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16. Literally: *sei-iki*, sanctuary. However, the media has consistently translated Prime Minister Koizumi's slogan "sei-iki nashi no kouzoukaikaku" (literally, structural reform without sanctuaries) as "structural reform without sacred cows."

17. See Friedman (1982).

18. On its role, function and origin, see Werner (2003b).

19. For important recent contributions to these issues, see Forder (1998, 2000, 2001).

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RICHARD A. WERNER

A Discussion of Anil K. Kashyap's Paper "Sorting Out Japan's Financial Crisis"

The purpose of this article is to discuss the paper by Anil K. Kashyap on Japan's financial crisis (Kashyap 2002). The reader is advised to read Kashyap's paper in parallel with this discussion, which closely follows the structure of his paper. Comments on Kashyap's statements are made in chronological order, and using Kashyap's section headings.

Summary

In his introductory paragraphs, Kashyap cites the Bank of Japan's (2002) announcement of its "unorthodox" policy initiative to purchase equities held by banks, which startled world markets in September 2002. He uncritically repeats the Bank of Japan's claim that the announcement of this policy initiative was evidence that the central bank considered the resolution of the nonperforming loan problem of Japanese banks "important." However, if this claim of the central bank was true, one wonders why the central bank did so precious little to solve the bad debt problem in the decade before September 2002. Analysis yields that the announcement and its stock purchases do little, if anything, to help in

Richard A. Werner is assistant professor of economics, Sophia University (Tokyo) and chief economist, Profit Research Center Ltd. (Tokyo). The author is grateful for invaluable research assistance by Yoko Minami. He is also grateful for financial support from the Japanese government in the form of a research grant on central bank credit controls, and for financial support from the Profit Research Center Ltd.

the resolution of the problem, while the policies that the central bank could and should have taken years earlier—more on these below—remain firmly shelved. Thus an interesting question is raised (though not by Kashyap): Why in the course of fifteen years did the central bank adopt policies that created this bad debt problem in the first place?

Instead, Kashyap claims that "macroeconomic conditions alone cannot account for the problems" in Japan's financial system. However, this statement is not backed by any evidence on the causes of the macroeconomic conditions and their appropriate connection to the problems of the banking sector. Furthermore, Kashyap discusses a small number of possibilities for the accelerated disposal of banks' bad loans and claims to "explain why a quick resolution to this problem has not been possible." For this purpose, a discussion of the most efficient solution suggested by objective economic analysis is necessary. Kashyap does not deliver such a discussion. He says that his "central theme is that the financial crisis is sufficiently broad and deep that the necessary institutional changes cannot be initiated or implemented immediately." Again, to come to such a conclusion, one first has to identify what these necessary institutional changes are, and why. Here Kashyap has nothing to offer, leaving his conclusion an unfounded assertion. Kashyap says that a "primary conclusion" from his work is that "the likely cost of the financial problems to the taxpayer is huge: My rough estimate of the *lower bound* for the full cost is approximately 24 percent of Japanese gross domestic product [GDP]." Kashyap's advice would indeed deliver a further major blow to Japanese taxpayers. However, this is due to the fact that his advice is misguided. While so far the cost to the taxpayer has clearly been substantial, it has been unnecessary and is due to ill-advised policies similar to those Kashyap suggests. The correct solution to the financial problems—nowhere mentioned by Kashyap—would leave the taxpayers without any costs. Kashyap appears thoroughly innocent of this fact, as well as of the heavy moral hazard issues that his proposed "solution" raises.

Role of Macroeconomics in the Financial Crisis

Kashyap argues that slow growth and price declines have "each contributed to Japan's financial crisis." "Obviously, if there had been more growth in the 1990s, the financial sector would be in better shape now." This implies that the question why growth has been slow and why Japan suffered from disinflation and then deflation must be considered important, as well as the related issue of the role played by the financial sector, including the central bank, in these events. Unfortunately, Kashyap makes no attempt at dealing with this issue, contradicting his claim to be "reviewing the macroeconomic factors." This omission also compromises his ability to make useful suggestions concerning suitable policy responses: Kashyap has not even explored the causes behind Japan's stagnation and financial troubles. How can he give advice on how to address them?

Specifically, Kashyap argues that "ending the crisis will require substantial changes in the financial institutions' operating practices." He follows this "conclusion" from the observation that asset price declines happened at the beginning of the 1990s, while "banks and government financial institutions continue to make losses on new loans today." Therefore, he argues, the asset price collapse "may have triggered the problems," but "it cannot be blamed for their continuation at this point." However, this conclusion is not obvious. Since it has not been derived from an understanding of the link between the economy, the central bank, and the banking system—which Kashyap avoids as being "beyond the scope of this article"—other explanations are neglected.

Kashyap concludes, by way of assumption (since he provides no valid grounds for his argument) that "recapitalizing the banks (and insurance companies) would not be a sufficient step to restore growth. The banking problems reflect the poor conditions of their borrowers. Putting capital into banks to make up for past losses would be pointless if the underlying corporate problems are not addressed." Kashyap has not presented any model of economic growth, yet considers himself fit to judge what will and what will not be a sufficient step to restore growth. How does he know? What is the empirical evidence he bases his claims on? Further, what underlying corporate problems is he referring to? Has Kashyap demonstrated that these problems are exogenous and not the result of actions by the banks or the central bank? Kashyap again neglects the important linkage between banks/central bank, the economy, and the state of the corporate sector.

Kashyap makes an interesting point when he argues that Japan's recession cannot simply be explained by the credit crunch argument, since there "have always been international banks (and insurance companies) operating in Japan. . . . These foreign firms are solvent but are choosing not to lend much in Japan." This is indeed a puzzle that the credit crunch theory (a version of the "bank lending channel" view), or other tradi-

tional theories which ignore the role of credit creation, cannot explain. However, Kashyap's logic is again faulty when he uses this observation to offer the non sequitur: "So the problem is not just that the domestic financial institutions are undercapitalized. This is important because it suggests that merely throwing money at the banks will not resolve the crisis." He can only conclude this if he has not considered the link between banks/central bank and the economy. Kashyap seems to capitulate when he says that "Determining the appropriate policies to address the problems is difficult" but then does not attempt to address this question seriously. In actual fact it is not difficult to determine appropriate policies if suitable macroeconomic and monetary analysis is applied, as we will see shortly.

Kashyap seconds a similar claim made by the Japanese central bank when he asserts that "it is true that standard open market operations will not be stimulative if banks will not lend," but again fails to back it up with any evidence. Indeed, the facts have already disproved his claim.

