

SYMPOSIUM ON BUILDING THE
FINANCIAL SYSTEM OF THE 21ST CENTURY:
AN AGENDA FOR JAPAN AND THE UNITED STATES
CAMBRIDGE, MA • NOVEMBER 4-6, 2011



AGENDA

FRIDAY, NOVEMBER 4

6:00-6:30 p.m. COCKTAIL RECEPTION TERRACE ROOM (SHERATON)

6:30-6:40 p.m. GREETINGS GEORGE WASHINGTON ROOM (SHERATON)

- Hal S. Scott, Nomura Professor and Director, Program on International Financial Systems, Harvard Law School
- Yasushi Akashi, Chairman, International House of Japan

6:40-7:40 p.m. KEYNOTE ADDRESSES GEORGE WASHINGTON ROOM

- Teisuke Kitayama, Chairman of the Board, Sumitomo Mitsui Banking Corporation
- Richard Neiman, Vice Chairman, Global Financial Services Regulatory Practice, PricewaterhouseCoopers LLP

7:45-9:15 p.m. DINNER GEORGE WASHINGTON ROOM

9:15-11:00 p.m. AFTER-DINNER COCKTAILS TERRACE ROOM

SATURDAY, NOVEMBER 5

7:00-7:50 a.m. BREAKFAST BUFFET GEORGE WASHINGTON ROOM

Panelists, Reporters, and Facilitators please sit at reserved tables

We will depart breakfast promptly at 8am to walk over to Ames Courtroom on the HLS Campus.

**8:15-8:25 a.m. WELCOME & OPENING REMARKS AMES COURTROOM
(IN AUSTIN HALL ON THE HARVARD LAW CAMPUS)**

- Hal Scott, Nomura Professor and Director, Program on International Financial Systems, Harvard Law School

8:25-8:45 a.m. PANEL SESSION AMES COURTROOM

Topic 1: Public Debt Overhang and the Financial Sector

- Hiroshi Watanabe President and Chief Executive Officer, Japan Bank for International Cooperation
- Brian Kelly, Managing Partner, Asian Century Quest

8:50-10:15 a.m. SMALL GROUP SESSIONS AUSTIN AND HAUSER HALLS

<u>Group</u>	<u>Room</u>	<u>Facilitators</u>	<u>Reporter</u>
1	Ames	Roger Servison, Yasuhiro Harada	Andy Conrad
2	Morgan	Terry Suzuki, Yutaka Endo	Dino Kos
3	Austin North	Joe Schmuckler, Rieko Shimojo	Bill Grimes
4	Austin East	Paul Sheard, Shigeki Kimura	Chris Wells
5	Hauser 101	Nick Reinhardt, Hiroyuki Kamano	Arthur Mitchell
6	Hauser 103	Jim Allen, Reese Harasawa	Peter McKillop
7	Hauser 105	Paul Speltz, Kenji Okamura	Akihiro Wani

10:15-10:25 a.m. REFRESHMENT BREAK AUSTIN HALL

10:25-10:45 a.m. PANEL SESSION AMES COURTROOM

Topic 2: Micro-Prudential Measures for Systemic Stability - Basel III and GSIFI Regulations

- Tsuyoshi Oyama, Partner, Financial Industries Group, Deloitte Touche Tohmatsu Japan
- Jon Malamud, Chief Legal Officer, Prudential Holdings of Japan

10:50-12:15 p.m. SMALL GROUP SESSIONS AUSTIN AND HAUSER HALLS

<u>Group</u>	<u>Room</u>	<u>Facilitators</u>	<u>Reporter</u>
1	Ames	Satoru Murase, Akira Ariyoshi	Andy Conrad
2	Morgan	Cliff Shaw, Takayoshi Hatayama	Dino Kos
3	Austin North	Emily Altman, Osamu Yamamoto	Bill Grimes
4	Austin East	Jeff Shafer, Naoko Nakamae	Chris Wells
5	Hauser 101	Jeff Hayman, Shigesuke Kashiwagi	Arthur Mitchell
6	Hauser 103	Doug Hymas, Takashi Oyama	Peter McKillop
7	Hauser 105	Allan Smith, Shuji Yanase	Akihiro Wani

12:15-1:30 p.m. LUNCHEON KEYNOTE ADDRESS ROPES-GRAY ROOM
(in Pound Hall on the Harvard Law Campus)

- Ronald O’Hanley, President, Asset Management and Corporate Services, Fidelity Investments

1:30-3:00 p.m. PANEL SESSION – PLENARY DISCUSSION AMES COURTROOM

Topic 3: Inflation or Deflation – Geological Risk, Geopolitical Risk and Macro-Policies

- Ardavan Mobasheri, Chief Economist and Senior Managing Director, AIG
- Yoshio Okubo, Vice Chairman & Managing Director, Japan Securities Dealers Association
- Naoyuki Yoshino, Professor of Economics, Keio University
- Masaaki Kanno, Managing Director, Chief Economist, JPMorgan Securities Japan Co., Ltd.

3:00-6:00 p.m. FREE TIME

* There are many attractions and areas of interest around Harvard Square, which is 2 blocks away.

3:00-6:00 p.m. REPORTERS MEETING CAPE COD ROOM (SHERATON)

6:10-6:45 p.m. COCKTAIL RECEPTION TERRACE ROOM (SHERATON)

6:45-7:45 p.m. KEYNOTE ADDRESSES GEORGE WASHINGTON ROOM

- Marisa Lago, Assistant Secretary for International Markets and Development, U.S. Department of Treasury
- Masatsugu Asakawa, Deputy Vice Minister for International Affairs, Japan Ministry of Finance

7:45-9:15 p.m. DINNER GEORGE WASHINGTON ROOM

9:15-11:00 p.m. AFTER-DINNER COCKTAILS TERRACE ROOM

SUNDAY, NOVEMBER 6

**Please don't forget to reset your clocks to fall back one hour.*

7:15-8:00 a.m. BREAKFAST BUFFET MOUNT VERNON (SHERATON)

8:15-9:15 a.m. PRESENTATION & DISCUSSION GEORGE WASHINGTON

Topic 1: Public Debt Overhang and the Financial Sector

- Jay Sapsford, Managing Director and Chief Administrative Officer, Morgan Stanley MUFG Securities Co., Ltd.
- Akihiro Wani, Partner, Linklaters Tokyo

9:20-10:20 a.m. PRESENTATION & DISCUSSION GEORGE WASHINGTON

Topic 2: Micro-Prudential Measures for Systemic Stability - Basel III and GSIFI Regulations

- Akinari Horii, Special Advisor and Member of the Board, The Canon Institute for Global Studies
- Ken Dam, Max Pam Professor Emeritus of American and Foreign Law and Senior Lecturer, University of Chicago Law School

10:20-10:30 a.m. BREAK

10:30-11:30 a.m. PRESENTATION & DISCUSSION GEORGE WASHINGTON

Topic 3: Inflation or Deflation – Geological Risk, Geopolitical Risk and Macro-Policies

- Yutaka Endo, Executive Director, The Japan Institute of International Affairs (JIIA)
- David Shuler, Managing Director, CME

11:30-12:45 p.m. CLOSING BUFEET LUNCH MOUNT VERNON

2011 Symposium on Building the Financial System of the 21st Century: An Agenda for Japan and the United States

The thirteenth Japan-U.S. Symposium was held in Cambridge, Massachusetts from November 4-6, 2011. Sessions discussed public debt overhang in Japan and the U.S. and its potential impacts on financial markets, microprudential measures for systemic stability, and risks to the world economy stemming from natural disasters, geopolitics, and macroeconomic policies. Despite the ongoing problems of the eurozone and concerns over the weakness of economic recovery in the developed world, participants were generally sanguine about the near-term sustainability of Japanese and U.S. public debt, focusing instead on the need for medium-term fiscal consolidation. There were also concerns raised about how recent regulatory developments might affect financial institutions and the global economy.

