


Global Focus on Knowledge/Winter Semester 2008  
**In Pursuit of Global Financial Policy**

Lecture at The University of Tokyo (Ⅲ)  
(October 30, 2008)

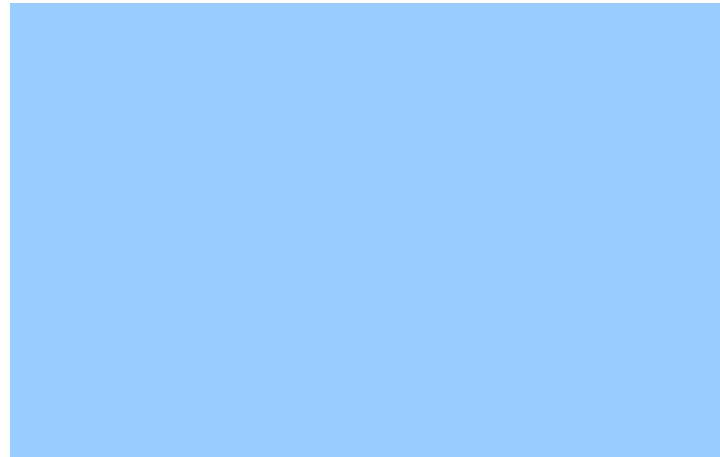
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# BOJ Grand Prix

- (1) Bank of Japan has hosted “BOJ Grand Prix: Opinions from Campus,” a contest targeted at college students, for three times to date.
- (2) The prize for best performance in the first time was awarded to “Creation of Electronic Paper Money,” which is the offering of a green opinion based on a fresh sensibility.
- (3) Second time’s best performance prize went to “From Savings to Participation—the longest journey,” suggesting a local bond in a dividend-in-kind type.
- (4) The same prize was given in the third time to “Investment Fund for Children’s Future—Financing for Support, Financing for Link,” which offers an opinion on establishing an investment foundation to save up funds for children’s education.



# 1. Policy Response: Liquidity Supply

- FRB's liquidity supply used to be restrained by the requirement to collect funds from the market in order to maintain a policy interest rate at a certain level, but which was resolved by the setup of the lowest limit with an interest accrual on a reserve for deposit (similar to the corridor form) and the new issuance of short-term government bonds by Department of the Treasury.
- In the wake of J.P. Morgan's buyout of Bear Stearns, a loan of \$29 billion was made under Article 13, paragraph (3) of Federal Reserve Act (compensation by Department of the Treasury, a Swedish bad-bank method, plus a special loan by Bank of Japan).
- Fannie Mae and Freddie Mac made net worth inadequate, and Department of the Treasury placed them under the public management with the contribution of \$200 billion.
- Bear Sterns, albeit sufficient with equity capital, bankrupted due to the shortage of liquidity. Subsequently the swing line was set up for primary dealers (PDCF) and, with the reason that a response in liquidity should have been possible in advance, Lehman Brothers was not rescued. Whereas placing AIG engaged in CDS trades extensively under the public management, the emergency loans were made for \$8.5 billion for the first round, then an addition of \$38 billion.