In 1998, bank lending continued to contract (down 1.5 percent compared to the end of 1997). However, during that year, for about one year, the Bank of Japan increased its net credit creation sharply, at a rate unprecedented in twenty-five years. This was achieved almost entirely via "standard open market operations," namely commercial paper and bills purchases (up 95.7 percent year-on-year on average in 1998) and the like. As a result, the yen not only weakened significantly (falling to ¥147/$ by August 1998), but a year later the economy staged a recovery that surprised many forecasters. We see that standard open market operations were possible, and they also appear to have achieved some results, despite the fact that banks continued to shrink their lending. The same policy was repeated by the Bank of Japan in mid-2001 for about one year, when its credit creation rose at a similar pace as in 1998. Again, standard open market operations were used (bond purchases were up 34.1 percent year-on-year, CP, and bill purchases rose by 256.5 percent year-on-year). As a result, economic growth once again staged a recovery about one year later, beginning in mid-2002 (while the yen weakened to ¥120/$). Again, it appears that monetary policy as conducted via standard open market operations had the desired effect, despite the continuation of bank credit withdrawal. Another example is the reverse process: Throughout 1999, the Bank of Japan withdrew purchasing power from the economy by selling assets on a net basis (CP and bills contracted by 29.6 percent). As a result, the yen strengthened back to ¥102/$ by the end of the year, and, more important, the economy slowed again in late

2000 and throughout much of 2001. These facts about how traditional monetary policies can be effective contradict Kashyap's claim, and it would be desirable for him to deal with them.

Kashyap also uncritically—and without reference to reality—endorses the Bank of Japan's claim that "without a functioning system of financial intermediation, there are limits as to how successful nontraditional monetary policy actions will be." Kashyap does not consider it necessary to offer any empirical support for this assertion about nontraditional monetary policy. Furthermore, Kashyap claims that "As growth resumes, government money will be needed to combat some of the insolvencies that are hampering normal financial intermediation." Again, Kashyap seems to consider these statements axioms that require no factual support.

To Kashyap, "the deflation that has accompanied the slow growth" has been the "second major macroeconomic problem." Is this a second problem, or just another symptom of the same underlying problem (of the type that is "beyond the scope" of Kashyap's paper)? Kashyap argues that deflation has been "pernicious" for the banking sector, because it "squeezes banks' profitability." Surely this is a problem not specific to banks, but affecting any participant of a deflationary economy.

Kashyap then makes the extraordinary claim that the "low nominal interest rates that are charged to bank borrowers also complicate the problem of regulating the banks. With near-zero interest rates, almost all borrowers can make their required interest payments." Lowering rates clearly helps borrowers—isn't that the point of lowering interest rates in the first place? Furthermore, if it was so easy as Kashyap suggests, then it is not clear why banks should not simply roll over all their loans, thus, according to Kashyap, allowing "almost all borrowers" to service their loans, and hence having only performing loans on their books.

Kashyap steps further into speculative territory by claiming that "Japanese lenders often allow borrowers with no hope of repayment to continue to operate (see Peek and Rosengren 2002). If interest rates were 3 percent or 4 percent higher, then many of these 'zombie' borrowers would soon be unable to service their debts." It is questionable whether it is appropriate for Kashyap or others to label any firm that has survived more than ten years of recession and record deflation as a "zombie" company. It also appears unscientific to introduce "hope" as a factor. How can Kashyap or others identify which firms have "hope" and which firms have "no hope" of repaying loans? Again, Kashyap's neglect of the macroeconomic inter-linkages shows up: If the economy recovered

significantly, would not many firms that were hitherto in financial difficulties turn into well performing borrowers? Conversely, would not even top U.S. firms start to look like "deadbeat zombies," to borrow another label Kashyap uses for Japanese firms, if they had gone through more than a decade of recession, regulatory changes favoring foreign competitors, and years of "pernicious" deflation? Counterfactual speculation on what would happen if interest rates were different is fraught with problems. The most common is the implicit and unjustified *ceteris paribus* assumption that Kashyap makes. *Mutatis mutandis*, borrowing rates that are 3 or 4 percent higher than the rates of late 2002 can safely be predicted to only occur when nominal GDP growth is close to or above 3 percent. Under these conditions corporate profits would grow by double-digits, and the majority of firms would indeed be able to service their debts. Thus Kashyap's claim remains without merit.

Kashyap acknowledges in the following paragraph that firms' inflation-adjusted debt burden has been raised by deflation. But if deflation is the cause that renders firms "zombies," should a policy response not focus on tackling deflation, instead of foreclosing on more firms, thus raising unemployment, lowering demand, and increasing deflation?

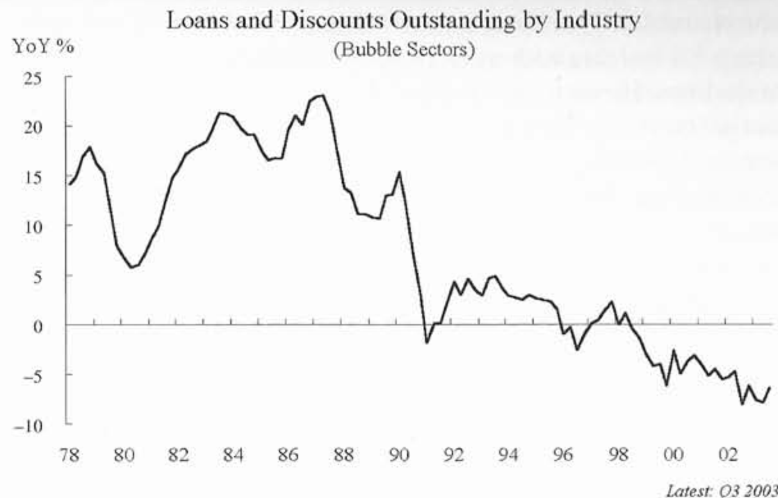
But quite to the contrary, Kashyap seems to believe that *insufficient* numbers of foreclosures by banks on their borrowers is the cause of losses: With higher interest rates, "The regulators would then be able to easily spot the deadbeat borrowers and pressure the banks to cut them off, before more money is lost." If banks lose money by not foreclosing on firms, why do they choose not to foreclose? Kashyap fails to demonstrate why banks need to be "pressured" by government intervention to stop losing money. The world in which Kashyap seems to live consists of irrational banks who prefer to lose money and of wise governments that can spot the "deadbeat borrowers," "pick the losers," and tell the banks which ones to shut down and which ones to keep alive. Does the revealed preference of banks not indicate that their choice not to foreclose is the one that minimizes losses for banks? In Kashyap's world, do banks need to be told by governments how to make money? Should perhaps firms then also be run by governments?