Session 1: Public Debt Overhang and the Financial Sector

Much of the discussion in Session 1 focused on Japan's public debt issues, including sustainability and effects on the financial sector. Among the issues discussed were what might spark a crisis, how to address the need for fiscal consolidation (deficit reduction) despite adverse economic conditions, and how the build-up of public debt on the books of private financial institutions (especially banks) would affect them and the broader economy. There was also some discussion of the U.S., particularly with respect to finding mechanisms for medium-term fiscal consolidation in a difficult economic and political climate.

Debt Sustainability

The sustainability of Japan's public debt has been called into question, with gross debt having surpassed 200% of GDP and net debt around 125%. With a slow-growing economy, participants generally acknowledged that Japan's task in reducing its historically high public debt would be a challenging one. Nonetheless, few if any expected that there would be a funding crisis in the short term.

In addressing the issue of Japanese debt sustainability, participants began by noting that 95% of Japanese government debt was held domestically. Moreover, it was mostly held by a small number of financial institutions, including the Bank of Japan, postal savings, the Big Three banks, and insurance companies. Private-sector banks had become particularly large holders of JGBs, and were continuing to increase their holdings more rapidly than other investors.

Thus, a key question for participants was why Japanese financial institutions were holding so much debt. Participants spent relatively little time going over the incentives for the public-sector institutions—postal savings and other government trust funds were described as following the needs of the government for stable financing. And private insurance companies were seen as buy-and-hold investors that had matched their payment streams to the government debt they held and as having few other good options.

Therefore, much of the discussion focused on banks, particularly the largest ones. There was considerable consensus that three causes were particularly important in explaining banks' behavior in this regard. First, bank deposits had grown continuously since 1998, requiring banks to find uses for those funds. Second, there remained weak private-sector demand for credit, due to a combination of high retained profits and declining appetite for investment in the corporate sector. These two factors left limited lending options for banks. Moreover, since government debt is considered "risk-free" in a regulatory sense, increasing holdings of JGBs and financing bills (FBs) would allow banks to expand their assets without needing to raise more capital. There were also suggestions that banks and other domestic financial institutions had been acting at the behest of the Japanese government, although this was not a prominent part of the conversation.

Although participants understood the logic for why banks had kept purchasing government debt, they worried about the implications. With such large concentrations of JGBs among their assets, major banks were seen to be highly vulnerable to rises in

interest rates, should they occur. (It was noted, however, that the Big Three banks had been reducing the duration of their holdings, perhaps as a precautionary measure to reduce the impact if and when interest rates start to rise.) It was also argued that banks, particularly the Big Three, had no good exit strategies, since any move to start unwinding holdings would have an immediate negative impact on the market value of their remaining government securities, threatening their balance sheets and perhaps even their solvency.

Financial Effects

In addition to thinking about the effects on individual banks, participants discussed ways in which the increasing concentration of government debt in the portfolios of Japanese banks might have broader negative effects. A key issue in this regard was crowding out, which is a typical concern when government debt issuance is high. Most participants agreed that in the Japanese case, however, there was no good evidence of crowding out. They argued instead that lending was low due to lack of demand for credit, as Japan's low-growth environment made investment unattractive. They also noted that the corporate sector was a large net saver, suggesting that most firms did not have a need to borrow. Some participants had a somewhat different take on the crowding out question. Although they acknowledged that there was weak evidence of crowding out in a macroeconomic sense, they argued that the relative safety of JGBs compounded what they saw as the problem of a financial system that did not support risk capital.

Participants also expressed concern about a financial distortion that was not related to the crowding out issue. Noting the high level of concentration of holdings by a small number of domestic financial institutions, they asked how JGBs were priced and whether they were being priced correctly. (Some noted, for example, that even downgrades of Japanese public debt by rating agencies had had little effect on yields and pricing.) With public debt providing the basic benchmark rates for the economy as a whole, this was seen as having potentially very broad effects.

Is a JGB Crash Inevitable?

In discussing the prospects for a crash in the JGB markets, it was pointed out that, despite many predictions of an imminent crash over the years, the crash had yet to happen. Indeed, a number of participants joked that, "You're not really a trader until you've been burned shorting JGBs." (Some added, "Or going long on Japanese equities.")

Nonetheless, participants agreed that at some point continued growth in debt would become unsustainable. Thus, a key question for many participants was under what scenarios investors (including those, such as commercial banks, that currently did not have an incentive to exit in the short-run) would stop accumulating, or even sell off, JGBs. At that point, interest rates on debt would begin to rise, threatening the ability of the government to continue to service the debt and leading to an upward spiral in total debt.

Given the extremely high level of domestic ownership of public debt, participants agreed that forecasting the timing of a potential crash meant imagining scenarios in which domestic investors stopped buying JGBs. In this respect, a number of participants

pointed to home bias as a key issue. Few expected preemptive capital flight (most felt that a “slow bleed” was more likely), leading participants to focus on the capacity rather than the will of domestic investors—thus, they focused on a shift from current account surplus to deficit as the most likely trigger. Based on current economic and demographic trends, most predictions ranged from five to eight years, with some as low as three. Thus, several gave five years as the window in which to start to make significant progress on fiscal consolidation.

Fiscal Consolidation in U.S. and Japan

While participants were not worried about a crisis in Japanese government bond markets in the near term, the mounting public debt and expectations of a medium-term shift to a current account deficit made many nervous about the future. Similar concerns were expressed concerning the U.S. The U.S. was not seen to have approached the scale of Japan’s problems and participants acknowledged that demographic trends in the U.S. were more favorable in terms of prospects for economic growth than in Japan. However, they also noted that the ability of the U.S. to fund its public debt was much more conditional on the confidence of foreign investors. Moreover, with the aging of the Baby Boomer generation, health care and social security costs could be expected to grow rapidly, leading to a significant long-term challenge for fiscal authorities.