## (Chart 8) Coordinated Interest Rate Cut

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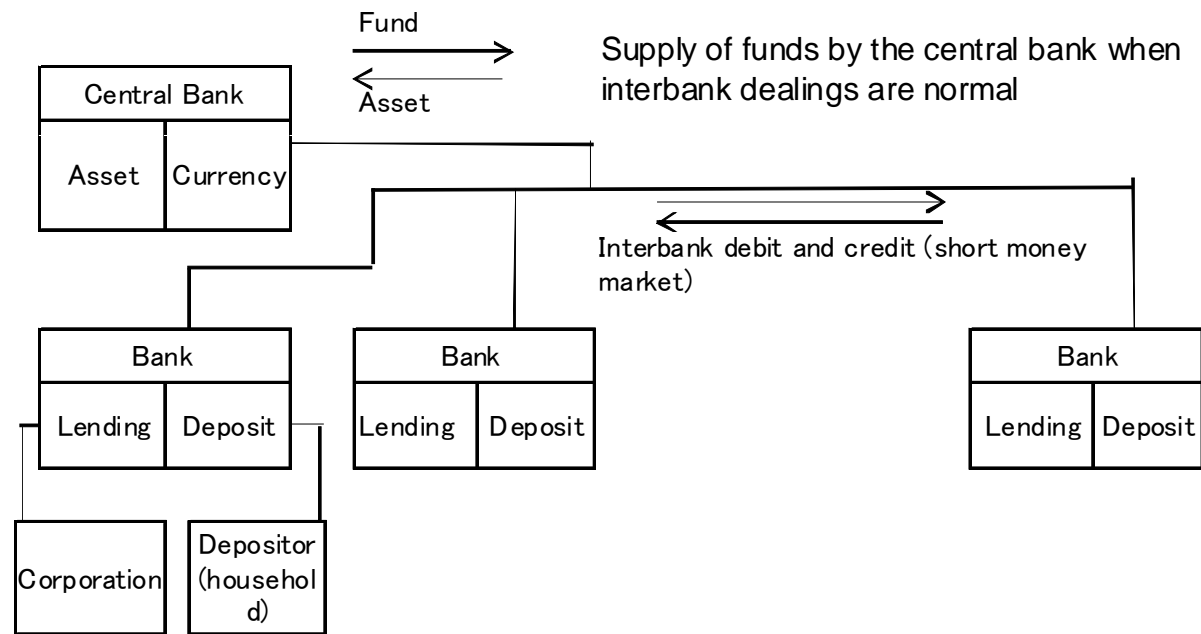
## (Chart 3) FRB's Liquidity Supply

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# 1. Policy Response: Liquidity Supply

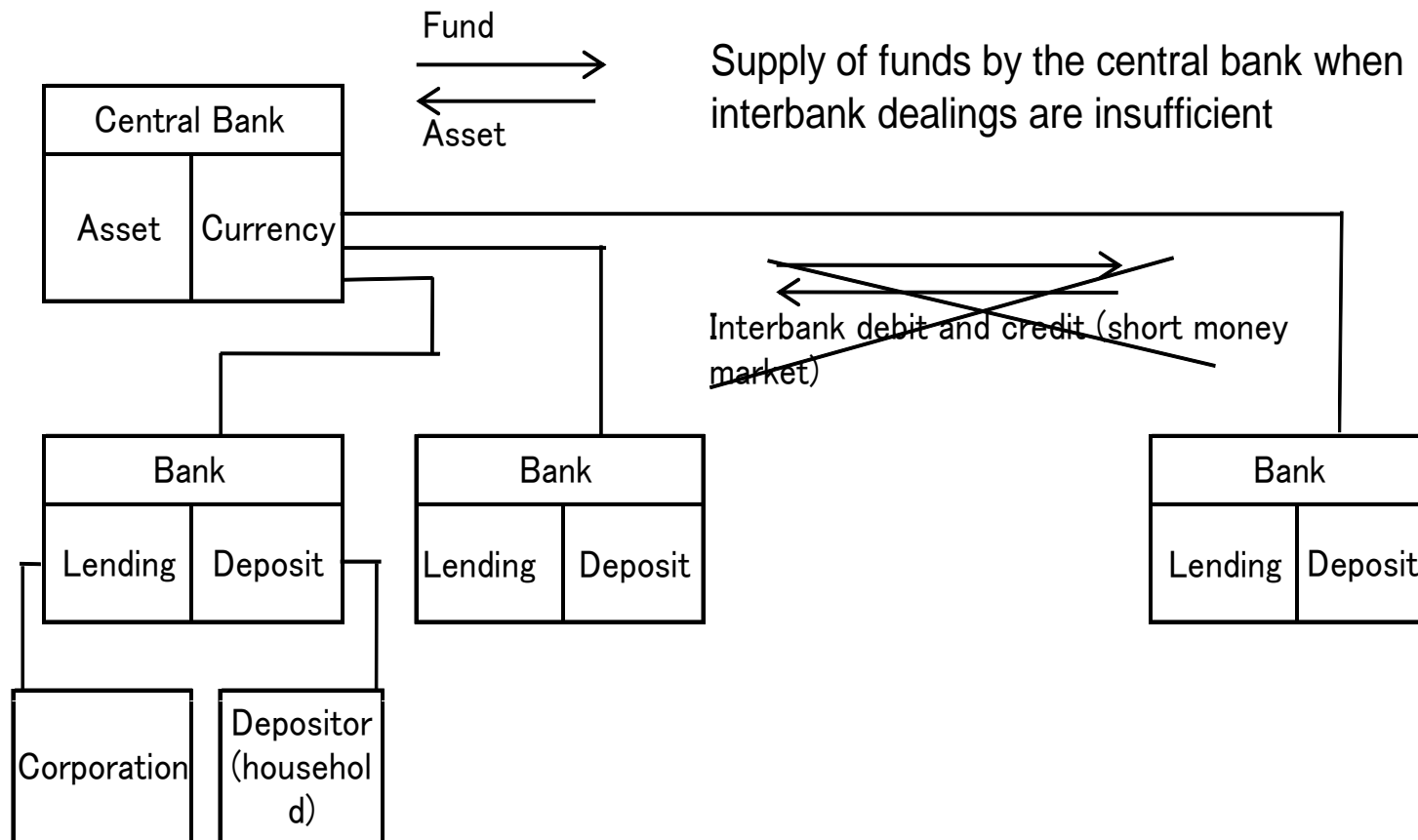
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# (Chart 2-1) Liquidity Supply



