Japan and the Asian Financial Crisis: The Role of Financial Supervision in Restoring Growth

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Summary

The crises of the Japanese and Asian economies in 1997-98 are reflection of the regional interdependence. One of the factors contributing to the baht devaluation of July 2, 1997 was yen depreciation vis-à-vis the US dollar in 1995-1997. The weak Japanese economy and the Asian economies mutually reinforced each other in the fall of 1997.

Both Japan and many Asian countries suffer from structural weakness in the banking system. Japanese banks are beset with nonperforming loans due to a sharp decline in land prices, and many Asian banks are burdened by excessive borrowing from abroad or nonperforming loans due to sharp currency depreciation. Japan and Asian countries did not have a legal framework to close insolvent banks before the crisis, which contributed to a protracted resolution of the problem.

The current downturn of the Japanese economy was triggered by the tax hike of April 1997. The Japanese economy became extremely fragile, when the two large financial institutions failed in November 1997. Uncertainties about the future of banks and other financial institutions depressed the stock prices, which in turn put pressures on bank balance sheets. It forced banks to curtail lending, which further worsen the macroeconomic conditions. Usual counter-cyclical macroeconomic policies do not seem to work in Japan in the second half of the 1990s. As the interest rate became near zero, the effectiveness of monetary policy is limited. Moreover, further expansion of liquidity would weaken the yen. Yen depreciation further depresses the Asian economies.

Despite the large devaluation, Asian export booms are yet to come. Japan, a large absorber of Asian exports, is struggling to restore its growth. The weakened banking system cannot provide financing for viable industries. Asian exporters suffer from credit crunch.

Restoring a robust financial sector is a number one priority for Japan and many Asian economies.

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I. Introduction

On July 2, 1997, the Bank of Thailand abandoned the currency peg to a basket (de facto U.S. dollar peg) and floated the baht. The baht immediately depreciated by 17 percent. This was the beginning of crises in the worldwide emerging market in the subsequent twelve months (and possibly more months). Thailand, Indonesia, and Korea asked International Monetary Fund (IMF) for a foreign exchange support by December 1997. At the height of the crises, the ASEAN currencies were depreciated by more than 50% in January 1998. The worst hit Indonesian rupiah was worth one-eighth of the level just before the baht depreciation. Contagion from Asian crises spread to Latin America (particularly, Brazil) and Russia. In August 1998, one year after the de facto baht devalution, the Russia essentially defaulted on its short-term government securities. It is not a direct spillover from Thailand to Russia, but it is not farfetched to argue that a chain of events led the crises from Thailand to Russia in thirteen months.

There have been many studies on the Asian financial crises. Many point out the yen depreciation from 1995 (peaked at 80 yen in April 1995) to 1997 (about 140 yen in June 1997). As the yen depreciated, the Asian exports plummeted. The Japanese yen was depreciating partly as a correction of the excess appreciation and partly as a reflection of the weak Japanese fundamental. However, it was unfortunate to the Asian economies.

The Japanese economy had been stagnant since 1992, before its short-lived recovery in 1996. The growth rate had been below 1.5% from 1992 to 1995. Although the growth rate became higher at 3.9% in 1996, it turned out to be a fragile recovery. A boom was felt in housing construction and consumer durables in the latter half of 1996, in anticipation of consumption tax rate increase to come. In April 1997, the consumption tax rate was raised from 3% to 5%, as scheduled, the temporary income tax cut was repealed, and the social security insurance premium was raised. The reaction of aggregate consumption was predictably negative. What was not expected was the duration of the negative reaction. Consumption and investment was still weak after six months since the tax increase. Then major financial crises shook Japan in November. The Sanyo Securities (a medium size securities firm), the Hokkaido Takushoku Bank (Takugin, for short), and the Yamaichi Securities (one of the Big Four) failed one after another. Since Takugin and Yamaichi were one of the largest financial institutions in Japan, which the government had indicated earlier to support, many people were shocked by the failure. Japanese consumer confidence was lost, and

the Japan premium soared in the international interbank market.

Weaknesses of the Japanese economy and crises among the Asian economies are connected through trade and investment ties. Despite the sharp depreciation of the currency, exports from the Asian countries do not seem to increase, partly because weak demand from Japan. It is also evident that weak Japanese exports to Asia is pulling down the Japanese growth rate. Weak economies are affecting each other. The crises of the Japanese and Asian economies in 1997-98 are reflection of the regional interdependence.