In discussing fiscal consolidation, participants noted as challenges not only the sheer scale of public debt in Japan and the U.S., but also several practical difficulties in reducing it. First, the Japanese (and to a lesser extent, U.S.) governments were seen to have become highly dependent on deficits as a means of supporting the sluggish economy. Several participants described the situation as a “debt addiction,” and called for immediate efforts to reduce the role of fiscal support for aggregate demand. In response, others counseled postponing fiscal consolidation for several years, cautioning that the economy would need continued fiscal support in the short run in order to counter weakness stemming from cyclical factors and the aftermath of the global financial crisis. This view was challenged by advocates of the “debt addiction” perspective, who pointed out that in Japan nearly two decades of fiscal policy aimed at supporting Japanese demand had added up into a long-term problem. (For the U.S. as well, many felt that lack of fiscal discipline had become a habit, although it had not been consistently tied to the need for fiscal stimulus over the same period.)

Participants identified as a second challenge the low potential growth rate of the Japanese economy due to its aging population and reduced prospects for productivity growth. Thus, Japan would not just be able to grow its way out of the problem, but rather would be forced into difficult trade-offs. The impending retirements of the Baby Boom generation in the U.S. was seen to create similar, but much less significant, problems.

Policies and Politics of Fiscal Consolidation

In discussing policy alternatives for fiscal consolidation, participants discussed spending cuts, tax increases, and efforts to promote economic growth. Most felt that some combination of the three would be necessary in both countries.

With regard to taxes, a number of participants argued that there was considerable room to raise tax revenues in both countries. Japan in particular was seen as under-taxed (despite high corporate and top marginal income tax rates), with most corporations

paying no tax at all and only about half of all household income subject to taxes. One proposed solution was a reduction in corporate and marginal rates combined with a concerted effort to expand the tax base through elimination of exemptions, better enforcement, and an increase in the consumption tax. Not all participants agreed that raising the consumption tax would be a good idea, and expressed concern that it would depress Japan's already-low consumption and disadvantage the poor. For the U.S., there seemed to be less consensus on the elements of improved tax policy, although the concept of expanding the base and lowering rates appeared to be attractive to many.

With regard to spending, there was a general feeling that one of the major challenges would be to slow the growth of entitlements spending related to aging, including pensions and health care. A number of participants pointed to other spending issues as well, in particular public works spending in Japan (which they saw as being often wasteful); some also raised the issue of military spending in the U.S. With regard to Japan, some participants argued that cutting public works spending might actually not have a very negative effect on short-term growth, as they felt that its stimulative effect had waned considerably.

Finally, participants agreed that policies to enhance economic growth could be a positive part of the solution. Many participants felt that overregulation in both countries was stifling businesses and entrepreneurship. (Uncertainty about regulation was the subject of much comment as well, as discussed in Session 2 below.) Somewhat more controversial was the question of infrastructure spending—some participants argued that well-targeted infrastructure spending could improve opportunities for private sector-led growth, while others expressed suspicion that it would be spent on wasteful projects such as “bridges to nowhere.” Turning to structural issues, participants agreed that there remained significant barriers to entrepreneurship in Japan. These included the lack of financial support networks for risk capital (e.g., venture capital, angel, and private equity funds), bankruptcy laws that punished risk-taking, and perhaps societal or cultural factors as well. Some participants argued that, in order to force structural reforms, Japan should join the Trans-Pacific Partnership (TPP), and expressed optimism that Prime Minister Noda would commit Japan to entering those negotiations.

Finally, participants agreed that the politics of fiscal consolidation were inherently difficult and expressed concern that the U.S. and Japanese political systems were ill-equipped to make difficult trade-offs. First, it was acknowledged that fiscal consolidation, particularly in a low-growth environment, would mean more pain across the board. In particular, the types of long-term spending cuts (and/or premium rises) in pensions and health care that most participants saw as unavoidable would be especially unpalatable to senior citizens and aging Baby Boomers, groups that were seen to have disproportionate voting power. Other vested interests would fight cuts to their preferred programs as well. With no obvious means to compensate losers, politicians would prefer to avoid making those choices.

Many participants described the U.S. and Japanese political systems as increasingly dysfunctional, pointing for example to partisan polarization in the U.S. and to the divided Diet and constant turnover of administrations in Japan. Thus, in the absence of confidence in the ability of their political systems to achieve a grand bargain, participants discussed the need for various commitment strategies, such as the U.S. super-

committee on deficit reduction. There was, however, no clear consensus on whether or how commitment strategies would work in the current political contexts.

Session 2: Microprudential Measures for Systemic Stability – Basel III and G-SIFI Regulations

Session 2 turned to financial regulation, as participants took stock of the large-scale reforms that had been put in place over the last year. They noted that microprudential regulation, which had traditionally focused on the level of individual financial institutions, had taken on additional responsibilities for promoting systemic stability in the wake of the crisis, during which the potential for large spillover and contagion effects had been clearly demonstrated. Still, there was significant skepticism as to whether global and domestic regulators had developed the correct policies to prevent and manage future crises. Discussion centered around global and U.S. regulations (including capital and liquidity requirements, G-SIFI designation and regulation, and the Volcker Rule), which were seen to have significant implications for Japanese as well as U.S. financial institutions as well.

Global Regulatory Change

Participants agreed that the scale and scope of new microprudential regulations decided in recent years—particularly over the last year—were enormous, perhaps unprecedented. Some of the new regulations were seen as simply enhancements of existing elements of microprudential regulation, such as capital requirements, while the regulation of liquidity, the Volcker Rule and SIFI-based rules constituted new types of regulation.

Capital and Liquidity Requirements

Participants acknowledged that capital and liquidity requirements were an essential part of the regulators' toolkit, but there was considerable dissatisfaction with the Basel III requirements. Many participants argued that the capital requirements in particular were excessive. They warned that such high capital requirements would raise costs and reduce banks' ability to lend, while also giving them incentives to chase yields and thus act more dangerously. There was a similar concern that strict liquidity rules would choke off long-term lending, for which some participants offered recent evidence from Europe. A number of participants also predicted that more financial activities would shift toward less regulated sectors.

Another common complaint was that the new rules did not take adequate account of differing business models of financial institutions. Some participants argued, for example, that in some cases liquidity was more important than capital in preventing financial institutions from being engulfed by crisis. Others suggested that in some cases, capital and liquidity might be effective substitutes. Either way, most felt that a maximalist approach to both capital and liquidity requirements was too rigid and raised costs unnecessarily.

There were also complaints that many of the new rules, including those on capital and liquidity, were unnecessary. Several participants asked whether any of these changes would have prevented the 2008 crisis; for some, the answer was no.

Not all participants were so negative about enhanced capital and liquidity requirements, however. Several argued that the costs of a serious financial crisis dwarfed the costs that the new rules would impose on banks and borrowers and that moreover the requirements would benefit everyone by reducing the likelihood of crisis. Others disagreed, arguing that the presence of the new capital rules would not have prevented the crisis. Some also suggested that it was time to move banks away from seeing themselves as a growth sector, and back toward acting more like public utilities. They felt that the enhanced capital and liquidity requirements would force banks to act more conservatively and responsibly.

