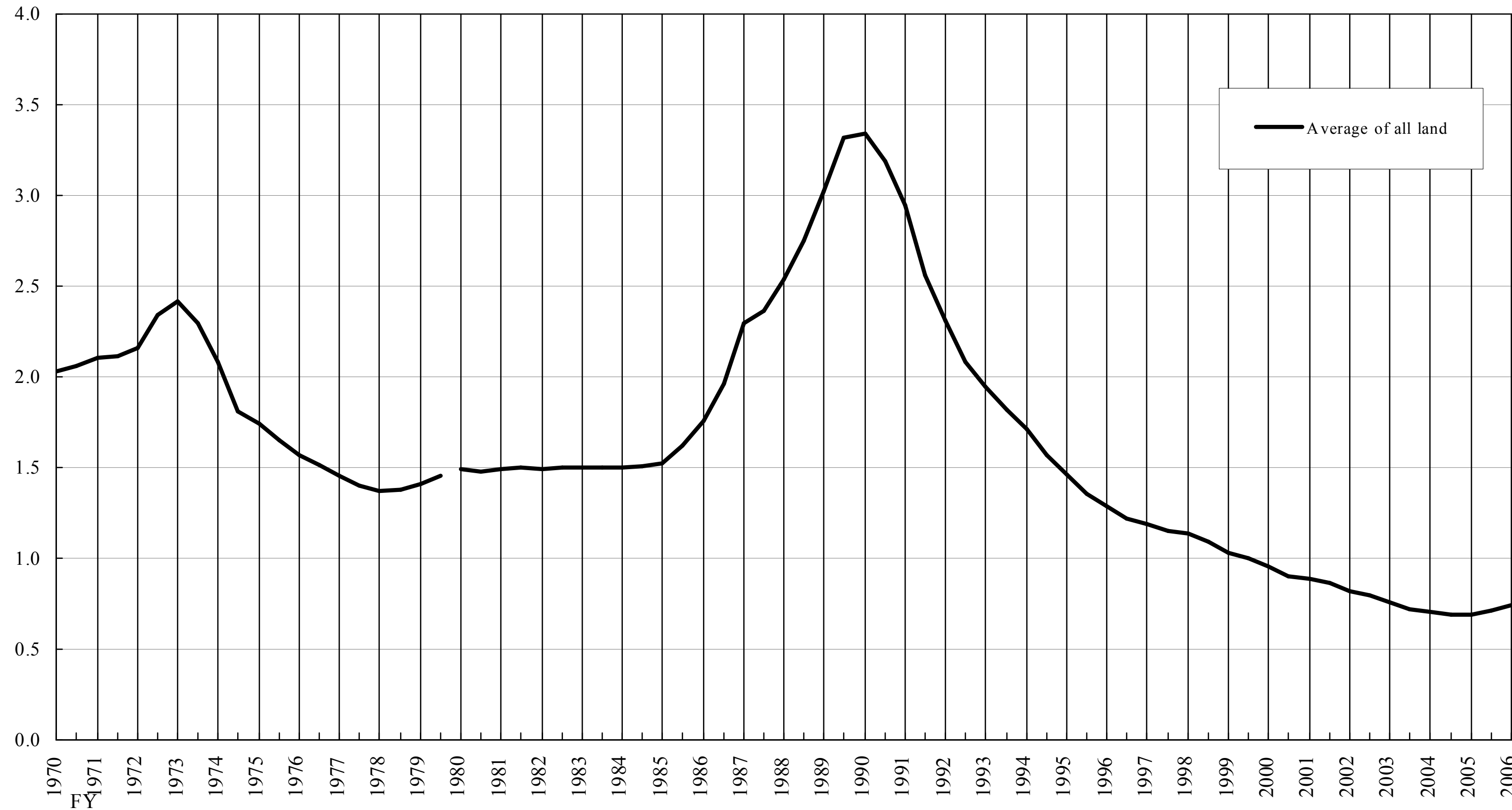
Example 1
Japanese real estate and stock market bubbles in the 1980s
=> Financial crisis in the late 1990s.

Example 2
US real estate market bubble in the 2000s.
=> World financial crisis in 2008-09.

