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Glass-Steagall Is Essential to Recovery

This paper was read on Mr. Kotegawa's behalf at the Schiller Institute conference in Flörsheim, Germany, on Nov. 25, 2012. He is currently research director with the Canon Institute for Global Studies; he was the former executive director for Japan of the International Monetary Fund, and a former official of Japan's Ministry of Finance.

1. I was in charge of the restoration of the Japanese economy in the late 1990s and early 2000s. Among others, I was in charge of the liquidation of Sanyo Securities and Yamaichi Securities in 1997, partial nationalization of Long Term Credit Bank and Nippon Credit Bank in 1998, and the establishment of the Industrial Revitalization Corporation of Japan in 2003. We were targets of criticism, not only from domestic voters, but also from international opinion leaders, for mismanagement of the Japanese financial sector. Several staff of the supervisory authorities, including the Ministry of Finance and the Bank of Japan, were arrested and found guilty. Some of them committed suicide, including friends of mine.

From this background, it is quite easy for me to predict what will come next in the ongoing financial crisis, because it really follows suit from the crisis I experienced in Japan ten years ago—an unwelcome déjà-vu.

2. First, it is essential to identify those who are responsible for this crisis. It is investment bankers in the Anglo-Saxon countries who were indulging in high-risk gambling types of trading, and created a bubble. It is quite awkward to see that nobody has been arrested who gained from this bubble.

In Japan, almost all the board members of liquidated or partially nationalized financial institutions during the financial crisis in 1997 and 1998 were arrested and prosecuted.

The Financial Bubble

3. The main structural cause of the financial bubble in the United States and Europe from 2002 to 2007 was the complete abolishment of the Glass-Steagall Act in February 1999. It was abolished under the leadership of Treasury Secretary Lawrence Summers during the process of liberalizing the financial markets in the late 20th Century.

Glass-Steagall was enacted in 1933 in order to divide the business of banking and securities, in light of the tragic experiences of the Great Depression. Surplus liquidity created by an extended period of lax monetary policy in the first decade of the 21st Century, under the auspices of the Federal Reserve Chairman [Alan] Greenspan, fueled a so-called money game by investment banks, which was inconsistent with the laws of real demand.

4. Then there were serious mistakes committed by the governments of the United States and the United Kingdom during the liquidation of Lehman Brothers.

When Yamaichi Securities closed in November 1997, the Japanese government allowed the liquidation of Yamaichi only after all cross-border transactions had been unwound. The main purpose of this was to not let the closure of Yamaichi affect overseas financial institutions and drag Japan into the epicenter of a world depression.

This was not the case for the liquidation of Lehman Brothers. Lehman went bankrupt *without* unwinding its huge volume of cross-border transactions. This had an extraordinarily contagious effect on the world financial system, and triggered a world depression comparable to the Great Depression before the Second World War. Liquidating Lehman only after all foreign transactions had been unwound could have averted a worldwide crisis.

The Bank Bailouts

5. The next problem involves the process of bailing out financial institutions. U.S. authorities bailed out banks by injecting public money in order to defend the financial system. In light of our experience in Japan, there are three problems with regard to the modality of the bailout in the United States:

(a) The balance sheets of all major financial institutions were not rigidly examined by any official authority, using mark-to-market accounting;

(b) The amount of public funds necessary to completely dispose of non-performing loans in each institution was not clearly identified;

(c) Each institution did not dispose of all non-performing loans, making it vague to market investors whether non-performing loans had been left on the balance sheets.

6. The mark-to-market accounting rule was frozen as a result of pressure by the U.S. Congress. The method of examining balance sheets of major financial institutions has not been stringent, unlike in Japan.

7. All major financial institutions avoided liquidation except Lehman Brothers, but they were kept intact through a bailout and because of their political clout. This situation made it difficult not only to launch fundamental reforms of the financial system, but to fully investigate the real cause of the financial crisis. In particular, it has made it extremely difficult to investigate the responsibility of executives of major banks. As a result, top executives of major banks in the United States have not learned any lessons from the Lehman crisis. It is frightening to think that such executives are likely to make the same mistakes again.

8. Western investment banks, British and American in particular, were kept intact, with unhealthy balance sheets. They have not recovered from insolvency, while superficially they look fine, thanks to the bailout, relaxation of accounting rules, and obscure stress tests. To get out of this dangerous situation as soon as possible, they are desperately seeking high returns within a short period of time.

9. Investment banks found good victims for this purpose: countries that suffer from budget deficits caused by fiscal stimuli that they enacted in 2009 to counter the economic downturn, such as Greece, Ireland, Portugal, Spain, and Italy. Banks used excess liquidity in the market, which had been supplied by central banks supposedly to enhance the economy, but which failed to stimulate the economy due to the lack of real demand. Short sales and credit default swaps were used as a means of attack. Consequently, European countries have had to rely upon fiscal austerity.

10. This has had a devastating effect on the recovery of the European economies. As was well witnessed in the economic crisis in Japan, at the time of economic crisis after the collapse of the financial bubble, the household sector and the corporate sector suffered from a hangover of over-borrowing during the bubble period. They tried to squeeze their balance sheets in order to repay loans. Left alone, this would have resulted in the shrinking of the national economy. It is the government sector that has to increase its expenditure to prop up the domestic economy, by way of deficits. But, the attack by the market has made it difficult for European countries to rely upon such policies. I am afraid that the European countries are entering a vicious cycle of economic contraction.

Fundamental Changes Needed

11. A fundamental change of thought to battle the economic crisis is essential now. Instead of relying upon austerity, rules and regulations which would make it impossible for banks to attack countries, such as the Glass-Steagall law, should be introduced.

12. With the introduction of Glass-Steagall, for the purpose of splitting commercial banks and investment banks, large banks will have to conduct "due diligence" in order to identify their assets and liabilities. It is highly likely that such due diligence will reveal that investment banks are insolvent, and that there are no options for them other than liquidation. Cancelling out their positions would substantially reduce the liabilities of commercial banks.

It is hoped that, by conducting this process, and possibly by injecting public money into commercial banks, the balance sheets of financial institutions in Western countries will be cleared, and confidence in the sector will be restored. This is a prerequisite for economic recovery from the crisis. The options left for us are very clear: interests of bankers or interests of the general public. The answer should be very simple.

13. Huge amounts of money have been used to bail out banks. That money was wasted. It did not help investment banks improve their balance sheets; instead, they were engaged in another round of speculative trading. Such money should have been used, instead, to stimulate the real economy. Provision of excess liquidity by central banks has failed to create real demand, and funds have been abused in attacking European governments and, thereby, brought misfortune to the general public in those countries. Fiscal stimulus has to be used for the purpose of investments, not for the sake of government or private consumption. It should be recalled that the stimulus package in the United States in 2009 was absolutely ineffective in this regard.

With the depth of economic contraction all over the world, governments should launch a global scale of large infrastructure projects to create real demand on a global scale. In addition to relaxation of international rules that have prohibited private money from taking risks, such as Basel III, governments should extend an umbrella, in such forms as government guarantees, to large-scale infrastructure projects, so that affluent resources in the market will be mobilized effectively to take risks in those projects.