Finally, one more view of the new capital requirements deemphasized the mandated ratios. Several participants argued that it would have been better to focus regulatory and supervisory attention on better valuation of assets and their impact on capital than on capital ratios per se. They noted that a number of financial institutions that had apparently had very high capital buffers (including the very recent example of Dexia, which had failed only two weeks before the Symposium) had turned out to be insolvent because they had improperly valued financial assets.

G-SIFI Rules and Designation

There was also a great deal of discussion in this Session about the new rules regarding SIFIs and G-SIFIs. Discussion was split between issues surrounding SIFI designation and the requirements that they would be forced to meet.

There was considerable discussion—and confusion—about which financial institutions should be designated as SIFIs, and the recent announcement of the first group of globally systemically important banks (G-SIBs) did not fully eliminate that confusion. One issue had to do with sector. While participants acknowledged the logic of subjecting banks and banking conglomerates to enhanced regulation, some questioned the logic of the next stage, at which other financial institutions such as insurance firms, investment banks, and others (e.g., clearinghouses, exchanges) might be designated despite their differing business models and modes of regulation.

Even with regard to G-SIBs, where the publication of the initial list of 29 had just cleared up some questions, participants debated about the proper emphasis on size vs. interconnectedness. Some questioned, for example, why the Bank of China was included despite not being very interconnected to the global banking system. On the other hand, others wondered why only one of the three mega Chinese banks was included.

There was also discussion about whether SIFI designation would be good or bad for financial institutions. Many participants expected that SIFI designation would be a bad thing for financial institutions, since it would mandate more capital, more restrictions on business, enhanced scrutiny, and greater regulatory burden in the form of compliance costs and possibly the need to structure their organization in order to make them easier to dismantle in case of failure. Others argued that SIFIs would have an advantage over competing financial institutions, either because clients would trust them more due to the greater regulation and supervision or because markets would see “systemically important” as synonymous with “too big to fail,” and thus supply funding to them at a lower cost and be more willing to take them on as counterparties to transactions.

There was relatively little discussion of a number of the specific rules facing SIFIs—probably because they are still unclear, but the requirement to create “living

wills” (resolution plans) proved to be controversial. Some participants were highly critical. They argued that the plans would be extremely costly to create, not only in terms of the creation of the plans themselves, but also because preparing for orderly resolution could require restructuring of business units and thus reduce managerial efficiency. Some were also skeptical that the plans would reflect the rapidly changing reality of financial institutions over time, even though the SIFIs would be required to update them annually. Moreover, several participants argued that in an actual crisis, living wills would be rendered unusable, as regulators either decided an institution was too big to fail or ring-fenced the national assets of transnational financial conglomerates. All in all, they felt that the living will exercise would be very costly while creating few benefits, and possibly creating a false sense of confidence.

Some participants disagreed strongly. They pointed out that one of the major problems of the global financial crisis had been the inefficiencies and uncertainties of resolving complex transnational financial institutions. They also argued that many of the changes required by living wills could actually make management of complex financial institutions easier, by forcing institutions to clarify lines of authority and relationships among the various business units. They felt that sufficient safeguards had been put into place to ensure regular updating in response to changes in business activities. Finally, they were skeptical that the costs would be particularly high (noting that firms had also complained bitterly about Sarbanes-Oxley 404, but the reality had not been so bad), while they argued that the potential benefits from improving resolution of complex financial conglomerates—and thus containing contagion—would be immense in comparison. Again there was the issue as to whether the costs of these policies could be justified if they could not appreciably reduce the likelihood of future crises.

Volcker Rule

While participants were divided over the costs and benefits of aspects of SIFI regulation, they were overwhelmingly negative about the Volcker Rule. A number of participants wondered whether the rule actually solved any problems, or would have had any effect on the global crisis if it had been in place. One went so far as to say that the Volcker Rule was “the most far-reaching regulatory prohibition in U.S. history.”

Many expressed skepticism that proprietary trading was actually a problem for banks. Part of the issue for many participants was the difficulty of defining banks’ proprietary trading, given that the rule accepted the principles of hedging and market-making under some circumstances and for certain financial institutions. Participants also saw the rule as increasing costs of doing business, both in terms of compliance and because it would reduce liquidity in several markets and make some risk management strategies untenable. (And may also tend to move more business into parts of the shadow banking system.)

A final criticism was what participants saw as the Volcker Rule’s extraterritorial effects. Not only did participants see it as affecting U.S. banks’ activities abroad, they also argued that it would affect the global operations of foreign banks, including Japanese ones, with U.S. branches or subsidiaries.

Despite the criticisms, a few participants offered a somewhat more sympathetic view of the Volcker Rule. They noted that there are a limited number of ways to deal with the problems of institutions that are too big or too complex to fail—either reduce the

size of institutions, reduce their scope through segmentation, or restrict their business practices. The Volcker Rule was as seen an effort to follow the last of those strategies. Nonetheless, there was considerable skepticism that the Volcker Rule was the best way to compartmentalize risk within and across institutions.

Effects of Regulatory Change

Many participants expressed negative views about the costs and potential effects of much of the new regulation that was discussed at the Symposium. One of the main concerns had to do with the costs and regulatory burden associated with global and U.S. regulatory shifts. In addition to compliance issues, increased capital and liquidity requirements were seen as particularly likely to affect financial institutions' profitability and flexibility.

A second issue was uncertainty. A number of participants noted that hundreds of rules had yet to be issued, leading financial institutions to delay making major decisions in response to changing economic conditions. Further, even when promulgated, the rules in the U.S. would be open to legal challenge due to lack of cost-benefit analysis by the promulgating agencies. Participants also pointed to significant uncertainty over the probable impact of various rules—and even more so, the *cumulative* effects of so many rules and standards being changed at the same time.

Fundamentally, participants asked the question of whether all the new regulations would either reduce the risk of future crises or make it easier to manage them. Participants voiced particularly grave concern that Dodd-Frank's restrictions on Federal Reserve lending facilities would destroy the ability of the Fed to act as an effective lender of last resort in the next crisis. More broadly, some argued that governments' commitment to never again have to bail out financial institutions was both unwise and counter-productive. They felt that it was unreasonable to believe that bail-outs would never again be needed, and that therefore the attempt to reduce the ability of central banks and governments to implement rescue operations would only serve to increase the risk of contagion should a major financial institution suffer a liquidity or solvency crisis.

Participants worried about unintended consequences and criticized lawmakers and regulators for not giving sufficient attention to cost-benefit analysis. As noted some participants predicted that the combination of high capital requirements and increased compliance costs would lead to credit contraction and higher prices for borrowers, to the detriment of growth, as well as shifting more financial activity into the shadow banking system.

A further concern for participants was the problem of contradictory regulations. For transnational financial institutions, contradictions between the rules in different jurisdictions (e.g., Dodd-Frank in the U.S. and similar regulations in the EU) could make compliance impossible or force them to separate business units along national lines. There were also concerns about contradictions between types of regulation. For example, if an insurance company were designated as a G-SIFI, it would face differing liquidity rules under Basel III and the E.U. Solvency II.

