ADBI-JFSA Joint Conference
March 8, 2013

ADBI-JFSA Joint Conference

"Strengthening the Asian Financial Sector toward Sustainable and Inclusive Growth"

Session 3 *Strengthening Regional Regulatory and Supervisory Frameworks in Asia*

Early Warning Indicators for Asia

Naoyuki Yoshino
Director, FSA Institute
Professor of Economics, Keio University
Tomoya Nakamura
Research Fellow, FSA Institute

Abstract

The paper will report that the causes of the Japanese and US bubbles can be seen in the expansionary monetary policy and aggressive credit expansion in the housing or real estate market. While it takes time for the housing market and real estate market to adjust to demand, housing and real estate prices rise very quickly when demand increases. Many banks expand their loans to the housing and real estate sector when they see that it is profitable based on short-term expectations. Real estate in Japan is used as collateral for bank loans.

When the land price was expected to rise, banks were certain that they can keep their collateral values even if bank loans defaulted. The Japanese bubble was contained within Japan. On the other hand, the US subprime loan crisis spread all over the world, since housing loans in the United States had been securitized and sold outside the country. Credit rating agencies gave high ratings to securitized mortgage products, since they were believed to keep rising in value. Many investors trusted the good ratings given to securitized products and suffered after the collapse of the US housing market. Securitization made banks less responsible for the quality of the housing loans they originated, because they were sold to other investors.

Many financial institutions in the United States increased their supply of loans to the real estate and the housing sector. Many of the loans were securitized without being kept as assets of the banking sector. Banks and mortgage companies became less cautious about their housing loans.

Excess supply was created in the housing and real estate market. This excessive supply of credit led to an excess supply of subprime loans created in response to an oversupply of housing. The excess supply in the housing market led to a rapid decline of housing prices, similar to Japan's experience in 1989.

Two indicators to help prevent a bubble are proposed in this paper. Regulators have to watch macroeconomic movements, as well as the microeconomic behavior of individual financial institutions. Excessive expansion of real estate and housing loans are one sign. Another is housing prices in comparison to incomes. A theoretical model is explained later in this paper. Inconsistening beween micro behavior of individual bank loan and aggregate total bank loan is closely related with bubble phenomena.

If monetary policy had been properly conducted, the excess expansion of the bank loans could have been prevented. The expansionary monetary policy created too much leverage in banks. The correct policy must be implemented when banks are faced with difficulties.