Example 3
Excessively loose ECB monetary policy for PIIGS countries
Much more free capital mobility within the Euro area
=> European sovereign and banking crisis in 2010-present

Urban Land Price-Nominal GDP Ratio in Japan

(Second half of FY 2000 = 1.0)



Notes: 1. Urban Land price index (6 large urban areas, second half of fiscal 1999 <end of Mar. 2000>=100) is dived by Nominal GDP index (second half of fiscal 2000=100)

2. Data until second half of fiscal 1979 = 68SNA basis
Data from first half of fiscal 1980 = 93SNA basis

US Real Estate Prices: Case-Shiller index

300
250
200
150
100
50

CA-Los Angeles
CO-Denver
FL-Miami
MA-Boston
MI-Detroit
NV-Las Vegas
NY-New York
TX-Dallas
Composite-20

January 2000
April 2000
July 2000
October 2000
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3. Similarity of Japanese and the global financial crisis

Lost confidence in the soundness in major financial institutions

Japan: successive failure of Sanyo Securities, Hokkaido Takushoku Bank, and Yamaichi Securities in the fall of 1997.

US: successive failure of Lehman Brothers and AIG in September 2008.

Causes of failures of financial institutions

Japan: Bad real estate loans for banks and hidden losses in forward security transactions. Large losses were hidden in unconsolidated bank subsidiaries.

US: Losses in securitized sub-prime mortgages, hidden losses in CDS, hidden losses in unconsolidated SPVs.

4. The origin of European sovereign crisis was somewhat different

With hindsight, the interest rates among member countries converged excessively

ECB targeted Euro-zone inflation rate at below 2 percent

The interest rates were too high for Germany but too low for PIIGS countries.

=> Domestic demand was weak for Germany but strong for PIIGS countries

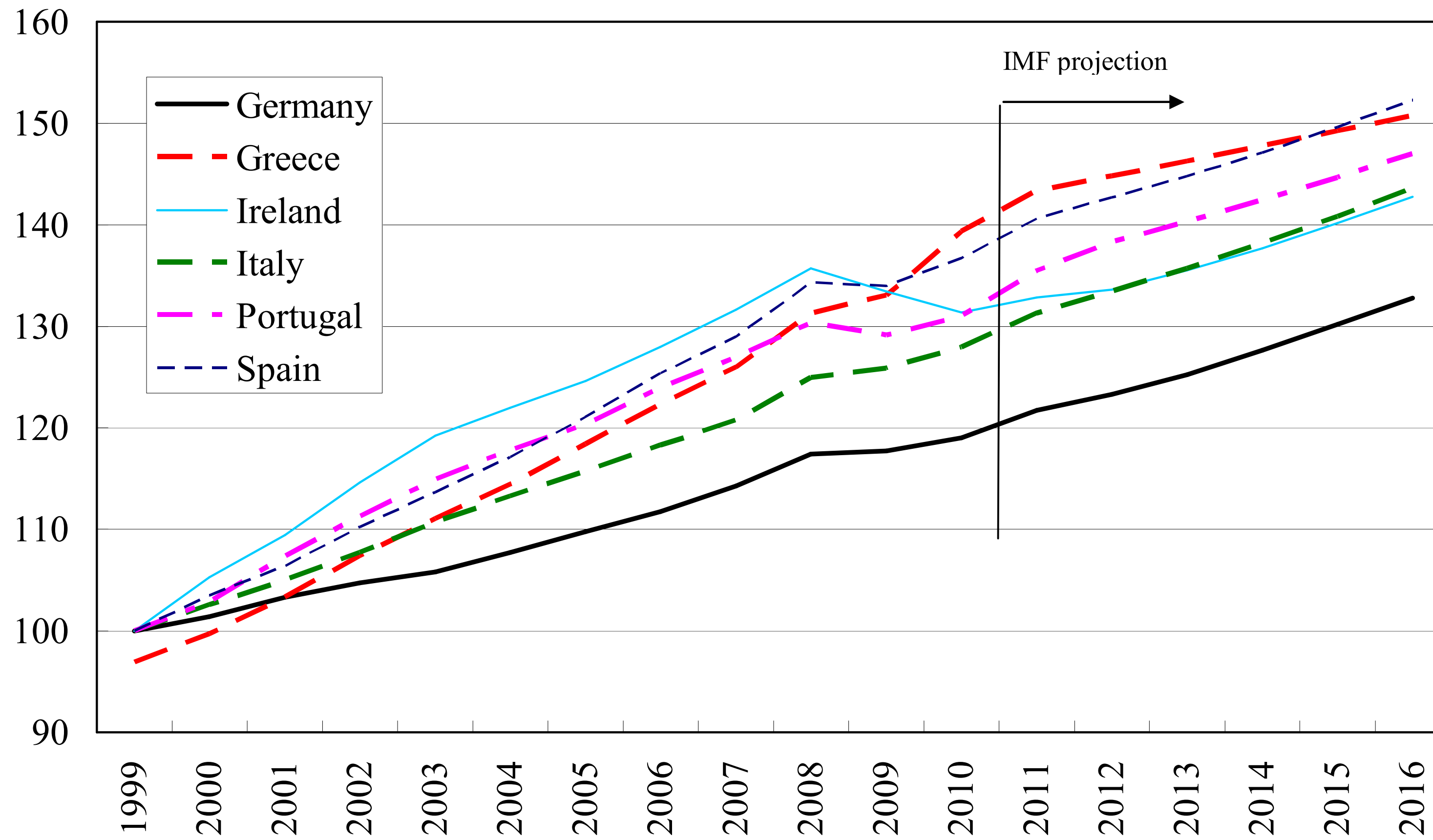
=> The CPI inflation rates of PIIGS countries were much higher than Germany.