Participants were not uniformly negative about the new regulatory regimes (nor were all the major changes discussed during the Symposium). A number of participants argued that it was important not just to look at the costs created by new regulations, but rather to compare them to the pre-crisis situation, in which the financial industry had

been allowed—or even encouraged—to act in ways that had brought on the greatest financial crisis in over seventy years. They saw the new capital and liquidity rules, as well as increased scrutiny and creation of living wills for SIFIs, as a necessary development in order to reduce the likelihood and severity of future crises.

Meanwhile, despite the uncertainties still remaining as a result of the rule-making process, there was a sense among a number of participants that the major contours of the new regulatory regimes were becoming clearer, allowing financial institutions and their clients to plan better for the future and begin to make needed investments again. Some also noted the anger of electorates and expressed the feeling that the stricter regulations that had been imposed had reduced the impetus for more populist, less considered responses. Finally, even some critics of the specifics of Basel III and the G-SIFI rules expressed optimism that those global agreements and the processes of arriving at them constituted an important step toward greater global harmonization and cooperation.

Session 3: Inflation or Deflation – Geological Risk, Geopolitical Risk, and Macro-Policies

Session 3 addressed longer-term issues of relevance to the financial system. Much of the discussion in the first plenary focused on whether the U.S., Japan, and other developed economies would be trapped in persistent deflation, as well as policies for addressing that possibility. The second plenary addressed non-economic risks to the global economy and financial system, in particular geopolitical risks stemming from war, revolution, rising powers, or shifting global alliances.

Inflation or Deflation

There was considerable debate over the prospects for persistent deflation in the developed economies, particularly Japan and the U.S. Discussion followed two main streams. One was about what policies could be mobilized to reverse deflation in Japan. The second was whether the U.S. was destined to repeat Japan's experience with deflation. Participants held a variety of points of view on these questions, but they agreed that understanding the Japanese case would be essential to addressing the future in both countries.

Dealing with Deflation in Japan

Participants offered several different, albeit in some cases overlapping, stories about the causes of Japan's persistent deflation. These included both supply-side and demand-side issues. A number of participants pointed to the role of societal aging in sapping Japanese economic vitality, which they felt was already having a major impact on demand. Not only did they see declining population as leading to declining demand for real estate and construction, but they argued that expectations of future declines in demand for goods and services would further depress investment. The declining working-age population was seen by some also to have a direct impact on Japan's potential growth rate from the supply side, requiring policies to expand employment of older workers. Participants also worried that societal aging would exacerbate Japan's fiscal problems, as income tax revenues would drop and pension and health care expenditures would rise. They noted that fears for the future sustainability of Japanese public debt greatly limited the scope of further fiscal stimulus.

Not all participants agreed about the role that societal aging played in Japanese deflation, however. Some argued that, while aging should have an effect on the supply side and thus be of great importance in the long term, in the current situation the greater problem was depressed demand. They pointed out that there was significant underemployment among younger workers, and argued that policies to encourage Japanese workers to stay in the labor force longer would not necessarily have positive effects in the short run.

There was considerable discussion of how Japanese demand could be stimulated. Some were pessimistic, on the basis that long-term demographics and competition from China, Korea, and other economies would weaken the case for new corporate investment. Others felt that there was much more that could be done in terms of policy, particularly

monetary policy. It was argued by a number of participants that much more vigorous quantitative easing could have the effect of reversing deflation, lowering long-term real interest rates, and helping to depreciate the nominal interest rate. There was some discussion of whether this should be done by monetizing fiscal stimulus directly, through massive unsterilized currency intervention (presupposing cooperation between MOF and the BOJ), or purchases of long-term assets throughout the economy, but no there was clear consensus.

There were also skeptics about the potential efficacy of monetary policy. Some doubted the ability of quantitative easing to create inflation. (The importance of inflation in and of itself was also contested—for example, one participant argued that Japanese consumers were not delaying spending because goods prices were dropping, but rather because they were expecting their own nominal incomes to drop.) Others were more worried about the micro-level effects of continued zero interest rates and quantitative easing, arguing that it contributed to making the Japanese government ever more addicted to debt and allowed zombie companies to remain in business indefinitely.

A number of participants suggested structural policies as either a substitute or complement to more aggressive monetary easing. On the supply side, many advocated improving employment opportunities for senior citizens and women as a way of combating the effects of societal aging. Another common recommendation was to remove obstacles to doing business, including what participants saw as excessive regulations, prevalence of de facto cartels, and inappropriate tax policies. Several also argued that the Japanese system did not provide incentives for risk-taking—specific obstacles included the lack of early stage financial support due to the dearth of venture capital and angel firms, the conservatism of bank lending officers, and bankruptcy rules that excessively penalized failure. A number of participants also suggested that micro-level policies could have an effect on the demand side. In particular, they expressed frustration that Japanese firms were simply depositing enormous amounts of retained earnings in banks. Although these participants recognized that not all the firms with excess cash had good investment opportunities of their own, they argued that policies (including those related to corporate governance and tax) could support much higher dividend payments, which in turn could be invested elsewhere or spent on consumption by households.

Will the U.S. Face Persistent Deflation?

Several participants argued that it was likely that the U.S. would fall into the same sort of deflationary trap as Japan. These participants predicted a substantial period of retrenchment by households due to weak employment and wage growth as well as the need to deleverage; meanwhile, they saw opportunities for new investment as limited, because of both excess stock of housing and limited need for new manufacturing investment. With corporations cautious and financing for expansion hard to obtain due to enhanced underwriting standards and higher capital requirements, they saw the government as a major supporter of total demand. However, the current move toward fiscal consolidation (which many participants nonetheless supported out of concern for fiscal sustainability) was seen to add to the economic headwinds. Finally, they were pessimistic about asset prices—real estate prices due to excess supply of housing and

office space in most of the country, and equities due to weak consumption in the U.S. and major export markets.

Others felt that the U.S. was unlikely to suffer from persistent deflation even though they agreed with many of the points raised by the more pessimistic participants in terms of their short-term effects. The argument against persistent deflation was based on comparisons with the Japanese case. First, these participants pointed out that even though the U.S. population was aging, it was doing so much less rapidly than Japan and also that it continued to grow due to a relatively high birth rate and high rates of immigration. Second, financial institution restructuring had happened much more quickly than in Japan, through TARP and other measures. A number of participants also argued that since the beginning of the crisis, the Federal Reserve had been far more assertive in easing monetary policy, including use of quantitative easing, than the Bank of Japan had been at any point over the last two decades. They saw this as having laid an essential groundwork for recovery in the U.S. Most also agreed that the U.S. fiscal situation was not yet nearly as bad as Japan's (although one participant pointed out that if the debt of Fannie Mae and Freddie Mac were included, gross U.S. debt would be around 190% of GDP instead of the current 80%). Finally, many participants expressed optimism about the ability of the U.S. economy to innovate and take advantage of creative destruction due to its openness and the flexibility of the system. Even the optimists were cautious in their optimism, however, particularly as they surveyed the difficulties in creating political consensus over how to manage medium- and long-term fiscal stimulus while not choking off the current weak recovery.