In addition to macroeconomic mismanagement, Japan and the Asian economies share structural weakness in their respective banking system. Japanese banks are beset with nonperforming loans due to a sharp decline in land prices, and many Asian banks are burdened by excessive borrowing from abroad or nonperforming loans due to sharp currency depreciation. Japan and Asian countries did not have a legal framework to close insolvent banks before the crisis.

The trigger of the current recession in Japan is the tax hike in April 1997, but the economy had become fragile due to the nonperforming loans problem in the banking sector. Uncertainties were sharply heightened when the three large financial institutions failed in November 1997. Usual countercyclical macroeconomic policies do not seem to work in Japan in the second half of the 1990s. As the interest rate became near zero, room to maneuver is limited. Moreover, further expansion of liquidity would weaken the yen. Yen depreciation and export drive is not a solution, because it would create a political conflict with the US and it would not help Asian countries economic recovery, which is important for Japanese economic recovery.

Despite the large devaluation, Asian export booms are yet to come. First, Japan, which absorbs about one third of Asian exports, is struggling to restore its growth. In fact, Asian exports to Japan have been declining from 1997 to 1998. Second, the banking system was damaged so that export financing has become difficult. Exporters are suffering from credit crunch.

Restoring a robust financial sector is a key to the recovery of the Japanese and Asian economies.

This paper draws the parallel between Japan and the Asian economies in the current

financial crises in the region. In Section II, the Japanese macroeconomic situation is described and possible policy options are discussed. In Section III, nonperforming loans problem in Japan is analyzed. In Section IV, reasons for the Asian financial crisis are explained, and parallels to Japan is discussed. In Section V, importance of the bank supervision in the region is emphasized. Section VI concludes.

II. The Japanese Economy: Current Status and Policy Options

(1) Incredible stagnation

The growth rate (real GDP growth rate) was more than 4 percent from 1985 to 1990, except for 1986 at 2.9%. During these years, the stock price index and typical land prices tripled. The stock prices peaked around 39,000. The growth rate reached 5.0% in 1990, but went down to 3.8% in 1991. However, the stock prices already came down by 40% in 1990. The business activities definitely turned down in 1992. The growth rate came down to 1.0% and the stock prices went down by 25%. The stock prices went down by 25% in the first half of 1992. The level of stock prices became below 15,000 in August 1992.

Japan grew less than 1.5 % a year in 6 years out of the last 7 years (1992 through 1998 except 1996), a performance much worse than other G7 countries or most of emerging market economies. The prospect is getting worse. The growth rate became negative in the last quarter of 1997 and has stayed negative for the first two quarters of 1998. This is the first time for Japan to experience negative growth for three quarters in a row. No recovery in sight if policy stays the course. What went wrong? What will lift the Japanese economy from stagnation or more recently a downward drift?

The immediate cause of the recent sharp downturn is clear. An increase in consumption tax rate from 3% to 5% combined with an end to temporary income tax cut in April 1997 amounted to a tax increase by 9 trillion yen. This pulled down the economy from a moderate recovery experienced in 1996. The fiscal contraction was compounded by credit crunch caused by bad-debt-ridden banks. Banks were under pressure to increase the risk-adjusted capital ratio. Banks being nontransparent about true size of nonperforming loans only multiplied suspicion among investors.

(2) Liquidity trap

The official discount rate (ODR) has been used as a principal tool of counter-cyclical policy. During the “bubble years” (the late 1980s), the interest rate was maintained at 2.5%. The ODR was raised in May 1989 from 2.5% to 3.25%. The ODR reached at 6.0% after increases in October 1989, December 1989, March 1990,

and August 1990. These frequent and sharp increases in the interest rate, along with the imposition of land tax and lending restraints to the real estate sector, made the land price turned around. As the stock prices and land prices started to decline, the real economy started to slow down in 1990-92. However, the growth rate in 1991 was still high at 3.8%.

As the bubble started to deflate and the real economy started to cool down, the ODR was lowered. The ODR was lowered seven times to 1.75% by September 1993. By this time, it was clear that the economy was in a recession. It was hoped that this record low interest rate, in conjunction with fiscal stimulus, would do a magic in 1994. The yen appreciation in 1993 (125 to 100) and again in 1995 (100 to 80) cancelled out the domestic stimulation. The ODR was further lowered to 1.0% in April 1995 and to 0.5% in September 1995. The record low interest rate has been maintained for three years, waiting for a sign of recovery. The yield curve became flat. The long-term government bond yield became less than 1% in September 1998. The low interest rates are unprecedented in modern history of Japan or any other industrial nations.