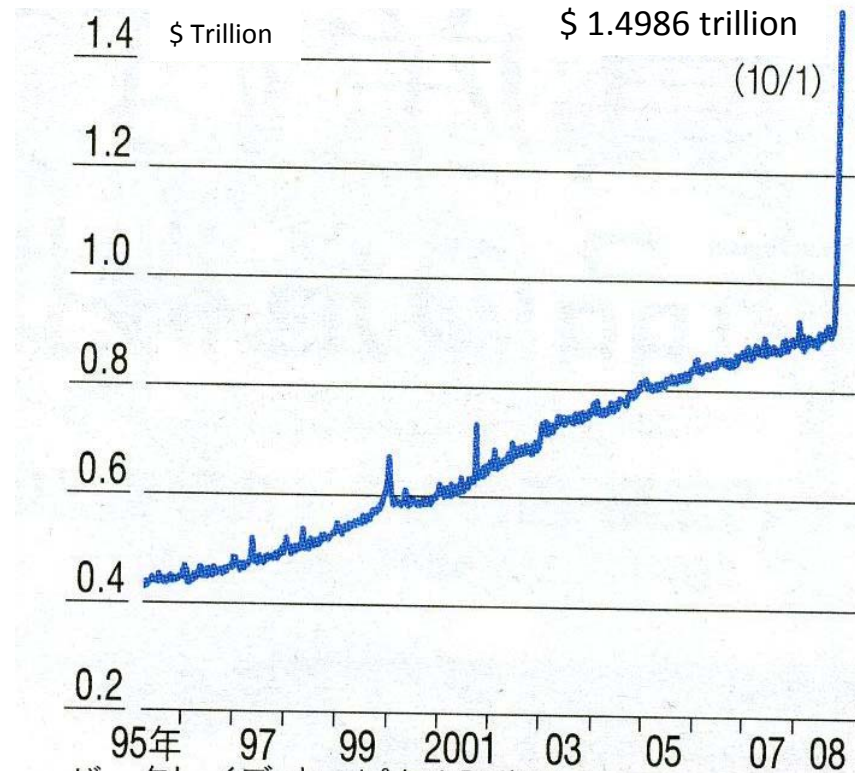


# (Chart 2—2) Liquidity Supply



# (Chart 3) FRB's Liquidity Supply

Rapidly Expanding FRB's Assets



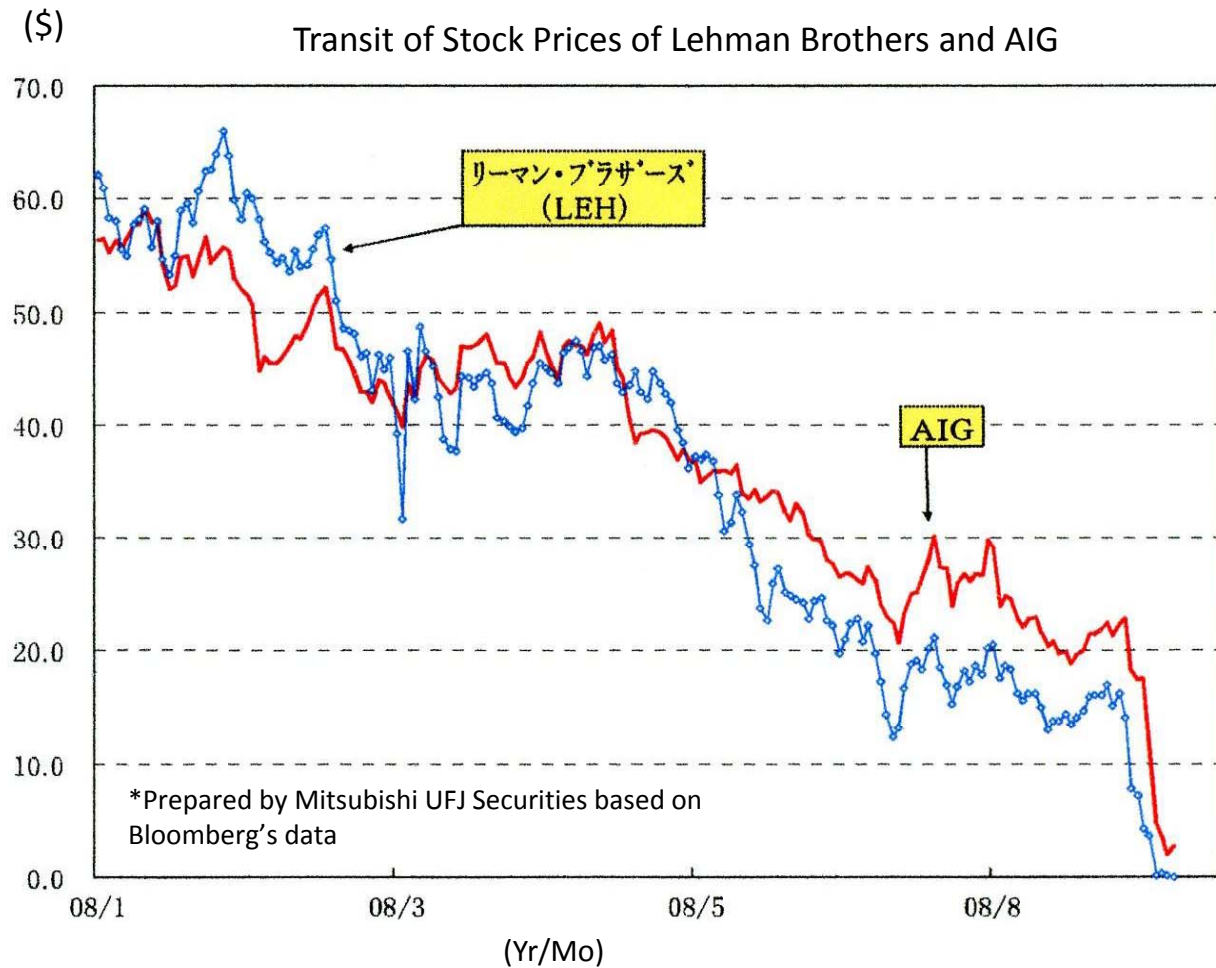
Survey by Barclays Capital Securities

Nikkei Veritas,  
Oct. 5, 2008

## (Chart 4) Stock Prices of Two Public Housing Corporations

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# (Chart 5) Plunge in Stock Prices



‡ Data of Mitsubishi UFJ Securities

## (Chart 6) From Bargain Sale of Financial Assets to One of Liabilities

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## (Chart 7) Vanishing of Investment Bank

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## 2. Coordinated Interest Rate Cut

- The coordinated cut by FRB and the central banks of advanced nations prior to a G7 meeting in October is to have an effect on:
  - (1) Providing underpinning for the economy with monetary relaxation;
  - (2) Increasing earnings of banks. But in the U.S., Treasury bill rate in mid-September fell close to 0% for the first time ever since the Great Depression and the interbank bid rate rose, TED spread continues to be stuck at a high level.