There was also some speculation that, rather than deflation, the U.S. might soon be facing inflation—or more specifically, stagflation. Several participants compared the contemporary U.S. economy not with the Japanese economy of the last two decades but with the U.S. economy of the 1970s. They drew a parallel with that period's global excess capacity in manufacturing and saw the current version as threatening to limit opportunities for new investment for several years to come. At the same time, they also pointed to the rapid increases in the U.S. base money due to quantitative easing, and argued that the resulting dollar overhang would inevitably cause inflation along with nominal depreciation of the dollar. They also worried that high federal deficits were contributing to inflationary pressures. Others were not worried about stagflation, arguing that excess capacity would be addressed by the growing demand from China and other emerging market economies, and that the dollar overhang could be absorbed as domestic demand began to grow.

Geological and Geopolitical Risks to the Global Economy

The second plenary focused on risks to the U.S. and Japanese economies other than inflation/deflation or fiscal sustainability. These included risks stemming from political factors as well as natural disasters.

The Great Tohoku Earthquake and the tsunami and nuclear crisis that ensued had made a significant impact on the way in which many participants understood economic risk. Not only did the scale of the natural disaster far exceed what anyone had anticipated, key systems had broken down despite multiple back-ups and supply chains had been severely disrupted. Even after the scale of the disaster was evident, participants saw the extent to which Tohoku was essential to specific supply chains and to electrical

generation for a significant share of Japanese industry as both a shock and a cautionary tale for business and government. Participants noted that, with an increasingly globalized economy, similar natural disasters could cause serious disruptions in the future and that companies and financial institutions would need to be prepared for that.

Despite the fresh memories of the earthquake and tsunami, participants spent more time discussing political risk. Several scenarios—including new EU crises, class conflict in the U.S., and social upheaval in the Middle East—were put forward as examples of how events can be disruptive across borders and regions. While none were meant as predictions, it was argued that governments and firms must always prepare for tail risks and must “think the unthinkable.”

Further discussion was based on “thinking the thinkable,” as participants grappled with the potential effects of ongoing trends. For example, there was a concern that the continued growth of emerging market economies might lead to a breakdown of the global trade and financial system in favor of mercantilism, as countries like China and Brazil took a larger role in rule-making and developed countries like the U.S. and Japan grew increasingly worried about their competitive threat. There was also a debate over the long-term prospects of the U.S.-Japan alliance in the context of a rising China; while most participants seemed to see the alliance as having staying power, others argued that the U.S. was likely to withdraw from the Asia-Pacific balance of power game and that Japan would move increasingly within the Chinese orbit. The economic implications of the potential shifts in alliance politics were not made clear, but participants agreed that governments needed to plan ahead for contingencies.

On *The argument that there are “limits” is highly exaggerated.* Government Activism

BY RICHARD KATZ

In the previous issue of *The International Economy*, Alan Greenspan blamed “governmental activism” for a shortfall in American business investment, saying that it accounted for one-half, perhaps even three-quarters, of the shortfall. Of that amount, 25 percentage points was due to fiscal stimulus allegedly crowding out investment, according a regression produced by Dr. Greenspan. However, as we’ll detail below, that regression’s results are wrong. For the 25–50 percentage points allegedly produced by regulation and other measures (including the new Dodd-Frank banking reform bill), Dr. Greenspan does not offer a regression. It is simply an unfounded assumption about business fears of uncertainty based upon a reading of the 1930s Depression and the current downturn.

His message—that governmental activism does more harm than good to the economy—was also the philosophy that guided his refusal to use his regulatory powers *vis-à-vis* the subprime and derivatives bubbles during the past decade. And his prescription against fiscal stimulus, if followed, would make recovery from the current slump even more difficult and prolonged.

Dr. Greenspan’s stance on governmental activism stands in contrast to his superb judgments—and monetary activism—for nearly two decades as the “maestro of monetary policy,” judgments guided by pragmatism and empiricism.

In the 1990s, he said that there was no need to simply accept *a priori* the common presumption that the economy’s “speed limit” was 2.5 percent annual GDP growth and that its non-inflationary unemployment rate was around 6 percent. Instead, in the new environment

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produced by the Clinton administration's deficit-cutting and new innovations in technology, he suggested removing the monetary tourniquets and testing how fast the economy could safely grow. The result was higher growth, a budget surplus, and millions more people with jobs—with neither a rise in inflation nor a revolt by the “bond market vigilantes.” The lower capital costs provided by the Clinton-Greenspan efforts were a vital ingredient in the famed productivity revolution. They enabled firms to buy the machinery in which the new technology was embedded. Business investment rose from an 8.6 percent share of real GDP in early 1995 to nearly 12 percent by the end of 2000.

During the early 2000s, the markets feared deflation. Even though the Fed thought deflation unlikely, it wanted an insurance policy. Its concerns were based on a careful Fed study of Japan's experience (*Preventing Deflation: Lessons from Japan's Experience in the 1990s*). The study showed that, given the Fed's own forecasts for Japan's growth and inflation in the early 1990s, the Fed would have had an even tighter monetary policy than that of the Bank of Japan. But when it comes to deflation, an ounce of prevention is worth a ton of cure. Hence, Dr. Greenspan chose to err on the side of caution and supply enough money to prevent a recurrence of a similar miscalculation in the United States. Despite jeremiads from critics, no burst of inflation followed this choice.

By contrast, as the chief U.S. policymaker in charge of supervising banks, Chairman Greenspan seemed to operate within a more ideological framework, one that gave excess credence to the desire and ability of financial markets to self-correct. In 1994, for example, a bipartisan coalition in Congress passed the Home Ownership and Equity Protection Act (HOEPA). This act recognized a new financial world, one in which banks no longer kept mortgages on their books, thereby giving the banks a stake in the borrower's ability to repay the loan. In the new world, nonbanks generated mortgages that they then sold off to investment banks, which sliced and diced them into mortgage-backed securities. These securities were readily given an AAA rating by the credit rating agencies paid by the issuers. None of these players had any financial stake in ensuring that borrowers could repay; they only had an interest in spawning as many fee-generating mortgages and mortgage-based derivatives as possible. Thus arose the no-documentation, no-down payment loans later nicknamed “liar loans.” HOEPA enabled, but did not compel, the Federal Reserve to force all mortgage generators and lenders to follow the traditional standards applied to banks: thou shalt not issue a mortgage unless the borrower makes a substantial downpayment, can prove he has the ability to repay, and can breathe (yes, in some locations dead people received mortgages). However, despite repeated pleading

by various officials, including Edward Gramlich, a colleague on the Fed Board, Dr. Greenspan refused any significant enforcement of HOEPA. When questioned on this, Dr. Greenspan countered that the Fed issued some “guidances,” but these were not mandatory.¹

Without the unregulated shadow banking system, the bubble would never have become so extreme. Homes were built, not for people to live in, but to provide an excuse for issuing derivatives. Yet Dr. Greenspan, along with the Clinton and Bush administrations and much of the Congress, refused to regulate—or even count—the derivatives.

