

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

The Global Response to the U.S. Subprime Crisis

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In August 2007, the United States experienced its most significant financial crisis in recent memory. The price of securities based on repackaged mortgage loans—and securities based on repacking already repackaged mortgage loans—tumbled. Consequently, foreign demand for these securities disappeared. Rather than buying the financial equivalents of a Mercedes or a Lexus, highly engineered luxury cars that trade at a premium, buyers discovered that they had bought the financial equivalent of lemons: dolted-up, poorly engineered cars that sell for a discount. Various onshore and offshore structures that had borrowed in the short-term money market to finance the purchase of long-term asset-backed securities found themselves in severe trouble. As demand for U.S. debt fell, the value of the dollar also fell.

The past year has been defined by policies the United States put in

place to respond to this crisis. It also has been shaped by policies other countries adopted in response to both the crisis and the United States' own policies. The next year—at least if the United States avoids slipping into a prolonged slump—is likely to be defined by how policy makers react to now apparent consequences of the policies adopted in the fall of 2007 and early 2008 and, perhaps, by new efforts to try to strengthen the resilience of the financial sector.

The full scope of the policy response to the crisis is worth spelling out in detail. The response includes:

- A series of cuts in U.S. short-term policy interest rates brought the Fed funds rate down to 2%.
- The adoption of a \$168 billion fiscal stimulus package looks set to combine with the normal rise in spending and fall in tax revenues associated with a slowdown to increase the FY 2008 deficit to around \$500 billion.
- The New York Fed engineered a takeover of Bear Stearns, a troubled broker-dealer, by JP Morgan Chase.
- A series of facilities were created at the Federal Reserve Bank to provide financing to both U.S. banks and broker-dealers, largely through lending the Treasuries on the Fed's balance sheet to financial institutions needing liquid assets. The resulting shift in the composition of the Federal Reserve's balance sheet—the Fed's holdings of U.S. treasuries fell from \$785 billion in August 2007 to around \$480 billion at the end of June 2008—has been far more dramatic than the increase in its size. Allowing broker-dealers access to the Fed necessitated a temporary extension of the Fed's supervision to a new set of institutions.
- Financing was provided to banks through the Federal Home Loan Banks, which can lend against mortgage collateral.
- A set of restrictions was lifted on the activities of the government-sponsored agencies active in the mortgage market. This allowed the agencies to make larger loans than in the past and to increase their own lending.

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- More recently, there was a series of steps designed to reassure the market that the agencies' debt is safe, including a larger credit line from the Treasury and the possible use of taxpayers' funds to rebuild their equity capital.

These steps produced a significant increase in the quantity of safe collateral circulating in the market, as both the Treasury's new issuance and the Fed's activities have increased the stock of available Treasuries. They also produced a dramatic expansion of the share of lending to households that was backed directly (or indirectly, through the agencies' perceived implicit government guarantee) by the U.S. government. Saskia Sholtes of the *Financial Times* reported that at the end of 2007, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks provided 90% of mortgage financing in the United States;¹ Richard Iley of BNP Paribas has called this the de facto nationalization of the U.S. housing market.

The reorientation of U.S. policy was matched by important policy shifts abroad. These include:

- The European Central Bank provided large-scale liquidity

to European banks (the Bank of England joined in, belatedly). The ECB believed that lending offered a substitute for rate cuts and, in early July, even increased rates.

- Interest rates in China were kept constant, despite rising inflation, and rates were cut in the Gulf.
- There was a significant increase in reserve accumulation by emerging economies that continued to either peg to the dollar or manage their currencies against the dollar. The dollar's slide—together with cuts in US rates—led many market participants (or speculators) to question the wisdom of China's ongoing efforts to resist rapid appreciation against the dollar, the Gulf's dollar peg and other currency pegs, and managed exchange rates. China's decision to shunt some of its reserve growth into the state banking system—and lags in the Gulf's reserve reporting—masked the extent of this intervention. But if the \$100 billion in foreign exchange that China's banks added to their foreign currency holdings in late 2007 and the \$90 billion the banks seem to have added in the first six months of 2008, as well as funds shifted to the CIC, are factored in, there is little doubt that the

scale of Chinese reserve growth accelerated dramatically. In April alone, China reported a \$75 billion increase in its reserves. The total increase in China's foreign assets in the first half of 2008 likely exceeded \$400 billion.