=> Germany experienced current account surplus but PIIGS countries experienced deficits.

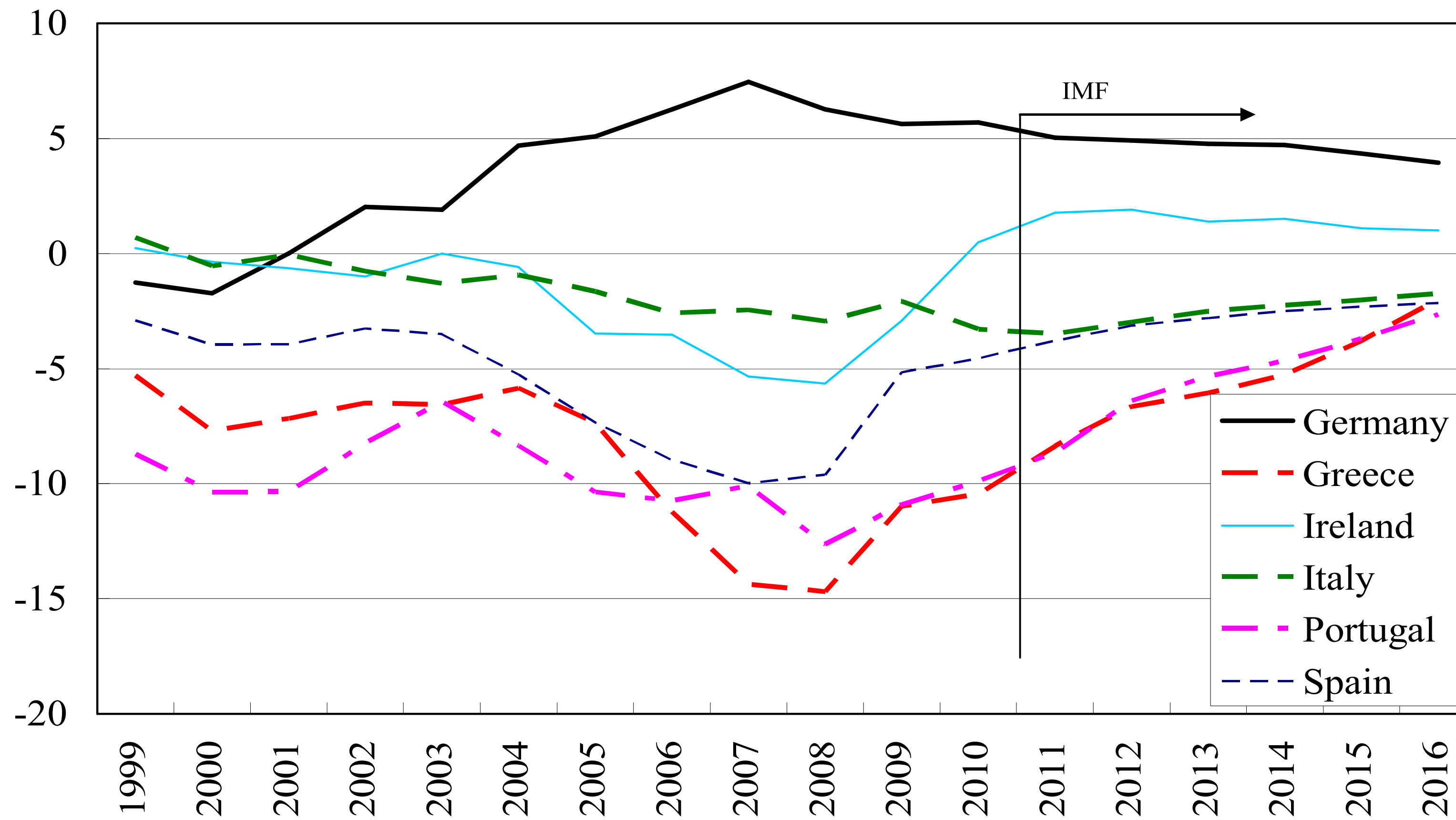
Current account surplus countries including Germany and the Netherlands financed the deficits of PIIGS countries under free movements of capital within the Euro-zone countries.