Banking Sector Problems

Kashyap cites figures by Fukao (2003) on banks' losses. Particularly, he notes that the cumulative losses recorded by banks amounted to ¥83

trillion since 1992. Kashyap then claims that "these losses are too large and persistent to be blamed solely on the rapid decline in asset prices at the beginning of the 1990s." Why is this implausible? Would ¥70 trillion be plausible? Or is Kashyap's cutoff line ¥60 trillion? Kashyap does not share his insights with us on how much can be blamed on the asset price declines. He then cites Bank of Japan figures on banks' disposals of bad debts, which amount to over ¥90 trillion in aggregate—a figure not dissimilar to the losses he cites. Kashyap immediately jumps to the conclusion that "Thus, it is implausible to suggest that the continued losses can be attributed to misguided lending decisions during the late 1980s. Rather, they are indicative of deeper underlying problems facing the financial services industry." Again, why is it implausible to suggest that the aggregated bad debts from the late 1980s could amount to ¥90 trillion? To leave the world of arbitrary assertions for a moment: In 1996, I produced an estimate of the aggregate bad debt problem of Japanese banks originating from the "misguided lending decisions during the late 1980s" (Werner 1996, see also Werner 2003, 205). It is well recognized that the misguided lending took the form of bank lending to the real estate sector, to the construction industry and to non-bank financial institutions, which served largely as conduit for speculative real estate loans (Werner 1991). As Figure 1 shows, such lending increased rapidly during the 1980s, and still showed growth in the early 1990s. Total outstanding loans to these three sectors increased from ¥56.97 trillion in Q1 1986 to ¥130.02 trillion in Q1 1993. Assuming that all of these loans were speculative and unproductive—and hence not repayable when such loan extension slows in aggregate and hence asset prices fall—we obtain a primary bad debt total originating from "misguided lending decisions during the late 1980s" of ¥73 trillion. In addition, many loans to the service industry were also of a speculative nature, and therefore it is easy to obtain a potential total of bad debts deriving from the 1980s of more than ¥80 trillion. By the end of 2002, the banks had indeed written off a cumulative total of ¥80trillion in bad debts. This figure is naturally also similar to the banks' losses of the 1990s, because these were the result of the very write-offs of bad debts. Thus Kashyap's claim that "these losses are too large . . . to be blamed solely on the rapid decline in asset prices at the beginning of the 1990s" is without merit.[1] As to Kashyap's claim that "these losses are too . . . persistent to be blamed solely on the rapid decline in asset prices at the beginning of the 1990s," it is not clear why the long time period it took banks to write off such

Figure 1. **Bank Lending to the Three "Bubble Sectors" (Real Estate, Construction, and Nonbank Financial Institutions)**



Source: Bank of Japan, compiled by the Profit Research Center, Ltd., Tokyo.

substantial bad debts should be surprising or implausible. Earlier in his article, Kashyap recognizes that banks had a hard time making significant profits (due to deflation). With their main business—lending—in steady decline during the 1990s, should it be surprising that it took them the better part of a decade to make enough latent profits (mainly from capital gains in equities and government bonds, but also in derivatives; see Werner 2003) to be able to write off their vast bad debts? Since the time series data indicates that the write-offs were spread out over the past decade, it is suggestive that banks wrote off bad debts whenever their capital gains situation allowed them to. Again, Kashyap's claim remains unsupported by the evidence.

Flow Profitability Problems

Kashyap notes that Japanese banks' profitability has been lower than that of their U.S. counterparts, as their loan margins were lower. He cites data from Fukao (2003) to claim that "Japanese banks' interest

margin relative to assets has hovered around 120 basis points." In actual fact, Fukao's table shows that this ratio rose by 67 percent, from 0.0076 in 1990 to 0.0127 in 2001. Kashyap fails to comment on this significant improvement. The fact that this ratio was two and a half times as high in the United States (in 2001) merely restates the well-known fact that the rate of return on assets (ROA) and rate of return on equity (ROE) in the Japanese, German, and Korean economic structures have been lower than in the United States or United Kingdom, since the institutional design in these countries is not aimed merely at short-term profit maximization, but also reflects other goals (such as higher long-term economic growth than the United States, which these three countries have achieved for the past fifty years, and a more equitable distribution of income and wealth; see Dore 2000 for a discussion of these issues). Kashyap criticizes that even when the economy recovers, Japanese banks would likely be less profitable than their U.S. counterparts. However, he fails to indicate why this should be a problem.

Kashyap claims that "Another problem is the Japanese banks' high labor costs." But the data he cites indicate that Japanese banks have succeeded in reducing salary and wage expenses from 52 percent of operating costs in 1990 to only 46 percent in 2001. This is almost identical to the 45 percent recorded by U.S. banks in 1990, and also not far removed from the 42 percent reached by U.S. banks in 2001. While Kashyap says that the somewhat higher ratio of Japanese banks is a "problem," it is not obvious why this should be the case. The economic structure of the U.S. economy is not identical to the Japanese structure and hence small divergences in such ratios remain not only within the margin expected from different statistical definitions, but also within the range of variation expected between differing economic systems.

Kashyap next laments that "while not evident in the table, it is also well known that the Japanese banks underinvested in technology during the last half of the 1990s." He fails to quantify this claim, and fails to mention that it is probably even better known that U.S. companies and banks likely overinvested in technology during the last half of the 1990s. The embarrassing glitch of the Mizuho computers is mentioned. But this resulted from the fusion of three different computer systems into one that is controlling the biggest bank in the world, and hence remains unprecedented by scale. Kashyap mentions that the Bank of Japan "subsequently had to order Mizuho to upgrade its computing systems," but fails to ask whether the central bank, once again, suggested to a private

sector bank to purchase the upgraded computing system from a specific computer maker, which has a large number of former Bank of Japan staff on its payroll in so-called *amakudari* jobs. Again, the role of the central bank in the lamentable state of the Japanese banking system, including its computers, remains off limits for Kashyap.

Japanese Banks' Limited Comparative Advantage

Kashyap claims that "there are few if any product lines for which the Japanese banks are world leaders." While it is not clear how Kashyap defines a "world leader," this claim is difficult to maintain. What about the main product line of banks, namely the granting of bank loans, and the acceptance of deposits? Mizuho Bank clearly is world leader as measured by size of bank loans and deposits outstanding.

"I find no examples where Japanese banks and their global rivals have competed for business on a level playing field and the Japanese banks have emerged as market leaders. Instead, the recurring pattern is that Japanese banks are later to enter markets or offer new products and, consequently, their profitability lags," writes Kashyap. This raises many questions. What, for instance, is Kashyap's definition of a "level playing field"? Would Kashyap recognize a central bank that prolongs a recession and creates record-beating "pernicious" deflation as a handicap for a country's banking system, thus preventing this country's banks from competing on a "level playing field"? Would political factors remain excluded from an appropriate definition of a "level playing field"? Is the often less-than-subtle unilateral political pressure by U.S. government representatives for the benefit of U.S. banks and investment funds—nonmarket intervention in the Japanese economy—not also relevant when talking about level playing fields? When has the Japanese government successfully intervened in U.S. economic policy for the benefit of Japanese banks and vulture funds? Will Kashyap's concern for a level playing field lead to the call to station Japanese troops in the United States?