- The oil exporters, concerned about a fall in demand for oil, didn't reverse production cuts that they implemented in early 2007—back when oil was trading in the \$60 range.

The effects of U.S. and international responses to the subprime crisis

These policies combined to achieve one key goal of U.S. policy makers. The fall in U.S. domestic demand that accompanied the collapse of the securitized housing credit market has been smaller than many feared last August. Rising central bank demand for U.S. assets offset falling private demand, helping to keep the dollar's slide orderly—and slowing the contraction of the U.S. current account deficit. The U.S. data, which tends to understate official purchases, indicates that official investors bought \$170 billion in Treasury and agency bonds in the first quarter, an amount roughly equal to the U.S. current account deficit. The purchases of safe U.S. assets by central

¹ Saskia Sholtes, "Fannie and Freddie Drive Home Loans," *Financial Times*, April 2, 2008. <http://www.ft.com/cms/s/o/65e8abo8-00dd-11dd-a0c5-000077b07658.html>

banks still far exceed the purchases of U.S. equities by sovereign funds (\$20 billion in Q1 2008 according to the U.S. balance of payments data, which likely fails to capture all sovereign purchases), but there is little doubt that pressure is building for emerging market governments to invest more aggressively to try to produce higher returns.

However, not all of the effects of the crisis have been benign. The surge in central bank reserve growth in the emerging world, which was only partially sterilized, led to significant monetary easing in many of the world's fastest growing emerging economies. Rising inflation rates combined in some cases with falling nominal rates to produce negative real interest rates in much of the emerging world. The ongoing boom in investment contributed, in turn, to a significant rise in oil prices. U.S. oil imports are falling and European imports are stable, so neither was a major source of pressure on supply. The rise in oil prices, in turn, has generated inflationary pressures in the United States even as the U.S. economy slows—an uncomfortable combination. The pattern of adjustment in the global current account also leaves much to be desired. European currencies appreciated not just against the dollar but against the Gulf currencies and China, even though the Gulf and China

are in surplus and the European Union countries run a deficit. As a result, China has shifted from relying on the United States to Europe to propel its export growth. The latest data suggests that the enormous surge in oil prices in 2008 will not bring China's surplus down in dollar terms. The combination of a constant Chinese surplus and a rising surplus in the oil exporting economies implies a rise in the aggregate current account deficit of the United States and Europe. The

peaked in January—but growth over the course of Q4 2007 and in January meant that average GDP in Q1 2008 was higher than in Q4. Employment and industrial production are down. The stimulus package should help support consumption over the summer, but there are still doubts that the U.S. economy will have regained enough momentum to resume sustained growth after the stimulus wears off. Growing difficulties in the U.S. financial sector, the slide in U.S. home prices, the slide

But at some stage, the most acute phase of the financial crisis will end. This hope has combined with growing evidence that, at least globally, inflation could be a bigger risk than the collapse of growth, to generate a new set of policy debates.

imbalances that have marked the global economy haven't really started to correct. Private capital is flowing to countries that have surpluses, not to the countries that need financing.

Prospects for recovery and implications for future economic policy

It is still unclear whether these steps will be sufficient to avert a US recession. Economic activity in the U.S. may have

in the U.S. equity market, and the contractionary impulse from the rise in oil prices suggest caution rather than unbridled optimism.

But at some stage, the most acute phase of the financial crisis will end. This hope has combined with growing evidence that, at least globally, inflation could be a bigger risk than the collapse of growth, to generate a new set of policy debates. Three stand out:

First, is the U.S. economy strong enough to be weaned off fiscal stimulus, or is a second round of stimulus needed?

Second, what regulatory regime changes are needed for U.S. financial institutions? Calls have been made to force banks to hold more capital in good times to build a better cushion against bad times, to extend the scope

should adjust their policies to guard against a further rise in inflationary pressures? Emerging markets that peg to the dollar or manage their exchange rates against the dollar blame loose U.S. policy, and argue that the United States needs to raise rates and do more to defend the dollar. Fed Vice Chair Donald Kohn, along with many economists, argues that many booming

The willingness of many emerging economies to shadow the dollar and build up their foreign assets—global reserve growth accelerated dramatically after 2002—contributed to the buildup of vulnerabilities that led to the August 2007 subprime crisis. So far the global response to the crisis largely has been defined by the ongoing interaction between dollar pegs and U.S. weakness. But the costs of dollar pegs that link the currencies of countries with strong economies to the dollar during a U.S. downturn are now more apparent. There is a possibility, though at this stage not yet a probability, that the next stage of the subprime crisis will be marked by the difficulties associated with a real transition away from a world where key emerging markets manage their currencies against the dollar—and the opportunities that such a transition might create.