Whereas, owing to financial institutions' credit crunch and severer lending practices, it is likely that an effect of the interest-rate cut diminishes.

In case of the U.S., having suffered a substantial loss by financing American banks, the role of SWF is limitative. Also caution is required as to a risk in an abrupt depreciation of the dollar to be generated by the constraint associated with a capital importer (need for an exercise of a fiscal policy). So far, the dollar has shown a steady tone because of American investors' sale of foreign-currency assets that is transmitted in the dollar to the mother nation (the dollar depreciated against the yen; the yen appreciated partly due to the reversing of Yen Carry Trade back to countries with high interest rates in the past).

## (Chart 8) Coordinated Interest Rate Cut

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## (Chart 9) Transit of Exchange Rates to Yen

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# (Chart 10) Banks' Credit Crunch

Bank Balance Sheet in Ordinary Time

Assets	Liabilities
Lendings + Other financial assets	Deposits + Other debt payables
	Equity capital

To decide on lending up to corporation's earning capacity within equity ratio

Bank Balance Sheet in Financial Crisis

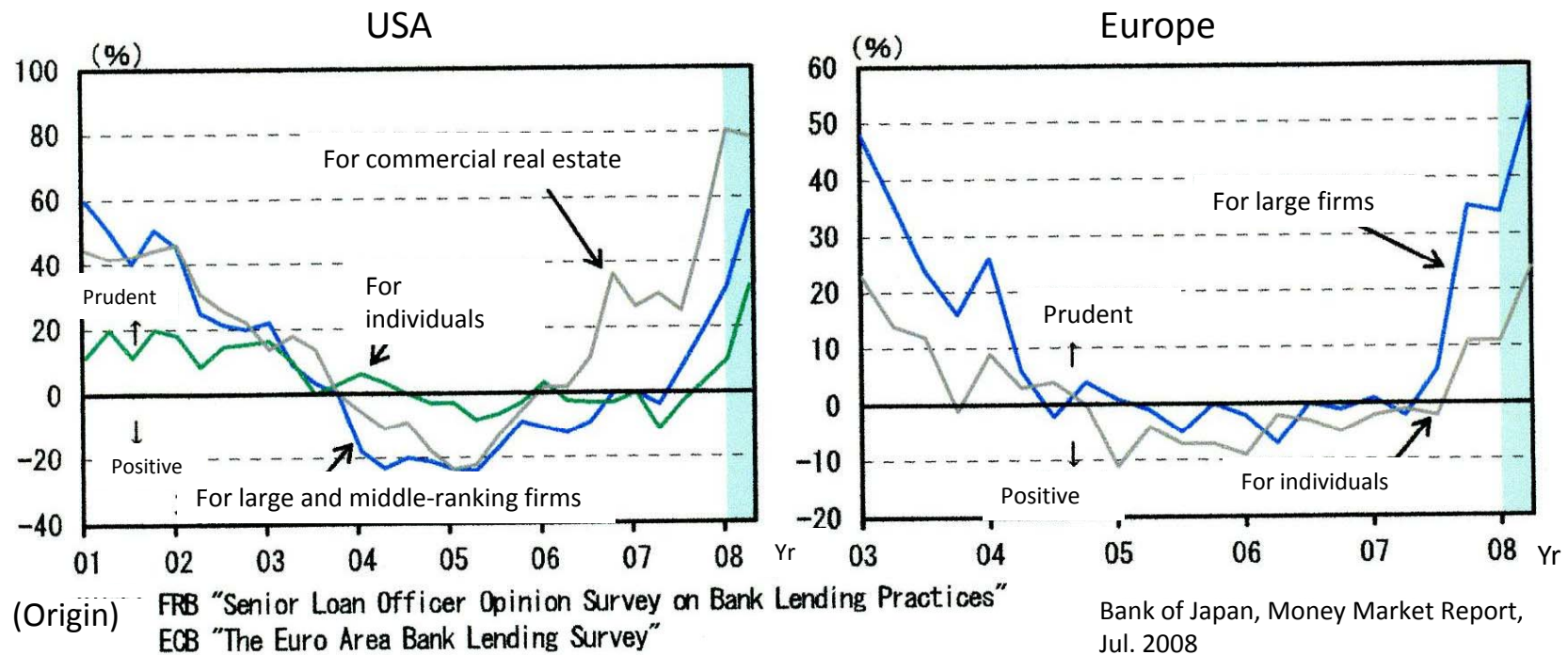
Assets	Liabilities
Lendings + Other financial assets	Deposits + Other debt payables
	Equity capital