But even leaving aside such issues, the fact is that foreign banks have not been able to make significant inroads into Japan, despite Japanese banks being severely handicapped by deflation and recession, as Kashyap admits. Kashyap's assertion that Japanese banks have not been profitable because they have been slow to enter markets or offer new products is contradicted by the fact that Japanese banks have been pioneers in aircraft leasing and financing deals, invented so-called impact loans, and have been innovative in developing and successfully marketing new real estate-related products during much of the 1980s, to name but a few examples. However, it is not clear that such innovations have been beneficial to Japanese banks or the Japanese economy. Kashyap's implicit claim that only pioneers that introduce new products will benefit is an unfounded generalization.

Kashyap points out that Japanese banks rely more on income from loans than on fees, compared to their U.S. counterparts. Yet, it is not clear that this is a problem. Substantial fees were generated by JP Morgan and other banks through their dealings with Enron and other firms. However, this was not necessarily efficient from a social welfare perspective, not to mention an ethical one. Kashyap calls the greater reliance on lending a "deficiency" and a "huge problem." But he does not demonstrate why this is so. Since his section is entitled "Banks' Comparative Advantage," it would have been desirable for Kashyap to consider what the comparative advantage of commercial banks actually is. It cannot be financial intermediation or fee-based advisory business, since other firms, such as stockbrokers, investment banks, and accounting and advisory firms are exclusively focused on this activity. There is, however, an activity that no other institution can replicate, namely the creation of credit. That, clearly, is the comparative advantage of banks.

If Kashyap followed through his suggestion to use comparative advantage as the criterion to judge the suitability of a bank's activities, would he not have to advise U.S. banks to reorient their activities back to their core competence, bank lending, while commending Japanese banks for recognizing theirs and sticking to their guns? However, a close reading of Kashyap's paper suggests that he is not aware of the meaning or functioning of the credit creation process and the special role played by banks in it. To spell out the difference: While capital markets merely transfer existing purchasing power, banks create new purchasing power that did not exist before.

Kashyap next recommends Japanese banks "to scale back on their operations and to focus on niche needs of Japanese customers (mostly small and medium-sized businesses). Japanese banks might arguably be better than foreign banks operating in Japan in this product line." Is this not why Japanese banks have throughout the postwar era focused on their comparative advantage, which is lending, and why their main customers have always been small and medium-sized businesses, which account for over half of all bank loans? Lending to them can thus hardly

sector bank to purchase the upgraded computing system from a specific computer maker, which has a large number of former Bank of Japan staff on its payroll in so-called *amakudari* jobs. Again, the role of the central bank in the lamentable state of the Japanese banking system, including its computers, remains off limits for Kashyap.

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But even leaving aside such issues, the fact is that foreign banks have not been able to make significant inroads into Japan, despite Japanese banks being severely handicapped by deflation and recession, as Kashyap admits. Kashyap's assertion that Japanese banks have not been profitable because they have been slow to enter markets or offer new products is contradicted by the fact that Japanese banks have been pioneers in aircraft leasing and financing deals, invented so-called impact loans, and have been innovative in developing and successfully marketing new real estate-related products during much of the 1980s, to name but a few examples. However, it is not clear that such innovations have been beneficial to Japanese banks or the Japanese economy. Kashyap's implicit claim that only pioneers that introduce new products will benefit is an unfounded generalization.

Kashyap points out that Japanese banks rely more on income from loans than on fees, compared to their U.S. counterparts. Yet, it is not clear that this is a problem. Substantial fees were generated by JP Morgan and other banks through their dealings with Enron and other firms. However, this was not necessarily efficient from a social welfare perspective, not to mention an ethical one. Kashyap calls the greater reliance on lending a "deficiency" and a "huge problem." But he does not demonstrate why this is so. Since his section is entitled "Banks' Comparative Advantage," it would have been desirable for Kashyap to consider what the comparative advantage of commercial banks actually is. It cannot be financial intermediation or fee-based advisory business, since other firms, such as stockbrokers, investment banks, and accounting and advisory firms are exclusively focused on this activity. There is, however, an activity that no other institution can replicate, namely the creation of credit. That, clearly, is the comparative advantage of banks.

If Kashyap followed through his suggestion to use comparative advantage as the criterion to judge the suitability of a bank's activities, would he not have to advise U.S. banks to reorient their activities back to their core competence, bank lending, while commending Japanese banks for recognizing theirs and sticking to their guns? However, a close reading of Kashyap's paper suggests that he is not aware of the meaning or functioning of the credit creation process and the special role played by banks in it. To spell out the difference: While capital markets merely transfer existing purchasing power, banks create new purchasing power that did not exist before.

Kashyap next recommends Japanese banks "to scale back on their operations and to focus on niche needs of Japanese customers (mostly small and medium-sized businesses). Japanese banks might arguably be better than foreign banks operating in Japan in this product line." Is this not why Japanese banks have throughout the postwar era focused on their comparative advantage, which is lending, and why their main customers have always been small and medium-sized businesses, which account for over half of all bank loans? Lending to them can thus hardly

be described as "niche" business. But how does this "advice" stack up with Kashyap's earlier recommendation that banks should stop their focus on lending?

Kashyap then asserts: "The loan demand of these customers, however, is much lower than the assets of the current banking system; therefore, shifting in this direction in order to raise profitability would imply considerable downsizing." Since the majority of bank assets already consists of loans to small and medium-sized enterprises, Kashyap's assertion is counterfactual. Indeed, a number of empirical studies on loan demand by small and medium-sized firms, both in the United States and Japan, has found that small firms have more loan demand than large firms, as the latter can access financial markets, while the former are often dependent on bank lending for their funding needs (see Gertler and Gilchrist 1994, on the United States).[2] This would explain why Japanese banks have mainly lent to small firms. But it has been the banks' increased risk aversion, raised by the sizeable bad debts, that has reduced the banks' supply of loans to small firms, so that many researchers found evidence for a "credit crunch" in Japan, whereby loan demand by small firms is larger than the loans supplied by banks (see Woo 1999, Motonishi and Yoshikawa 1999, Morsink and Bayoumi 2000, Bayoumi 2000).

Kashyap then reiterates an old complaint of the banks and the central bank, namely that competition by government financial institutions has impeded their profitability. "The postal savings system poses a particularly big problem." If we accept the above facts, of which Kashyap seems unaware, namely that high bad debts have rendered commercial banks so risk averse that they have rationed credit to small firms (their main customer base and the segment of the credit market with excess loan demand) then the lending by government banks to small firms cannot be considered to have a negative impact on commercial banks. To the contrary, research has shown that the "cow bell effect" of usually small loans by government lenders to small and medium-sized enterprises encourages commercial banks (who apparently had not done their credit analysis homework) to jump on the bandwagon and then also lend to these firms. Thus, instead of taking business from private sector banks, government lenders appear to have performed a service for them, as the government lenders spent resources on primary credit analysis from which the commercial banks profited.