The weakening competitive position of PIIGS countries put pressures on fiscal policy. However, the governments of PIIGS countries could borrow easily from the market until 2009.

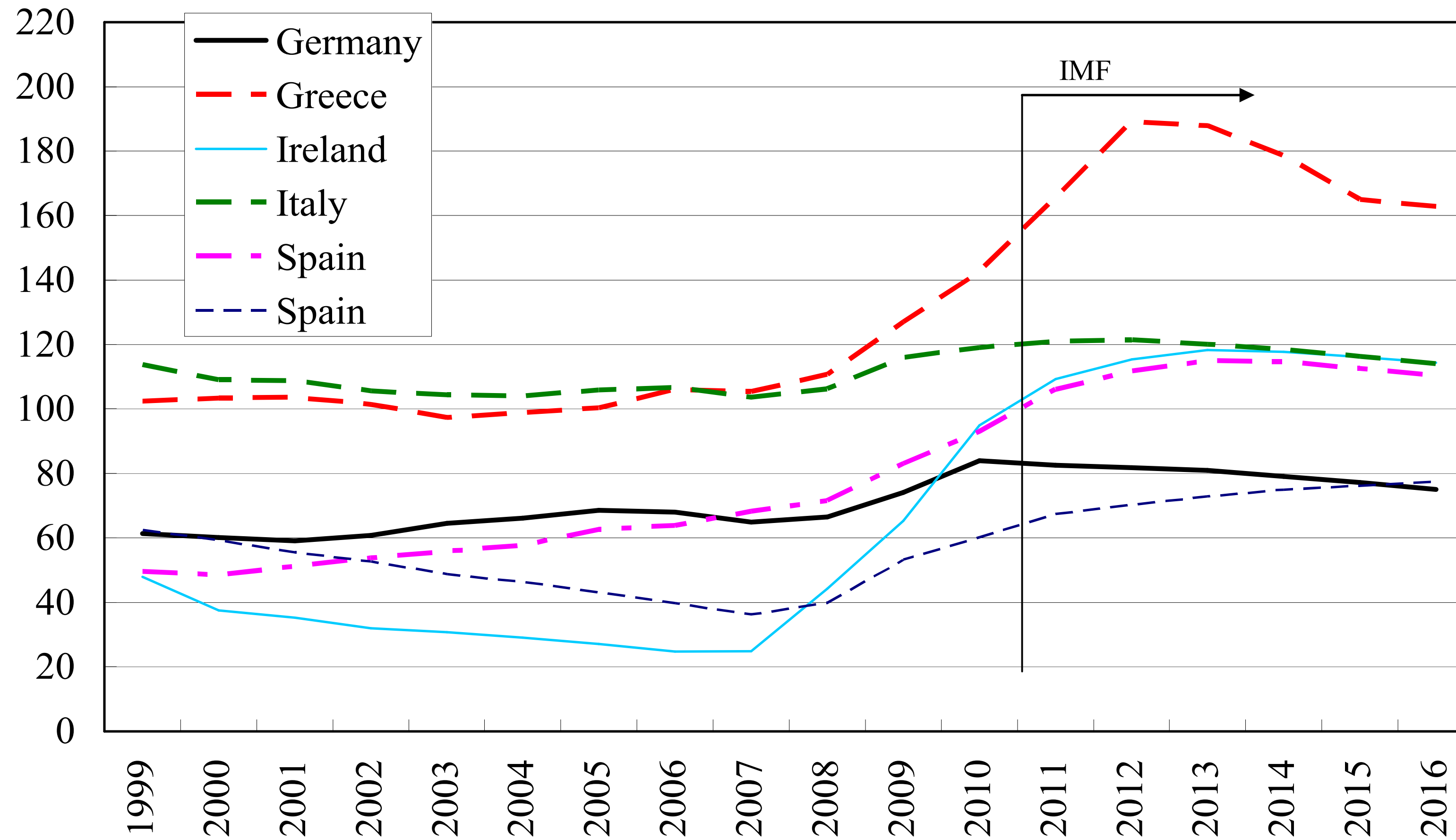
Consumer Prices in Germany and PIIGS countries