As of September 1998, there has been no recovery in fixed investment or consumer durables which would be responding to a low interest rate in normal circumstances. An expansion in monetary base (monetary base increasing at around 9%) does not result in increase in M2 (increasing at around 3%), or lowering interest rate. A situation like this is termed a liquidity trap in Keynesian economics. Although the intereset rate target of the Bank of Japan was lowered from 0.45% to 0.25% in September, 1998, investment does not respond. Investment seems to be insensitive to the interest rate.

Increasing money supply, or credit lines, would not increase output, because the confidence among businesses are lost at the floor of the interest rate. Indeed, the current macroeconomic situation in Japan *is* under a textbook liquidity trap (flat LM curve) and insensitive investment (vertical IS curve). Keynes had a solution for such a situation–fiscal policy.

Fiscal expansion under the liquidity trap will not increase the interest rate, thus not crowing out private investment. It seems so straight-forward. Even if reducing fiscal deficits is desirable as a medium term objective in this aging society, desirability of a discretionary counter-cyclical policy is not diminished. The credibility of the Japanese government in reducing deficits when the economy booms, like the 1980s, would not be lost even if the government exercises a discretionary policy in a recession. So far, a straight Keynesian prescription applies.

(3) Reasons for reluctance

Then, why was the Japanese government so reluctant in using this policy? There are three possible explanations, contradictory among themselves, for the reluctance before the summer of 1998.

First, some economists believe that Keynesian textbook, on which the above reasoning is based, is wrong. In other words, Keyensian fiscal stimulus is ineffective. Evidence is in the record of Japanese fiscal stimulus in the last six years. Facing slow growth, the government has adopted five stimulus packages in various stages, cumulative of 60 trillion yen. However, the average growth remained at around 1 percent. Although it is debatable how much of it was a genuine increment and how much repackaging of existing package, a sizable fiscal stimulus appears to have had a little impact.

Second, the public opinion has it that fiscal spending in Japan is wasteful. Shares of public works spending in the budget have been more or less fixed for years. Agriculture-related investment—Agricultural irrigation, agricultural road, forestry road, and fishery port improvement—receive disproportionate shares in the budget. Costs of tunnels and bridges in relative to benefits are questioned. Therefore, critics argue, fiscal spending is a waste of tax-payers' money.

Third, there is a political constraint. The Hashimoto government has just passed the fiscal consolidation legislation. It would hurt credibility of the government if it changes the course only a year later. This reason was removed by the defeat of Hashimoto government in the House of Councilors election of July 1998.

The first objection from non-Keynesians clearly overlooks the issue of benchmark. Without fiscal stimulus, the growth rates would have been in the negative territory. The underlying economy was so weak that fiscal stimulus did not bring the economy all the way to a potential growth rate. A question remains what prevented the economy from getting back on a self-sustained growth. Were there a series of bad shocks? Or has the dynamic spill-over effect of fiscal packages become smaller in the 1990s?

The second objection has some merits. Clearly, if government investment is poured in projects which do not significantly improve productivity or living conditions, would it still be worthwhile? In fact, a hard-core Keynesians would say, "yes." Any spending, whether productive or unproductive, would increase aggregate demand would serve the purpose. Keynes himself used an example of building a pyramid, totally nonproductive investment, in order to raise aggregate demand.

However, it is obvious that wasteful investment would not be as desirable as productive investment. Moreover, those who oppose public spending on the basis of

wasteful investment should look to another avenue for stimulus, namely tax cut. A hard-core Keynsian would argue that the multiplier from fiscal spending is much higher than tax cut. One billion yen of public spending would raise GDP by anywhere between 1 and 2 billion yen, while one billion yen tax cut would not raise even 1 billion yen, as some of the tax cuts are not spent but save.

Third objection is based on a political constraint. However, the Hashimoto government should have reflected on the choice between a slow decline in political support due to coming negative growth with a do-nothing approach and a calculated risk in explaining the need for temporarily shelving a medium-term fiscal consolidation plan.

(4) Income tax cut

So what is a real option? Here, I deviate from an old-fashioned Keynesian approach, by promoting tax cut. I have three reasons: (i) Fiscal spending has been wasteful from the supply-side point of view; (ii) In the medium term, current fiscal spending will increase fiscal deficits in the future by committing fiscal funds to maintain wasteful structures being built by current fiscal spending; and (iii) Tax cut will boost the consumer confidence. In the medium term, the dynamic multiplier from well-designed tax cut will be no less than that of fiscal spending.