As to the postal savings system, how can Kashyap claim that it com-

petes with private banks, when it has never even entered their main business? The main business of Japanese banks, as Kashyap's figures show, is lending. The postal savings system has never extended loans. All it does is offer deposit facilities. Kashyap asks (quoting Fukao 2003): "How can the private banks make profits when Japan's government-sponsored postal savings system has forty times the number of offices of the largest banking group, pays roughly the same rate on deposits as the banks, and charges no maintenance fees?" The answer to this question is straightforward, though apparently not for Kashyap. Japanese banks make money just the same way they have always made money over the past century: by focusing on their main business, which is lending. The banks of course do not need deposits from the public to fund themselves, as they can obtain funding cheaper, namely either via the costless creation of deposits or by borrowing from the central bank (at an overnight uncollateralized call rate of 0.001 percent, at the time of writing). Their vast excess reserves (amounting to over ¥30 trillion at the time of writing) are testimony that funding bottlenecks of the type suggested by Kashyap do not exist. Kashyap therefore fails to demonstrate entirely why the postal savings system should have had a detrimental effect on the banks' profitability. Indeed, the Japanese postal savings system did not come about in the early 1990s, as Kashyap seems to imply. It was founded in 1875. Yet, over the past 128 years, Japanese banks have, on average, been profitable. This suggests that the postal savings system cannot be a significant obstacle to bank profitability.

Having made baseless assertions on the treasury operations of banks, Kashyap returns to the lending business and states that the government-owned Housing Loan Corporation (HLC) "compromises the banks' ability to make money through home mortgage lending." However, commercial banks' housing loans rose 8.7 percent year-on-year in Q3CY03, the latest data available at the time of writing, and the highest growth rate since Q4CY96 (when the consumer tax rise induced a temporary housing boom; see Figure 2). This market segment remains a profitable one for banks.

Housing loans by commercial banks have been rising, despite the continued activity of the HLC. Kashyap claims that "These kinds of government-sponsored financial institutions will have to be reigned in if Japanese banks are to regain profitability." Facts have already disproved his assertion: By the time of this writing, many large Japanese banks had returned to profitability, and did so despite the continued existence of government-

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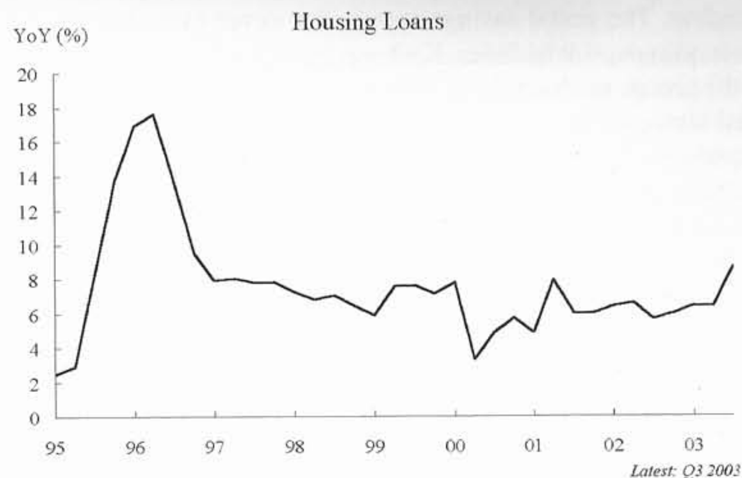
Housing loans by commercial banks have been rising, despite the continued activity of the HLC. Kashyap claims that "These kinds of government-sponsored financial institutions will have to be reigned in if Japanese banks are to regain profitability." Facts have already disproved his assertion: By the time of this writing, many large Japanese banks had returned to profitability, and did so despite the continued existence of government-

Figure 2. **Housing Loans Extended by Commercial Banks**



Source: Bank of Japan; compiled by the Profit Research Center Ltd., Tokyo.

owned financial institutions.[3] It is true that the loans of government lenders have been falling recently. However, their main job has been to act counter-cyclically and step in the breach when and if private banks do not fulfill their function of providing credit to the economy. Government lending increased in the early 1990s, as the lending of private banks decreased, due to their bad debts. To suggest reverse causation means putting the cart before the horse.

Kashyap, despite the limited grounding of his assertions on empirical evidence, further ventures into giving policy advice to the Japanese government, by noting that "despite making it a priority to privatize the postal savings system . . . the Japanese government has encountered strong resistance to its efforts to address this problem. The postal savings system and the government's home lending program are popular with the public. Furthermore, the public has not been convinced that these programs in fact are contributing to the banking troubles." Quite. And for good reason. It seems the Japanese public understands the facts concerning the Japanese banking industry better than some commentators do. Besides, to make marginally cheaper public funding available to the population is a political decision that has to do with maximizing a

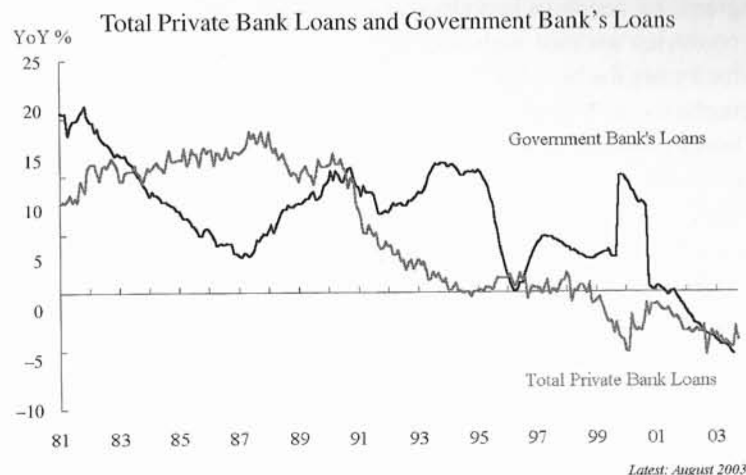
social welfare function which includes the goal to foster a reasonably equitable society. Thus, public support of socially weaker groups in the form of providing decent housing is likely to be socially efficient. If Kashyap disagrees, he needs to introduce comparative empirical work on Japan and countries without such housing programs, and he needs to examine to what extent the benefits of the Japanese-style economic structure, with its emphasis on greater equality, has resulted in greater social stability and lower crime rates, and to what extent these benefits have exceeded the costs.