Data: IMF World Economic Outlook, September 2011.


Current Balance-GDP Ratios of Germany and PIIGS countries
10
5
0
-5
-10
-15
-20
IMF
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
Germany
Greece
Ireland
Italy
Portugal
Spain

General Government Debt-GDP Ratios in Geramny and PIIGS countries



5. Why financial crises repeat so often

Structural incentives to use debt instruments excessively

Joint-stock companies: use of debt over equity finance
- Tax incentive to use debt
- Limited liability for shareholders encourage the use of debt
- Subsidized government loans to SMEs in many countries

Households: use of debt to won houses rather than renting them
- Subsidies to home mortgage loans

Governments: use of debt over taxation
- Government debt is not fully recognized as future tax liabilities for households

Banking sector: use of deposits due to deposit insurance system and central bank support. BIS zero risk weight and Euro-system's TARGET2 collateral rules favor government bond investments.

6. Conclusions: major rethinking of the economic system is necessary

(1) Abolish tax incentives to borrow money for companies and households.

Corporate tax should be levied on profit before interest payments

Abolish corporate tax on financial institutions and introduce progressive but low tax on gross asset size.

(2) Raise minimum capital requirements on banks to 20-30% of gross assets.

(3) Change tax incentives from owning house to rental house.

(4) Introduce a new tax system to stimulate demand when the government raises tax rates.

Low rate tax on all the government-guaranteed assets to stimulate shifts from safe assets to risky assets.

Expanded Gesell tax may be a promising option.

Appendix on Gesell tax

In order to stimulate the economy by raising tax, it is necessary to levy tax on all the government-guaranteed assets including banknotes. In this appendix, we assume that 2% tax is levied on such assets.

(1) Effective target of the tax: All the owners of safe assets.

(2) Implementation of Gesell tax.
This tax is levied by a partial default of government-guaranteed assets. The debt service is cut by 2% by reducing the interest payments and the repayments of principal. This debt reduction is treated as tax revenue by the government.

(3) Taxable assets: all the government debts, all the domestic currency deposits effectively protected by deposit insurance system or implicit government guarantee, all the liabilities of the central bank including banknotes.

(4) Banks' domestic currency debts are cut by 2%. This profit from the debt reduction will be absorbed by the government as tax revenue. Since bank will also lose money from government bond investments and the holding of monetary base, only the net profit from this Gesell tax will be paid to the government.

(5) Taxation on banknotes will be messy. The ideal taxation method is to replacement banknotes with stored value cards such as Suica or PASMO in Japan or Oyster card in the UK. At the taxation day, 2% of the remaining value of the card will be taxed. If this taxation method cannot be adopted, the central bank has to print new money and exchange it with the old money with a fee of 2%.

(6) This tax will stimulate spending before the taxation. Money will shift from cash and deposits to stocks, corporate bonds and real estates. Banks will try to extend loans by using monetary base which will be taxed. Inter-corporate lending will be stimulated because receivables are not taxed but cash will be tax. The domestic currency tends to depreciate against foreign currencies that are not taxed.

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