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of regulation to cover the broker-dealers now that they have access to the Fed, to consolidate U.S. regulation, and to make the system safe enough for big institutions to fail by, among other things, moving certain over-the-counter derivative markets onto organized exchanges. Those calls have yet to translate into concrete actions.

Third, who bears responsibility for the uptick in global inflation? And who

emerging economies shouldn't peg to the dollar and tie their monetary policy to that of the United States. If they don't believe U.S. policy is right for their economies they should allow their currencies to appreciate and create the conditions that allow them to adopt monetary policies suited for their own conditions.

The final question has implications that go beyond monetary policy.

Achieving a Soft Landing for the Global Imbalance and a Worldwide Recession

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The subprime mortgage crisis that appeared in summer 2007 has deepened with the passage of time, and its impact is being felt not only in the United States but also in economies around the world. Its global repercussions have spread in stages. First, as subprime mortgages fell into default in the United States, the crisis affected the financial institutions that made those loans. This led to the initial credit crunch. Next, financial institutions primarily in the United States and Europe suffered heavy losses as the prices of the residential-mortgage-backed securities that included subprime mortgages in their portfolios—and the collateralized debt obligations that included these subprime RMBSs—collapsed. The macroeconomic impact of the losses these financial institutions needed to write off gradually spread with the drop in prices of other financial products that incorporated subprime mortgages, resulting in additional losses for the financial sector and a further deepening of the credit crunch. This is now applying recessionary pressure on the economy as a whole in the United States and Europe, and the slump in these economies is adversely affecting the economies of Asia, which were not directly involved in the mortgage crisis.

Most prominently, these subprime mortgage-related developments came at a time when the global economy had become seriously imbalanced, characterized by the US deficit and Asia's surplus in the current account. Chairman of the Federal Reserve Board Ben Bernanke has blamed the imbalance on Asia's surplus, which

into the country, a more fundamental problem is the sudden expansion of the U.S. deficit prior to the crisis. Had vast Asian savings not financed the U.S. deficit, it would have become unsustainable, and the value of the dollar may have taken a nosedive. In this light, the U.S. economy is clearly more at fault for creating the global

In this light, the U.S. economy is clearly more at fault for creating the global imbalance than the excessive saving in Asia—which helped support the U.S. economy in the face of a huge current account deficit.

he contends is caused by the region's excessive saving—that is, insufficient consumption. In the late 1990s, though, as the U.S. economy's current account deficit began to grow, Asia was hit by a financial crisis in 1997 that shackled its economy for many years thereafter. At that time, moreover, the bountiful savings that had been amassed in Asia flowed into the United States, contributing to financing the U.S. current account deficit. While the U.S. deficit may not have grown as large had Asian capital not flowed

imbalance than the excessive saving in Asia—which helped support the U.S. economy in the face of a huge current account deficit.

