

## Geithner's Comprehensive Plan in 2009 and Japan's Total Plan in 1998

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About a year ago, I started to compare seriously the current financial crisis to the Japanese crisis of a decade ago. I initially hoped that the policy responses by the U.S. policy makers would be very different from those by the Japanese policy makers and much more effective. In some aspects, such as monetary policy, the Federal Reserve has been more aggressive than the Bank of Japan was, although whether they will be successful in staving off the deflation remains to be seen. In addressing the problem of toxic assets and restoring confidence in the financial system, however, the U.S. government has not done much better than the Japanese government did a decade ago.

As I argued in [my paper with Anil Kashyap](#) and elsewhere, following the crisis of November 1997, when some major financial institutions including Hokkaido Takushoku Bank and Yamaichi Securities failed, the Japanese government put together a bank recapitalization and injected ¥1.7 trillion into major banks in March 1998. The capital injection was done without serious inspection of the financial condition of individual banks, so almost an equal amount of capital was allocated to all the major banks. This is very much similar to the public capital injection of October 2008 in the U.S., which was conducted without inspection nor serious oversight on the banks that received public funds.

The Japanese capital injection in 1998 failed to restore confidence in the financial system. Japanese continued to face much higher cost of funds compared with their U.S. and European counterparts (Japan premium), and the stock prices of the banks that are suspected to have problems (such as the Long-term Credit Bank of Japan (LTCB) and the Nippon Credit Bank (NCB)) continued to fall. The results of the 2008 capital injection in the U.S. have not been better. For most of the financial institutions that received capital in the first round of recapitalization, the stock prices today are even lower than the stock prices right before the announcement of capital injection. Citigroup and Bank of America have received additional capital injection but they still seem to struggle.

Facing the continuing troubles in the financial system in Japan in 1998, the LDP, the ruling party, proposed a new plan to address the non-performing loans problem. The "Total Plan for Financial Revival" included new legal framework and institutions to simplify restructuring and/or liquidation of loans collateralized by land, expansion of CCPC (Cooperative Credit Purchase Corporation, an asset management company), creation of the market for asset based securities, public/private partnership on purchasing and developing land that were collaterals for non-performing loans, intensified inspection of major banks by the newly created Financial Supervisory Agency (FSA, the predecessor of the current Financial Services Agency), and creation of a bridge bank that inherits deposits and assets of failed banks. Now in the U.S. the Treasury Secretary Timothy Geithner

announced last Tuesday (Feb. 10) the “comprehensive framework” to deal with the problems in the U.S. financial system.

The framework is supposed to address both financial system issues and mortgage/housing issues. The comprehensive housing program will be announced in the next few weeks. Geithner’s address focused on the policy to restore health of financial institutions and re-establish credit flows. The policy consists of three parts.

First, all major financial institutions are required to go through stress tests. These tests will determine the extent of capital shortage. The government will provide capital support for those financial firms with capital shortage. They will come up with a new funding program. The government capital is supposed to be a bridge to private sector finding and not a long-term substitute for private funding.

Second, public/private partnership (PPP) will be created to buy troubled assets. The details are still being discussed and will be announced later. The government plans to invest about \$500 billion first and then raise the involvement up to \$1 trillion.

Finally, the government is expanding the Federal Reserve Term Asset Backed Securities Loan Facility (TALF) up to \$1 trillion. The Treasury contributes \$100 billion. The program aims to revive the markets for student loans, auto loans, consumer loans and small business loans.

Will this new comprehensive framework solve the problem of the U.S. financial system? The answer is not clear. There are many important details of the plan that are not specified, yet. The success will critically depend on those details.

The introduction of stress tests to determine the extent of capital shortage and the necessary amount of capital injection will be an improvement over the status quo, where the public funds have been given out to financial institutions without serious inspection. Any stress test, however, needs some probabilistic ideas about the value of assets on the balance sheet of a financial firm. Having a good idea about the value of assets that the financial institutions own is exactly the difficult problem we are facing today, but the plan does not specify any new solution to this problem.

The plan may be to rely on the pricing of toxic assets conducted by the PPP investment funds to assess similar assets remaining on the balance sheets. If this is the case, the government needs to move quickly on the PPP part of the plan, so that the information obtained can be used to help the stress tests.

The problem is, however, the PPP part is the least articulated part of the plan. At this point, it is not clear how the prices of those toxic assets will be determined. If the banks find the prices too low, they will not have incentive to sell the troubled assets. Those assets the banks end up selling are likely to be the worst assets in a particular category. If

the prices are too high, the government will have trouble finding willing private partnership. So we are back to the original TARP (Troubled Assets Relief Program). The PPP is likely to face the same problems that the original TARP would have faced.

If the PPP turns out to be successful in spite of these problems, there is a problem of what to do with insolvencies potentially revealed by the disposal of troubled assets. If the prices of troubled assets become substantially lower than those currently used by the financial institutions, it may reveal some financial firms are actually insolvent. The plan is silent about what to do with those insolvent financial firms. Would the government continue to help them by injecting capital into them?

Finally, announcing the size of the resources that are committed to the PPP *ex ante* is problematic. The size of PPP will depend on how much troubled assets need to be removed to restore the health of the financial system, at what price the assets will be purchased, and to what extent the private investors are willing to participate. Depending on the exact mechanism used in the PPP and the extent of private sector involvement, the PPP is likely to be re-sized. At the very least the government should have explained at how it arrived at the size it is proposing for the PPP.

In the Japanese case a decade ago, the situation continued to worsen even after the LDP floated the idea of the “total plan.” The “total plan” never passed the diet, because the LDP lost big in the election in July 1998. Eventually the government ended up creating a more drastic framework that allows temporary nationalization of insolvent but systemically important banks in October 1998. The LTCB and NCB were both nationalized and later sold to new investors: LTCB to the investors led by a U.S. investment group Ripplewood and NCB to a group of Japanese investors.

The U.S. situation does not look better. The stock prices fell as Treasury Secretary announced the plan. It is good that the financial stocks fell because it suggests that the market did not see any additional transfers from taxpayers to bank shareholders in the plan. It is not good that the other stocks fell as well. The U.S. needs a plan clearer than the one announced this week. Otherwise, the government may be forced to come up with a more extreme plan, which includes nationalization of large troubled financial institutions.