This is not to say that there is no room for improvement concerning the government-owned financial institutions. There is indeed an important policy that should have been implemented, and which would have created a lasting economic recovery in Japan (one of many such policy options that were unfortunately not taken). Kashyap appears unaware of the fact that the government-owned financial institutions actually do not compete at all with banks in their area of comparative advantage. As discussed above, this is their activity of creating credit. Unlike private sector banks, the government banks are not client institutions of the central bank and they do not have the ability to create credit. This has been a problem, for it has meant that their loans did not increase purchasing power and the money supply. At a time when private sector banks are not doing their job and are not creating credit, it would be helpful if government banks did. Thus, ironically, suitable policy advice concerning the government-owned banks is quite the opposite of what Kashyap suggests: Government banks should have been given proper banking licenses and should have funded themselves through the normal credit creation process, not postal savings. Instead of reducing competition from government banks, Japan would have benefited if government banks had indeed been competing with banks in the business of creating credit.[4]

How Much Would Recapitalization Cost?

Kashyap attempts to answer this question by estimating the amount of true bad debts in the banking system. He makes no attempt at arriving at plausible figures, but merely cites, without further explanation, estimates by analysts of foreign securities houses (CSFB and Goldman Sachs). According to Goldman Sachs, all bad debts in the entire banking system amount to ¥236.6 trillion, which would be almost half of all bank loans.

Figure 3. **Loans Extended by Private-Sector Commercial Banks and Public Financial Institutions**



Source: Bank of Japan; compiled by the Profit Research Center Ltd., Tokyo.

Kashyap does not comment on these or other estimates or on how one should go about arriving at a sensible estimate of bad debts. He thus fails to tackle his self-imposed question of how large the bad debts of the banks are.

I have argued elsewhere that there are two types of bad debts: Primary bad debts are those deriving from the excessive lending of the second half of the 1980s. My estimate, mentioned above, amounted to about ¥80 trillion. Since banks have by now written off as much as this amount, it can be concluded that the primary bad debts have been taken care of. There are, however, also secondary bad debts. These are not due to the behavior of banks, but depend on monetary policy. When banks reduced lending in the early 1990s due to bad debts, this exerted a negative externality on the economy: Unbeknown to Kashyap, banks fulfill a public goods role when they create money through their lending. Bank lending is credit creation. For economic growth to take place, monetary growth is a necessary condition. When bank lending fell, purchasing power available for transactions in the economy shrank, thus reducing demand and GDP growth (a more precise theoretical model with em-

pirical tests, also in comparison with competing models, can be found in Werner 1997, 2002b, 2003). This is indeed the issue that Kashyap considered beyond the scope of his paper: Bank credit is linked to economic growth, since economic growth requires credit creation. As growth shrank during the 1990s, factor inputs became idle, unemployment rose, corporate sales and profits came under pressure and bankruptcies rose. This meant that bad debts of the banks had to rise, due to the economic downturn. This secondary type of bad debt has the same effect of primary bad debt on banks' ability and willingness to lend: it renders banks risk-averse. Thus as secondary bad debts rose (even though primary bad debts were increasingly written off), banks' risk aversion did not fall. Bank loan growth continued to decelerate and then turned negative. This again had the negative externality that demand had to fall, which in turn acted to increase bankruptcies and hence bad debts (this vicious cycle is also described in Werner (2002d) in this volume). In this situation it is the job of the central bank to step in and end the vicious cycle by increasing credit creation. It can do this by increasing its net open market purchases of private sector assets, by lending to the government or firms, and by taking a number of other policy measures—none of which are new or "unorthodox," since the Bank of Japan adopted them right after 1945 (see Werner 2003). Thus the attempt to find an estimate of the secondary bad debts must remain open-ended: The precise figures remain contingent on the policy action taken by the central bank. If the central bank continues to create insufficient credit for a sustained recovery or fails to take policies to coordinate a recovery of bank credit, then the secondary bad debts will continue to rise. The limit is, however, clear: At most they can reach 100 percent of all remaining bank loans.

Despite Kashyap's belief that an estimate of the bad debts is necessary to answer the question with which he entitled this section, namely "How Much Would Recapitalization Cost?," it turns out that the size of the bad debts is irrelevant to answer it. The answer depends on the way in which the banks are recapitalized. Kashyap immediately suggests that they should be recapitalized with tax money. He fails to establish why he prefers this option and fails to discuss any other avenue. He merely asserts that "it is clear that the losses for the taxpayers will be substantial." The question is whether Kashyap's suggested solution is really the most cost-efficient way to deal with the banks bad debt problems. Furthermore, it raises issues of moral hazard, equity, and social justice concerning

his proposed allocation of these costs. Is it really economically and socially efficient to saddle the taxpayer with these costs? Why does Kashyap reject the principle that moral hazard should be avoided? Put simply, those who "mess up should pay up," otherwise counter-productive incentives are provided and a repetition of the wrong policies is likely in the future. If one wishes to avoid creating moral hazard, one first must establish who is responsible for the creation of the bad debts, and then structure the allocation of costs accordingly.

One thing is certain: The tax payer is not responsible for the creation of bad debts in the banking system. It is thus difficult to see why Kashyap seems adamant that taxpayers carry the cost of recapitalizing banks. Indeed, even when ignoring the moral hazard issue, we find that using tax money to recapitalize banks is not the most cost effective (and hence economically efficient) solution. The entire banking system could be recapitalized at zero cost by the central bank, which could simply accept all bad debts on its balance sheet. This transaction would neither create new money in the nonbank private sector (and hence could not possibly stir inflation, as some critics have suggested) nor would it create any costs to society.[5] While tax-funded measures increase Japan's already precarious debt and require future generations to service more debt and interest on interest, the central bank can solve the bad debt problem without incurring any debt and without incurring any costs at all. The most effective method would be for the central bank to purchase the bad debts at their former face value. Thus loans that were worth 100 in the late 1980s, but whose current market value has fallen to, say 20, could be purchased by the central bank for 100.

Bank of Japan officials have criticized this suggestion by arguing that the central bank would incur a loss—of 80 in our example. However, this is not the case. The central bank would make a profit of 20, since it has no funding costs and obtains something worth 20 for nothing (it is "paying" by crediting banks' accounts with "book money" it created, which is then used to substitute for the former holes in the banks' balance sheets). It is of course possible to book these transactions in such a way on the central bank's balance sheet that the illusion of a "loss" is created. However there is no logically compelling reason why one would wish to do so. As for the argument that such a policy would be "unorthodox," observers like Kashyap seem unaware that the Bank of Japan has already adopted this policy in the past, namely right after the end of World War II. At that time the bad debts in the Japanese banking system

were far larger than in the 1990s. Despite this, there was no credit crunch, no decline in bank lending, and hence no recession. The main difference between post-1945 policies and those taken during the 1990s is found in the attitude and policies adopted by the central bank. After 1945, the Japanese central bank saw no reason to allow a recession or banking crisis, and it wished to create a swift recovery. It therefore stepped in and created more credit, while banks were not creating enough (it did this through expanded net purchase operations of bills and other assets). It also solved the bad debt problem in the banking system by buying the worthless war bonds owned by banks, at prices far exceeding market value.