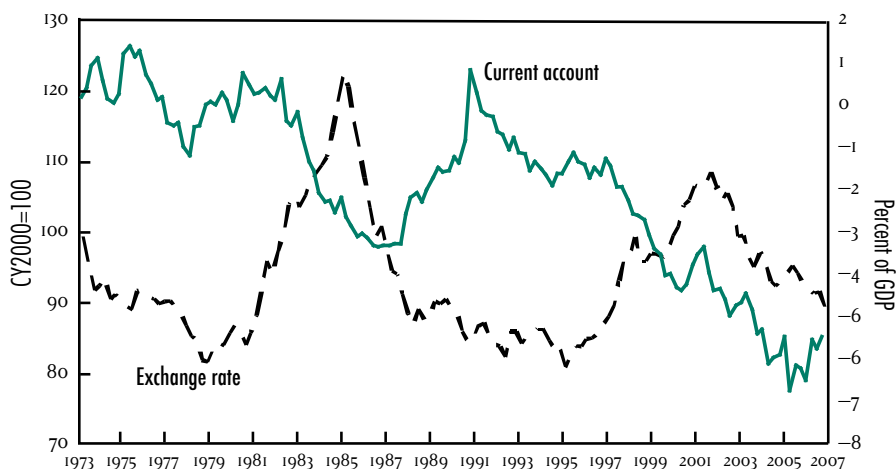
A decade of growing imbalances

The U.S. deficit that began to swell in the late 1990s ballooned to 7% of GDP (gross domestic product) in 2005 (figure 1). This is often compared with the twin deficits the United States faced in the 1980s. This prompted the September 1985 Plaza agreement among the

Group of Five industrial countries on macroeconomic policy coordination, which slashed the value of the dollar in half in just two years. The U.S. current account deficit at the time was little more than 3% of GDP, but even then there was deep concern about the size of the deficit and the overvalued dollar—which many believed was caused by the fiscal deficit—and so an agreement was reached on coordinated intervention in the currency market to drive down the dollar’s value.

The primary factor behind today’s alarmingly large current account deficit is the lopsided saving-investment balance in both the government and private sectors. The causes of the imbalance have shifted since the late 1990s: in the late 1990s, information

Figure 1. U.S. Current Account and the Real Effective Exchange Rates of the U.S. Dollar



Source: Ogawa and Kudo 2007. Data sources: Federal Reserve Board of Governors (exchange rate) and Bureau of Economic Analysis (current account).

U.S. fiscal deficit began to grow due to stimulus spending, especially so following the September 11 terrorist attacks that prompted massive military

fiscal deficit, further exacerbated the U.S. current account deficit.

There is no question that this surge in housing investment—and the resulting swelling of the current account deficit—was buoyed by subprime loans to low-income households. The subprime mortgage crisis is thus integrally related to the worsening of America’s international balance of payments and, in turn, to the global imbalance. Given Washington’s plans to reduce the deficit in its public finances, the cooling of housing purchases in the wake of the mortgage crisis will no doubt help to alleviate the country’s current account deficit.

A secondary wave of the subprime mortgage crisis is starting to reach Asian shores, as the U.S. economy enters a period of slowdown induced by the credit crunch.

technology investments leaped on the wings of the IT boom and bubble, but when the boom subsided and the bubble burst after 2000, the

expenditures. Credit was eased to stimulate economic activity, prompting a surge around 2005 in consumer home purchases. This, along with the growing

The perilous road to recovery

The author conducted a simulation of how much the dollar needs to be devalued in order to halve the current account deficit from a share of 6% of GDP to 3%, using just the exchange rate and assuming the fiscal deficit and other factors as givens. This was a VAR (vector auto-regression) analysis with two variables, namely, the U.S. current account deficit and the real effective exchange rate of the U.S. dollar (Ogawa and Iwatsubo 2008). Our conclusion was that the dollar would have to depreciate by 45% over a period of 50 quarters. Analyses conducted using other, analogous variables produced similar results, with the necessary rate of depreciation ranging from 30% to 50% (Ogawa and Kudo 2007).

The shrinking of private housing investment in the United States has had a recessionary impact on the U.S. economy, dampening household consumption and private capital spending. This should act to diminish

the U.S. current account deficit, which will help alleviate the global imbalance. If the subprime mortgage crisis could reduce the fiscal deficit, a soft landing through a more gradual weakening of the dollar would hopefully be possible, rather than the hard landing that the simulations suggest (Ogawa and Iwatsubo 2008).

But a secondary wave of the subprime mortgage crisis is starting to reach Asian shores, as the U.S. economy enters a period of slowdown induced by the credit crunch. Asia's exports to the U.S. market are falling, causing a drop in aggregate demand in Asia. Global capital, now looking for new investment opportunities following the subprime mortgage disaster, has been flowing into petroleum, other natural resources, and foods such as grains, driving up their prices. Unlike the Persian Gulf countries, Asia has not benefited from soaring commodity prices; on the contrary, they have experienced

a supply shock that has lowered productivity and GDP. The combination of higher prices and diminishing GDP is unsettlingly reminiscent of the stagflation that followed each of the two oil crises during the 1970s.

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