There are those who blame the 2008 implosion on Dr. Greenspan's earlier monetary ease. But a close look at the numbers shows that regulatory abdication, not easy money, was the dividing line between sound and unsound loans. In the fall of 2008, when the Lehman shock sent the economy plunging, 21 percent of subprime adjustable-rate mortgages were in foreclosure. By contrast, among the loans guaranteed by Fannie Mae, most of which met traditional standards regarding down payments and proof of ability to pay, a mere 0.65 percent were in foreclosure.

During Congressional testimony, when Rep. Henry Waxman (D-CA) pressed Chairman Greenspan on whether “your ideology” prevented him from heeding advice to restrain irresponsible lending practices, Dr. Greenspan acknowledged, “Yes, I've found a flaw [in my economic model]... Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief.”

Frankly, it's hard to comprehend this statement given that decades of research have highlighted the divergence of

Dr. Greenspan's stance on governmental activism stands in contrast to his superb judgments—and monetary activism—for nearly two decades as the “maestro of monetary policy,” judgments guided by pragmatism and empiricism.

interests between shareholders (principals) and managers (agents), and when we live in a world where CEO Stan O'Neal can bring Merrill Lynch to the brink of collapse and still walk away with a \$161 million severance package. Firms do not make decisions. Rather, individual executives make the decisions—often at the expense of the firm, its shareholders, its customers, and the nation.

The same approach that guided Chairman Greenspan's regulatory abdication in the 1990s and 2000s permeates the criticism of government activism as expressed in his *TIE* essay. Dr. Greenspan's criticism of governmental activism rests on a regression purporting to show that an activist fiscal policy causes business to invest less. Yet the regression is fatally flawed.

Dr. Greenspan's measure of business investment (his dependent variable) is the ratio of corporate investment to total internal funds (mainly cash flow). He argues that this ratio shows whether firms are choosing to invest in physical capital or financial assets. Yet Dr. Greenspan ignores the one curiosity that invalidates the entire regression. Why is it that this ratio is often the highest during recessions, when real business investment is falling? And why is the ratio sometimes the lowest during expansions when business investment is booming (see Figure 1)? Why, during the four decades from 1970 to 2010, is there a 34 percent *negative* correlation between quarterly investment growth and the ratio of investment to internal funds? The reason is simple. During recessions, internal funds can fall more quickly than investment; hence, even though investment is falling, the ratio of investment to internal funds will rise. Conversely, during booms, internal funds may rise faster than investment; hence, even though investment is growing, the ratio of investment to internal funds can fall. The bottom line is that the one piece of statistical evi-

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dence for the entire Greenspan thesis is skewed by an inaccurate measure regarding firm behavior.

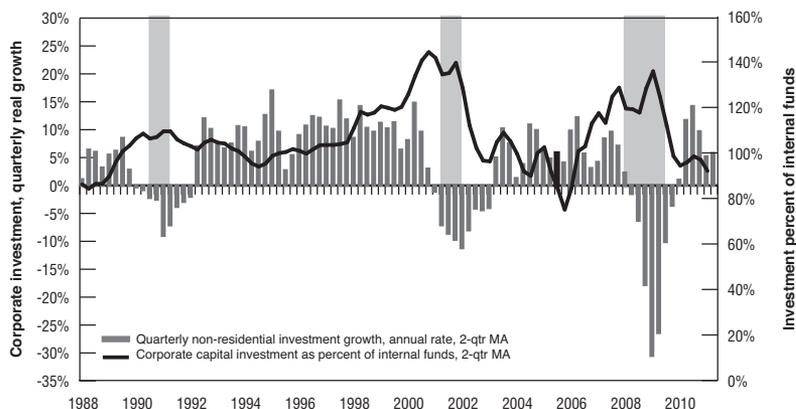
A more careful regression demonstrates the opposite of Dr. Greenspan's assertion. In reality, fiscal stimulus (as measured by the cyclically adjusted federal budget deficit) lessens a recession's severity and brings about quicker recovery. Once recovery has been achieved, it is safe to withdraw the stimulus. Before presenting our own regressions, let's consider how fiscal stimulus works. The initial impact is that more spending and/or increased tax cuts directly inject purchasing power into the economy, thus causing more sales, production, and hiring. However, if that were the only impact, then the result would be reversed as soon as the stimulus was withdrawn.

Therefore, we must look at the longer-lasting secondary effect. Fiscal stimulus helps transform a vicious cycle into a virtuous cycle more quickly than the market can do so on its own. In a recession, low sales lead to layoffs and decreased investment, which lowers consumer spending and sales even more, leading to a new round of layoffs and further investment cuts. Fiscal stimulus reverses this cycle. It raises the operating rate of firms and

lowers the unemployment rate. As a result, firms invest more and hire more. Consumers not only have more money to spend but are more willing to spend what income they do have. That leads to more spending, production, investment, and hiring, as firms and consumers come to expect the expansion to continue. Once a critical threshold on the operating rate and unemployment has been reached, the recovery becomes self-sustaining and it becomes safe to withdraw the stimulus.

By contrast, in the current downturn, fiscal stimulus began to be withdrawn long before the critical threshold was reached. In fact, total federal, state, and local government purchases of goods and services actually fell from the last quarter

Figure 1: Investment Growth vs. Investment/Internal Funds Ratio



Sources: Federal Reserve "Flow of Funds" and U.S. Commerce Department GDP tables.

of 2010 through the first half of 2011. This premature withdrawal is one of the main reasons why the recovery sputtered in 2011 and why the economy faces the risk of a double-dip recession. In his article, Dr. Greenspan advocates a policy that is preventing recovery and keeping millions of Americans without jobs.

Let's look at the evidence. In Dr. Greenspan's regression on investment, he used as independent variables the level of the nonfarm business operating rate as well as the cyclically adjusted budget deficit. However, how much companies invest and hire depends not only on the level of the operating rate but on the change in that level, as well as the change in the unemployment rate. The current level tells firms about current sales, but the change in the level tells firms about future sales, and, therefore, whether to expand or cut back. Suppose the operating rate is 79 percent with no change in either the operating rate or the unemployment rate. Then investment growth will be zero. If, from that level, the operating rate goes up 1 percent, then investment will expand at a 3.6 percent annual rate. If the operating rate goes down 1 percent, then investment

*During recessions, internal funds
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to internal funds will rise.*

will drop 3.6 percent. (See discussion below of regression for Figure 2). Similarly, consumer spending depends not only on disposable income but on the unemployment rate

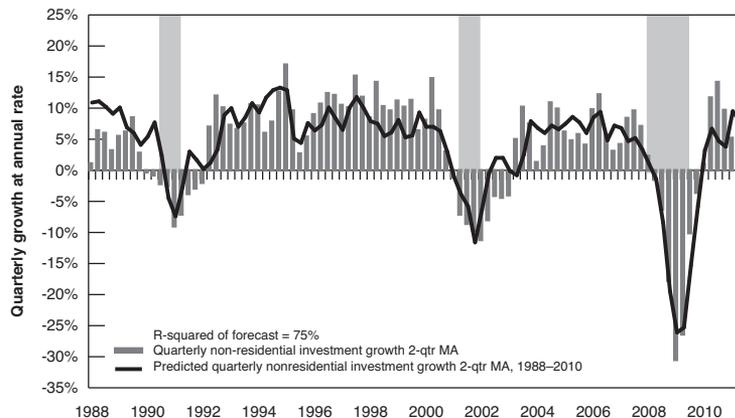
and on the change in the unemployment rate. At any given level of disposable income, consumers will spend less if unemployment is high and getting worse. To the extent that fiscal stimulus lowers unemployment, it increases not only income but also the propensity to spend. (If we regress real consumption on real disposable income for 1988–2011, the R-squared, that is, the percentage of the ups and downs of consumption that we can explain, is 60 percent; however, if we add the unemployment rate and the change in unemployment, the R-squared rises to 72 percent.)