Compared to this, solving the bad debt problems of the banks in the 1990s would have been a trivial exercise of one morning, given the advances in real-time settlement systems between the central bank and the banks. (Just like after 1945, it was clear in the 1990s that interest rate reductions were irrelevant, as had been pointed out by Werner, 1995). The really interesting question, which is also beyond the scope of Kashyap's paper, is just why this time round the Bank of Japan chose—for over a decade—to do nothing to end Japan's banking crisis and recession (for an analysis of the Bank of Japan's revealed policy preference, see Werner 2003).

Returning to the moral hazard issue, we note that an examination of the causes of the primary and secondary bad debts and the identification of those responsible is necessary. Research on the causes of the excessive bank lending of the 1980s has been completed (Werner 1999, 2002a, 2003), and it found that the Bank of Japan was responsible. It turns out that the central bank ordered Japanese banks to expand their speculative lending aggressively between 1986 and 1989, using its extra-legal "window guidance" credit controls—a form of administrative "guidance." This created the primary bad debts. Since the misguided policies of the Bank of Japan during the 1990s were the cause also of the secondary bad debts, from a moral hazard perspective it is clear that the burden of solving the bad debt problem should fall squarely on the Bank of Japan. Also, the staff responsible for these policies should be held accountable. The fact that no public examination of the Bank of Japan's window guidance policies and punishment of the relevant staff took place is likely to have exacerbated the secondary bad debts by allowing the same bank staff to stay in positions of influence and maintain their misguided policies. Indeed, the head of the Bank of Japan's Banking Department in the

crucial years from 1986 to 1989, in charge of the window guidance loan growth quotas imposed on the banks, was Mr. Toshihiko Fukui. Instead of being disciplined for his disastrous policies in the 1980s, which created Japan's bubble and thus were responsible for much of the resource misallocation that has cost Japan dearly over the past fifteen years, he was rewarded and promoted, first to deputy governor (from 1994 to 1998) and then governor (since 2003). As a result, he stayed in charge of the policies of the Bank of Japan, which duly continued on their ruinous path during the 1990s, causing and exacerbating the very banking problems that Kashyap discusses. However, none of the above, including the literature discussing these findings, seems to have appeared on Kashyap's radar screen.

In his further discussion of bank capital, Kashyap suggests that it is a problem that banks' capital has been bolstered by permitting them to include tax credits against future profits. However, if the objective function is to help banks restore their balance sheets so that they can lend again, and hence allow an economic recovery, there is no reason why such accounting treatment should be problematic from a social welfare perspective. Kashyap appears to agree with the recommendations of Minister Takenaka's "Financial Sector Emergency Response Project Team," which made the surprising suggestion in late 2002 that measures should be taken to *worsen* the balance sheets of Japanese banks, *increase* the number of corporate bankruptcies and also allow bankruptcies even of large banks. The stock market reacted predictably to such a self-destructive policy program (since then fortunately abandoned with the bailout of Resona Bank).

Kashyap says that "the private sector analysts are unanimously of the view that the banks are bankrupt—by a significant amount. This suggests that barring a miraculous economic recovery that no one is forecasting at this time, the banks will eventually be forced either to close or to raise more capital." These assertions are false. There are many analysts that took a different view—and they have been vindicated by the fact that bank shares rose by several hundred percent in 2003, many banks returned to profitability, and none of the large banks came close to bankruptcy (although it was the announcement of the above misguided policies that Kashyap seems to endorse which produced a sell-off of bank shares and the equity market in late 2002 and early 2003). Also, a modest economic recovery was already under way when Kashyap's article was published and has since been confirmed. Was this a miracle? Perhaps in Kashyap's eyes. But some forecasters had correctly predicted it—presumably because they had a reasonably accurate model of Japanese economic growth (for instance, I forecast a recovery in Japan for the second half of 2002, based on my observation that Bank of Japan credit creation expanded significantly in 2001 and 2002; see Werner 2001, 2002e).

Kashyap next repeats his unfounded assertion that the Japanese banking sector needs "downsizing and consolidation." This is quite inexplicable. It would appear that Japanese banks have already downsized their loan books too much—total bank loans outstanding fell from ¥471.8 trillion at the end of 1992 to ¥422.2 trillion at the end of 2002. Since this was the very cause of Japan's long recession, what the banks and Japan's economy need seems to be the opposite, namely more bank lending and thus an expansion of the operations of the Japanese banking sector.

Kashyap's assertions continue: "Second, since money to bail out the banks is limited, any refinancing proposed should be done in a focused fashion. In particular, if exit of some banks is inevitable, then it is poor policy to prop up banks that will soon go out of business." Why is money to bail out the banks limited? The most effective method to recapitalize the banks is via the central bank. Given the current state of the Japanese economy, there appears hardly any meaningful limit on the Bank of Japan's ability to bail out the banks. Why should exit of some banks be inevitable? It may be inevitable as a result of a decade of misguided central bank policies, but in principle it has not been an inevitability. Kashyap again fails to support his claims.

Problems with the Life Insurance Sector

In his discussion of this industry, Kashyap fails to explain that the insurance sector is of different macroeconomic importance than banks. While bank loans create credit and hence new money, the insurance sector has no ability to create credit and thus merely acts as a financial intermediary. As a result, the insurance sector is of limited interest if we are concerned with the fundamental problems that befell the Japanese economy in the 1990s. For different reasons, Kashyap happens to come to the right conclusion, namely that "there seems to be no reason to provide public money to rescue the insurers."

Government-Sponsored Agencies

Kashyap again hastily asserts that "many of these agencies are losing money and will ultimately require a taxpayer bailout." He keeps neglecting the root problems of Japan's recession and focuses on treating mere symptoms. Further, his unfounded fixation on landing taxpayers with bailout bills is somewhat tiring. After over a decade of recession it is not surprising that state coffers are empty and public sector agencies, entrusted with public goods functions, are not profitable. A full-blown economic recovery is, however, likely to change this. Which is why, again, Kashyap would have done well to focus on the role of credit creation and the central bank.

"The money that will be spent here constrains the funding that is available for the insurance and banking restructuring," asserts Kashyap. This is untrue. No public money is needed for the insurance sector, as Kashyap seemed to agree above, and the funding for the banking sector recapitalization should come from the central bank. Finally, it is not clear that the government-sponsored agencies will actually require public funds, when and if a full-blown recovery is established.

Kashyap then repeats his claim that the government agencies compete unfairly with private sector firms. I refer to my discussion of this issue above. In his discussion of the fiscal investment and loan program (FILP), Kashyap fails to recognize that the biggest problem with this program has not been its existence, but the fact that it was not funded by credit creation. Just like the government banks (which FILP funds, among others), the fiscal investment and loan program merely served to reallocate existing purchasing power. As a result, during the credit recession of the 1990s, the FILP could do nothing to alleviate the credit crunch. As discussed, reforms should indeed change this and allow government banks to create credit.

