Daisuke Kotegawa

The Lost Two Decades Of the EU and USA?

Mr. Kotegawa is the Research Director for the Canon Institute for Global Studies in Japan. He addressed the Schiller Institute conference in Frankfurt, Germany April 14, on the panel, "The Future of Eurasian Cooperation."

As a director of the Ministry of Finance, I was in charge of liquidations of major financial institutions in Japan in 1997 and 1998, such as Yamaichi Securities, LTCB, and NCB. At that time, we succeeded in containing the gigantic scale of liquidations, and avoiding Japan becoming an epicenter of world economic crisis. During the weekend when we liquidated these institutions, we unwound all cross-border transactions, including huge amounts of derivatives. Such unwinding was not done by the authorities of the United States and the United Kingdom at the liquidation of Lehman Brothers, which triggered the world economic crisis.

Despite our success, however, we were heavily criticized by the national public and international opinion leaders, including [former Treasury Secretary] Larry Summers, those who are struggling now to deal with the crisis. As a result, we went through an investigation of public prosecutors, and I lost several friends who worked with me; some were arrested, and others committed suicide, as did board members of major financial institutions which were liquidated.

It is quite strange to see that those Japanese who worked to avoid the world economic crisis were punished, while nobody that was responsible [for the latest crisis], has been punished.

In the meantime, as a survivor of the crisis, it is easy for me [to see] what will happen next in the ongoing crisis: a *déjà vu* of ten years ago.

The Lehman Shock

Why are people in Europe suffering from economic crisis? The answer is simple. The bubble created, since the early 2000s, exploded with the Lehman shock. What is an economic bubble then? An economic bubble occurs when people dream that prosperity will last forever. In the case of Japan, people dreamed that prices of real estate and stocks would rise forever. What happened in the Western world? The crisis now was triggered by the completion of the abolition of the Glass-Steagall Act in 1999. This policy change enabled investment banks to mobilize deposits collected by commercial banks as the source of their dealings; which sometimes could be called gambling.

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Daisuke Kotegawa told the conference: "It is of vital need now, that the Glass-Steagall Act be reinstated and investment banks be liquidated, as soon as possible, to save Europe."

It also set the stage whereby the loss incurred from dealings of investment banks could be covered by the injection of public money to save the financial system. The amount of dealings by investment banks, including derivative transactions, skyrocketed. False, virtual, and imaginary profits or commissions resulting from these dealings brought investment bankers extraordinary incomes and bonuses. Investment banks on Wall Street, such as Goldman Sachs, Merrill Lynch, Morgan Stanley, and JP Morgan, and in the City of London, such as Barclays, Royal Bank of Scotland, and Lloyds, enjoyed an unprecedented level of profits. Some institutions outside the Anglo-Saxon countries, which were partly Americanized, such as Deutsche Bank and UBS, followed suit.

The other imaginary bonanza that was experienced in Europe during the same period should be called the EU membership bubble. Newcomers to the EU, and sometimes candidates for membership, enjoyed extraordinary capital inflows, which led to steep increases in wages and prices of real estate. The membership standards were sometimes maneuvered artificially, using derivatives proposed by investment banks.

These bubbles collapsed in 2008 with the liquidation of Lehman Brothers.

What Did They Learn?

In the U.S.A. and in Europe, they seem to have learned nothing from the crisis in the late 1990s—that is, how we should try to maintain confidence in the financial markets, and the difference between the regular kind of economic slowdown, and the crisis that was caused by the financial crash. Examples are abundant, starting with the crisis in Mexico in 1994, followed by the Asian crisis and the financial crisis in Japan, which happened while I was in charge.

As I have mentioned again and again, repeatedly, there are two steps countries must take to deal with an economic crash caused by a financial crash:

Firstly, countries must restore confidence in their financial system, and then, secondly, by way of fiscal stimulus, countries must revitalize the real economy. In order to restore confidence in the financial system, countries must create three kinds of safety nets:

1. Establish a mechanism to bail out financial institutions;

2. Establish a system by which you can log the non-performing loans; and,

3. Establish a system whereby you can guarantee interbank lending, by the government.

These safety nets were established in the trans-Atlantic region in October 2008, after the Lehman shock. But, then, the order of the actions taken to deal with these systems was completely wrong. Let me present you an ideal way that should have been done.

1. A rigid examination of balance sheets by public authorities, based upon mark-to-market accounting, would calculate an honest amount of non-performing loans.

2. Such a calculation must have disclosed an unprecedented amount of non-performing loans, because there were no quoted prices for securitized products after the Lehman shock.

3. Most of the major banks in the Western world, investment banks in particular, would become largely insolvent as a result.