Tax cut should take the form of permanent income tax reduction and temporary consumption tax reduction in the specified housing-related expenditures. Temporary income tax cut will not stimulate the economy because it will not affect life-time (permanent) income from which consumption decision will be based. Temporary consumption tax (VAT) reduction will kick start the economy, but it will cause a problem of reactionary recession when it is terminated, creating another volatility. However, a specific sector, namely the housing sector, can be targeted to stimulate the economy with desirable impact on the supply-side. The housing sector was hit by a last-minute rash before the consumption tax increase of last April and a subsequent crash.

In fact, it was announced in the spring of 1998 that individual tax cut and corporate income tax cut would be introduced. However, Prime Minister Hashimoto was swayed between permanent income tax cut and temporary income tax. The flip-flop must have cost him several points in the July election of the House of Councilors.

(5) Housing-related tax cut

Further measures can be considered. Given that housing structures are still

underdevelped in Japan (compared to the United States and European cities), tax break for housing structures is a good long-term social policy. Housing is probably a least-satisfactory aspect of Japanese living standard, and encouraging measures on housing would be desirable. However, a notion of punishing by tax a "luxury" home has prevailed. The problem is that the definition of "luxury" has not changed much, while Japanese income has grown dramatically, in the past decades.Moreover, housing investment is particularly hard hit, structural incentive is a good countercyclical policy. Eliminating consumption tax of 5% on the value of new housing structures should be considered to revive the housing sector. Indeed, many kinds of tax relief (eg reduced rates of real estate tax, real estate registration tax) and subsidies (of government Housing Finance Agency loans), designed to encourage owner-occupied housing, does not apply if a house is larger than a rather conservative restriction (currently 240 square meters).

The currently-available tax break for owner-occupied housing is income tax credit for new home owners. This also is limited for a moderate income earner (15 million yen taxable income) with a moderate-size house (up to 150 square meters) and a large housing loans balance (30 million yen). There is an elaborate scheme of calculating tax credit, but the ceiling of tax credit is 300,000 yen for 6 years. This can be replaced by more comprehensive deduction of housing loan interest payments from taxable income without limitation of qualifying housing size, taxable income level, or the number of years for qualification.

Larger houses will encourage purchases of consumption durables. In many households in Japan, limited floor space is holding back purchases of larger refrigerators, TVs, personal computers, and other household goods. Notorious Japanese "salary-men" stays late at companies, or wine and dine with colleagues, and rarely see children while awake, partly because there is no study or space for him at home.

In sum, putting incentives for larger houses will stimulate the housing and real estate industry, consumer durables industries, slow down aging by promoting a larger family, and increase family satisfaction. The following incentives are recommended: eliminating housing structures consumption tax, eliminate housing-size restrictions on reductions of real estate tax and real estate registration tax; replacing restrictive and limited income tax credit for home-owners by a US type tax deductible housing loan interest rates without income restrictions.

(6) Public works reform

If there is a way to insure that public works are spent on productive projects,

that should be done both for a counter-cyclical reason and for long-run supply-side argument. It is just too wasteful right now to continue the current bureaucratic and political system to decide which projects to be funded. One way to force project evaluations by markets is to fund public works by project bonds, rather than direct government spending. The market will evaluate the viability of the project and price bonds accordingly. Some critics would say that most projects, with social purposes, are not viable in commercial terms. The policy intervention, based on either public goods nature of projects and economic benefits externality to the community, can take the form of interest subsidies or government guarantees on principal. But it is important that investors evaluate the different projects on its merits. If some projects command high interest rate, reflecting risk premium, it also broadens the capital market for high-risk high-return financial products, which currently are provided by Samurai bonds issued by emerging market government entities. For example, Central Bank of Romania, National Bank of Hungary and the Mexican government have issued Samurai (yen-denominated) bonds at 5.8 - 6.0 percent coupon rates in the past several years. Would some of the projects in Japan, say the Hokkaido Bullet Train project and the Chubu New International Airports near Nagoya, be as risky as those sovereign papers? If Japanese investors invest in project bonds in Japan, structures are built in Japan stimulating the economy, which desperately needs a push.

Project bond schemes should be applied to most public works: agricultural irrigation, fishery ports, agricultural road, forestry road, inter-city highways, metropolitan highways, airports, bullet trains, dams, and so on. The market mechanism will make it harder for the wasteful projects to be adopted. As wasteful projects are not realized, fiscal deficits will be contained (both as current expenditures and future maintenance).

Non-project based government spending should be concentrated on social infrastructure. A complete sewage network, improved sidewalks in cities, and more computers in schools, reduction in the student/teacher ratio, can be achieved by increased general spending. It is most shocking to learn that sewage connection is not 100 percent even in Tokyo. A plan for extension can be accelerated at this recession.