In Kashyap's discussion of possible estimations of potential losses of the FILP agencies (made by other researchers), Kashyap again fails to discuss just why asset prices have been falling during the 1990s and why the economy has remained in a slump. This is clearly an issue that has been connected to these losses and if addressed could reverse latent losses. The space and time devoted to such futile estimations could be more usefully spent on discussing the link between banks and the macroeconomy.

Conclusion

"There are different reasons for the sizable losses lurking in Japan's banking, insurance, and government agency sectors," claims Kashyap in his conclusion. However, there is one underlying reason common to them all. Unfortunately, it remains outside Kashyap's interest, namely the monetary policy of the Bank of Japan, which is conspicuous by its absence in his paper. Given the pivotal and rather obvious role of the Bank of Japan in the events of the 1980s and 1990s, this omission is difficult to fathom.[6]

"The banking problems that attract so much attention will persist until the troubles in the other two sectors are also addressed," claims Kashyap. His assertion remains a non sequitur. Nowhere in his paper does he demonstrate this claim. Indeed, it can be demonstrated that solving the banking problems by adopting the right central bank policies will solve the main problems in the other two sectors as well. If the Bank of Japan solved the bad debt problem at zero cost in one stroke and also created credit sufficient for an economic recovery, the financial difficulties of the insurance sector would disappear over time (they have been due to low returns on assets and due to low interest rates, all of which were the result of the protracted recession) and the government sector would find that its revenues are rising.

Kashyap then asserts that "Japanese taxpayers are likely on the hook for roughly ¥120 trillion (24 percent of GDP)." This claim is not true: if the right policies (those not discussed by Kashyap) are taken, taxpayer liabilities would be nil. If the wrong policies are taken (those suggested by Kashyap), the economy will not necessarily recover, as banks could remain too cautious for a significant recovery in bank lending, and the central bank, unaccountable as it has been for its actions, could persist in its policies to prolong the recession. In that case, potential costs to taxpayers could easily be far larger than Kashyap suggests, but precise calculations would be fruitless as the figures remain contingent on the future policies taken by the central bank.

Kashyap concludes that much restructuring of the banking sector is necessary, which "will lead to business closures and job losses." But it has not been demonstrated that the type of restructuring he envisages is actually necessary. Moreover, Kashyap fails to explain the macroeconomic consequences of his advice—would more bankruptcies and higher

unemployment not result in weak demand, further bad debts, and hence a continuation of the vicious cycle that has kept Japan more or less in recession for over a decade?

In his final paragraphs Kashyap argues that "banks are already routinely rolling over loans rather than pulling the plug on bankrupt firms." He cites a joint paper in progress, entitled "Zombies," which purports to explain that "suppressing the normal process of creative destruction leaves all banks with fewer good borrowers to lend to." However, this assumes that there is a limited stock of money available to banks, and by rolling over loans to some firms, banks are unable to extend loans to other, deserving firms. That is not the case. Is Kashyap not aware that over ¥30 trillion in reserves are lying idle at banks that could easily be lent? Is Kashyap not aware that banks can create money out of nothing through the process of credit creation, and therefore lending to one firm does not prevent loans to another?

Kashyap further claims that "continuing to funnel the money through the banks creates other costly distortions. Because this stifles the creation of new jobs, there will be fewer alternatives for the displaced workers and less tax revenue accumulated to cushion the blow when the firm finally fails or is significantly downsized." Kashyap here seems to argue that the problem is *too much* money being "funneled" through the banks. In actual fact, bank lending has been contracting for five consecutive years and macroeconomic research has established that the cause behind Japan's recession has been a lack of credit creation. Instead of lending too much, as Kashyap claims, there can hardly be any doubt that banks have been lending too little. It is also wrong to argue that failing to foreclose on certain firms is the reason why banks don't lend more to others. The banks are far below their maximum loan growth potential. Kashyap has the economic causation in reverse right to the end. It is hard to see how he can seriously argue that Japan's problem is *too few* bankruptcies, when in actual fact there have been over 210,000 bankruptcies in Japan since 1990, and this has created a post-war record high unemployment rate and weak demand.

Kashyap claims at the outset of his paper that "In this article, I explain why a quick resolution to this problem has not been possible." Kashyap asserts that the reason was that "the financial crisis is sufficiently broad and deep that the necessary institutional changes cannot be initiated or implemented immediately." To come to this conclusion, one first needs to examine what these "necessary institutional changes"

are and how they could be initiated. Yet, Kashyap has consistently ignored the key institutional aspects that were instrumental in the development of Japan's crisis, namely the role of the central bank, its informal credit guidance policies, and the lack of accountability for any of its disastrous actions. Thus Kashyap fails to suggest any of the necessary institutional changes, such as a change in the legal status of the central bank to make it de facto accountable.

Possibly the goal to explain "why a quick resolution to this problem has not been possible" was nevertheless fulfilled. Advice such as Kashyap's is not part of the solution. It has been part of the problem.

Notes

1. It should be noted that when my estimation of the primary bad debts originating from the late 1980s was made, it was one of the largest predictions of any forecaster and at the time considered far too pessimistic by the majority of economists.

2. Gertler and Gilchrist (1994) considered the impact of a liquidity shortage on different types of firms (small vs. large) and found significant differences in their behavior. Unlike large firms, small firms are more likely to cut working hours and production, as they apparently have limited access to short-term credit markets.

3. According to news wire reports: "Mizuho Financial Group, Japan's largest bank by assets, said its net profit surged more than six-fold from a year earlier to 255.4 billion yen ($2.34 billion) in the April–September period." "UFJ said its net profit surged 147.6 percent from last year to 179.8 billion yen in the six months to September." "Mitsubishi Tokyo Financial Group (MTFG) said it posted a net profit of 301.9 billion yen in April–September, reversing a net loss of 188.1 billion yen for the same period last year." AFP, Top Japan banks' profits jump on stock market gains, tax refund, November 25, 2003.

4. For details on how it came about that the government banks lost their ability to create credit, see Werner (2003). For a more rigorous empirical model of growth, which objectively confirms the crucial role of credit creation, see Werner (2002b).

5. The Chinese central bank seems to recognize this, as it has suggested that it is considering purchasing the (vastly more substantial) bad debts in the Chinese banking system and thus taking them off banks' balance sheets. See Kynge and McGregor (2003).

6. It is not suggested that this has anything to do with the fact that Kashyap is on the payroll of a central bank (Kashyap duly discloses his affiliation, as he is introduced as a "consultant" to the Federal Reserve Bank of Chicago).

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