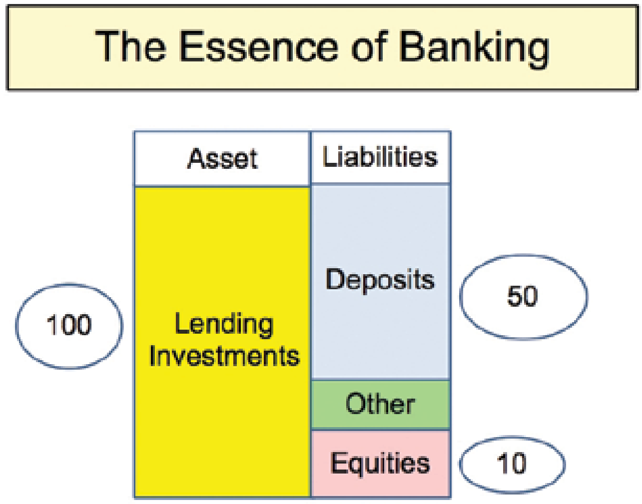
4. The total amount of public injection required to bail out those banks must be calculated honestly, and be disclosed to the public. This process is essential to inform the market of the magnitude of the problem and, once the bailout is done, restore confidence by showing that all amounts of non-performing loans were covered by the injection of public money, and that surviving banks are clean.

5. Most of the investment banks must be liquidated, because the amount of public money required is beyond the level which can be covered.

6. Managers and board members of failing institutions that needed public money have to be prosecuted for their responsibility for making the use of taxpayers' money indispensable to save the financial system.

In the case of the United States and the European countries, those kinds of very neutral, dependable financial examinations by the banking authorities have never been conducted. Instead, a fake examination, called a stress-test, was introduced to distract attention. Bankers have been window-dressing their balance sheets, which should have been condemned as insolvent long ago. Without that kind of transparency, it is impossible to persuade all the participants in the market that all the financial institutions' balance sheets have been cleared.

FIGURE 1



Bad Advice

This is an anecdote: When we suffered from the financial crisis in Japan, we received much advice and preaching from prominent economists in the U.S.A., including Larry Summers. The advice can be summarized as follows:

1. Banks should be hard-landed, that is to say, should be liquidated.

2. Stick to mark-to-market accounting to calculate

the amount of non-performing loans.

3. Do not stop short sales.

4. Do not bail out banks.

As you can easily recall, after the Lehman shocks, these recommendations were never observed by those who gave them.

If most of investment banks had been liquidated after the Lehman shock, European government bonds would have not been under the attack of short sales and credit default swaps by investment banks. It was those investment banks that attacked European government bonds, seeking high profits in the short run, in a desperate struggle to get out of insolvency. Such attacks brought about the tightening of budgets, despite the fact that, after the financial crisis, the government is required to put in a fiscal stimulus, because households and private corporations have to squeeze their balance sheets in order to repay their over-borrowing.

As mentioned above, however, activating such a fiscal stimulus was made difficult by the attack of the investment banks on government bonds. European authorities have not prosecuted the banks which caused this crisis, and gained the most. Instead, they have recommended the completely wrong policy of fiscal austerity, and put the burden on ordinary taxpayers. This is a ridiculous situation and, if such a stupid policy were to continue, Europe will have to suffer from two lost decades, I am afraid.

Cyprus: A Stupid, Crazy Policy

Taking this opportunity, I would like to comment on a stupid, crazy policy taken by the EU authorities regarding Cyprus. It is of the utmost importance to guarantee a certain level of deposits for all depositors in the country. So, in most countries now, we have a certain ceiling under which all deposits would be protected during any kind of financial crisis. But what happened in Cyprus was completely opposite to this policy. They have been trying to introduce a system whereby depositors are also asked to lose part of their deposits. This will completely destroy confidence in the financial system, and thereby aggravate the financial crisis.

So, I can't understand why people in Brussels should use this kind of stupid policy, which in everybody's eyes, at a glance, is a completely wrong policy for maintaining the confidence in the financial system.

Let me elaborate why. As you know, a bank can operate as long as it maintains 10% of its total assets as equity. The essence of the banking business is this creation of confidence. Take an example whereby a bank has total assets of 100 million. It does not need to keep 100 million available for payment, because, as long as confidence in the system is sustained, depositors would not demand their deposits back in an instant. The difference between the 100 million and the requirement of 10 million can be used as the source of lending, in addition to the equity held by the bank.

The policy taken by the EU completely destroys such confidence. It violates the basic notion of how a bank can exist and operate. I hope that this kind of policy, which has been advised by Brussels, will be reversed as soon as possible, because this will have tremendous contagion effects for the other countries in question.

It is of vital need now, that the Glass-Steagall Act be reinstated and investment banks be liquidated as soon as possible to save Europe. This is a war against filthy bankers who gained a lot of money from gambling, and let taxpayers pay for their losses, while they avoided paying taxes, using tax havens, and against the financial authorities who are their allies. This is a war for diligent workers who work hard, save small amounts of money in deposits in commercial banks, and honestly pay their taxes.

That's my view. Thank you.

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—*Lyndon LaRouche, Feb. 11, 2013*

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