↑                      ↑

Equity ratio in decline due to appraisal loss in holding financial assets => lending tougher than in ordinary time

# (Chart 11) Severer Lending Practices of Western Financial Institutions

Lending Practices of Financial Institutions



‡ Bank of Japan, *Money Market Report*, Jul. 2008

### 3. Policy Response: Fiscal Policy

- The U.S. exercise of a fiscal policy (\$168 billion); distribution of checks from May 2008 (amounting to \$110 billion, and \$168 billion including corporate tax cuts)
  - This has an effect to provide underpinning for the economy against the negative wealth effect (about \$500 billion) caused by the slump of housing prices, but which is tentative (giving some 1% boost in the second and third quarters).
  - If an immediate capital shortage of financial institutions is something worth about \$150 billion, credit crunch amounts to be ten times larger in the region of \$1.5 trillion.
  - Department of the Treasury prepared \$50 billion out of the exchange stabilization fund in order to protect IMF that ran a fall below par value.

## (Chart 12) American Public Funds

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### 3. Policy Response: Fiscal Policy

A bill on buying up of bad assets in the scale of \$700 billion was rejected once in Congress but was passed after the amendment. The function switched from RTC (buying up of bad assets) to RFC (injection of public funds).

- Conditions are not clear about the decision on purchase prices and injection of public funds to banks.
- Setting purchase prices on a higher side and providing subsidies to financial institutions would be difficult to gain the taxpayers' understanding, while setting them on a lower side would enlarge losses of financial institutions.
- There is a need to raise the level of transparency in off-balance transactions and derivative instrument dealings, and to bring out in the open the loss integrating off-balance-sheet liabilities. So is an issue of changes in the accounting system.

# (Reference) Outline of Emergency Economic Stabilization Act of 2008

## 1. Purchases of illiquid assets

- To establish TARP (Troubled Asset Relief Program) to purchase bad assets owned by financial institutions
- Main assets for buying out are housing and commercial mortgage-backed securities and related securities thereof formed or issued before March 14, 2008.

## 2. Scope of purchasing authorities

- To empower Department of the Treasury to execute TARP up to \$700 billion.
- To authorize the Department to immediately spend up to \$250 billion; an additional spending of \$100 is possible with the president's discretion. The balance of \$350 is expendable unless Congress should adopt a resolution of disapproval.

## 3. Setup of insurance for bad debts

- For the Department to create a program to guarantee bad assets owned by financial institutions.

## 4. Termination of authorities

- The powers for the buy out and guarantee of assets are effective till December 31, 2009, but which can be extended for another year with the approval of Congress.

## 5. Setup of supervisory authorities

- To create Financial Stability Oversight Board, composed of FRB chairman and others, for reviews and advices as to the execution of authorities under this Act.

## 6. Executive pay limits

- For financial institutions from which the Department directly purchases assets to observe executive pay limits as to an incentive income, return of reward, retirement grant, etc.

## 7. Payback of profits to taxpayers

- For the Department to receive warrant rights (subscription rights) from financial institutions participating in TARP in order to return increases in stock prices to taxpayers.

## 8. Tentative upward revision of indemnity limits of deposit insurance

- To raise the upper limit of deposit insurance for FDIC and others from \$100,000 to \$250,000 until December 31, 2009,.

## 4. Response of Europe

The U.K. and other European nations adopted political measures based on three main points as follows:

- (1) Deposit protection
- (2) Guarantee of interbank transactions
- (3) Capital injection, or, nationalization in certain cases

Meantime, as for current-value accounting, it is regrettable that a movement has emerged to place it under a ban.