In Figure 2, we can predict a very high 75 percent of the ups and downs of investment during 1988–2010 based on our regression. For 1995–2010, the prediction capability rises to 84 percent. For the much longer period of 1970–2010, we can predict 72 percent of the changes, compared to 46 percent in Dr. Greenspan's equation. Doing a similar equation, based on the business operating rate and changes in that rate, we can predict 74 percent of the ups and downs of job growth during 1988–2010.

The critical role of fiscal stimulus is to raise the operating rate and thereby

Continued on page 64

Figure 2: Investment Depends on Operating Rate and Change in Operating Rate



Source: U.S. Commerce Department for actual figures, and author for predicted investment. For prediction, investment is regressed on the nonfarm business operating rate (provided by Greenspan Associates), the change in the operating rate, and the change in the unemployment rate.

Note: R-squared means that 75 percent of the ups and downs of the operating rate can be predicted by the equation.

Regression Equation: Quarter-on-quarter change (an annual rate) in nonresidential investment growth (2-quarter moving average) =

-0.818 (t-stat = -3.12)

+1.029 * Nonfarm business operating rate (2-qtr MA) (t-stat = 3.315)

+3.65 * Quarterly change in nonfarm business operating rate (2-qtr MA) (t-stat = 2.585)

-18.0 * Quarterly change in unemployment rate (2-qtr MA) (t-stat = -5.770)

Continued from page 51

investment and hiring, setting in motion the self-sustaining virtuous cycle. Of course, how fiscal stimulus affects the economy depends on whether or not there are slack resources. If the economy is operating at full employment, then adding more fiscal stimulus will raise interest rates and “crowd out” private investment, as Dr. Greenspan argues. However, in the depths of a recession, fiscal stimulus will boost the operating rate and thus “crowd in” investment and hiring.

In Figure 3, we regress the operating rate on the unemployment rate, the change in the unemployment rate, and the cyclically adjusted budget deficit. For 1988–2010, the R-squared, that is the prediction rate, equals a very high 85 percent. For 1995–2010, it equals an extremely high 92 percent. During 1988–2010, for every increase in the cyclically adjusted budget deficit equal to 1 percent of GDP, the business operating rate rose by 0.83 percentage points. That, in turn, based on the equation for Figure 2, translates into a 3 percentage point

hike in investment; it also means a 2.3 percentage point hike in job growth.

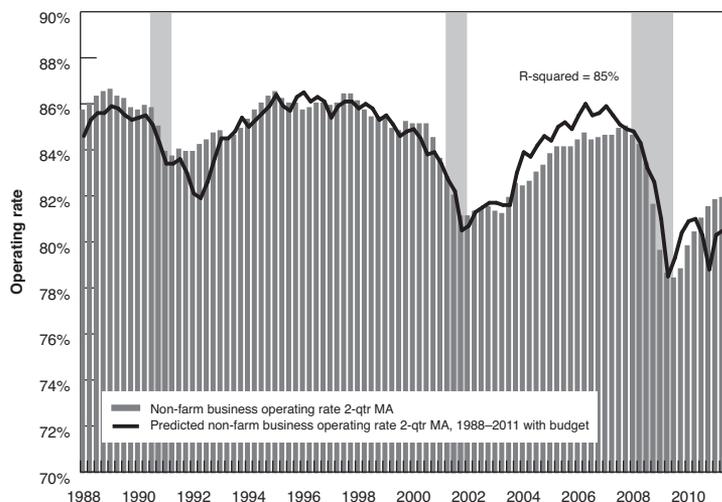
How important is fiscal stimulus to the overall result? For the last two decades (1988–2010), removing the fiscal variable from the equation drastically lowers the R-squared from 85 percent to only 52 percent. In other words, out of the entire 85 percent prediction accuracy, 33 percentage points is provided by changes in the budget balance.

Let’s also consider Dr. Greenspan’s assertions regarding Dodd-Frank and other regulatory efforts. Whatever flaws Dodd-Frank may have—many of which were caused by the continued enormous power of the Wall Street lobby in hog-tieing the bill—it is the first significant attempt to correct the regulatory irresponsibility that led to the 2008 cataclysm. Even if this did cause a slight dip in investment, not all of which is productive, wouldn’t that price be worthwhile if it prevented a repeat of the worst crisis since the 1930s?

But why just assume that sound regulations hurt investment? Isn’t the opposite more likely? Wouldn’t investors be more likely to entrust their savings to financial markets where a triple-A rating actually means something, and where a derivative issued by Wall Street can be trusted? Wouldn’t greater investor confidence in the honesty of the markets provide firms with more capital at a lower risk-adjusted cost? Just as effective commodity regulations have helped grain and meat futures provide us more food at lower cost, so would effective financial regulations boost economic output.

For markets to work, they need market institutions. That includes regulations that prevent conflicts of interest and fraud, and that align the compensation packages of top executives with the interests of the firm whose fate is entrusted to their hands. ♦

Figure 3: Business Operating Rate in Recessions Depends on Fiscal Stimulus



Source: Greenspan Associates for operating rate and author for predicted rate; for the prediction, the operating rate is regressed on the unemployment rate, the change in the unemployment rate, and the adjusted budget deficit (the latter provided by Greenspan Associates).

Note: R-squared means that 85 percent of the ups and downs of the operating rate can be predicted by the equation.

Regression Equation: Nonfarm business operating rate (2-qr MA) =

+0.9234 (t-stat = 191.03)

-1.4059 * Unemployment rate (2-qr MA) (t-stat = -16.762)

-2.949 * Change in unemployment rate (2-qr MA) (t-stat = -9.182)

-0.8305 * Cyclically adjusted budget balance % of GDP (2-qr MA), lagged two quarters (t-stat = -13.99). (Note: co-efficient is negative because a decline in the budget balance, i.e., smaller surplus or bigger deficit, means more fiscal stimulus, hence a higher operating rate.)

NOTE

1. See “Did Greenspan Add to Subprime Woes?” *Wall Street Journal*, June 9, 2007; *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, Financial Crisis Inquiry Commission, January 2011, pp. 93–97; “Testimony of William Black before the Financial Crisis Inquiry Commission,” September 21, 2010, p. 20; and “Memorandum for the Record,” FCIC meeting with Alan Greenspan, March 31, 2010.

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