(7) Financial Crisis

Japan experienced a near banking crisis in November 1997. First, the Sanyo Securities, a medium-size securities firm, failed. It applied for a rehabilitation (protection from creditors) so that the asset was temporarily frozen and a default on the interbank market loan was defaulted. That sent a shock wave, and changed the behavior of foreign institutions. The Hokkaido Takushoku Bank (Takugin, for short),

one of the 20 international banks of Japan, and the Yamaichi Securities, one of the Big Four securities firms failed in that month. Although both institutions were rumored in the market to have had problems in their balance sheets, but many believed that something would be worked out to rescue them, rather than being liquidated. Takugin was scheduled to merge with Hokkaido Bank (Dogin, for short), as announced on April 1. However, the merger talk broke down over the summer.

The Ministry of Finance had announced earlier (as early as 1995) that none of the 20 international banks would fail, so the news that the Takugin failed was received with a surprise. It was the largest bank failure in the post-war Japanese history. The Yamaichi failure was also a surprise for some observers because of its status as one of the Big Four.

The way Takugin and Yamaichi failed was widely regarded as an evidence of past mistake in government policy. First, while the government had promised to extend a blanket guarantee to deposits while the deposit insurance was running out of the funds. Second, how other weak financial institutions would be dealt with was unclear. Both failures prompted a sense that no institutions are too big to fail, and the stock market negatively.

Economists and policy observers abroad were also alarmed by the failures of Takugin and Yamaichi. When an internationally active bank fails, there is risk of spillovers to other countries through a payment system and money market. International risk was minimal in the failure of the Sanyo Securities and Takugin. The Sanyo had little international business. Yamaichi had an extensive banking business abroad through subsidiaries, and there was a fear that it might trigger a crisis. One of the reasons that Yamaichi chose to "decertify" itself rather than "bankruptcy rehabilitation with protection from creditors" was that the latter would freeze the assets, possibly causing a chain reaction.

In fact, the Yamaichi failure prompted a strong pressure from abroad to do something to avoid a melt down of the Japanese financial system.

Stock prices of many financial institutions became sharply lower, which was only reversed after the government announced to put 30 trillion yen to help banks recapitalize and consolidate. The government screened and purchased the preferred stocks or subordinated debts of the 18 largest banks and three regional banks in March just in time to help their capital ratios for the fiscal year ending March 31.

Another jolt hit the banking sector in the summer of 1998. The Long-term Credit Bank (LTCB) became a source of instability, as it was suspected that LTCB was near insolvent (A first credible report was published in May that LTCB nonperforming loans were far more than believed.) It was arranged that the Sumitomo Trust Bank

would merge LTCB, after due diligence. In addition, the Liberal Democratic Party tried to inject public funds to LTCB in order to improve the balance sheet before the merger. The plan of pre-merger injection of public funds was criticized by the opposition parties. In the Diet session which started in September, two different plans, one from LDP and another from a coalition of the opposing parties, to restore confidence in the financial sector was submitted.

A group of economists formed the Shadow Financial Regulatory Committee (Japan) in 1998. Its second recommendation on the situation of bank supervision was issued in September 1998. (See Appendix to this paper.) The group pointed out that there are important principles, such as shareholders' responsibility and management responsibility that should be pressed when the government intervention is attempted. However, the difference between the LDP's proposal and opposition parties' proposal was narrow. The group urged politicians on both sides to compromise on the outstanding issues on how to deal with large banks that are near insolvent, with the case of LTCB in mind.

(8) Prospects

The government is deciding on the details of a necessary supplementary budget in May and finalizing it in the Diet session in the fall. The magnitudes of tax cut and public funds will be at around 16 trillion yen. The size is crucial in lifting the economy out of the downward spiral and consequential collapses of more financial institutions. However, political temptations of funding vote-maximizing public works on wasteful projects should be resisted. Income tax cut and reform on housing-related taxation, giving more incentives for larger houses, are recommended. The growth in 1998 has been lost. The growth rate will be at –1.5 to –2.0%. With a strong fiscal stimulus package, the economy may grow at around 1 percent for 1999. The government is also deciding with opposition parties how to recapitalize banks, and establishing a rule to take over weakly-capitalized banks.

III. Nonperforming Loans problem[1]

(1) The problem

The nonperforming loan problem has plagued the Japanese economy for several years, and it is a major reason for the very slow growth of the Japanese economy (the average growth rate being about one percent per annum for the last seven years). Nonperforming loans are largely a result of the burst bubble (a sharp decline in real

[1] This section draws on Cargill, Hutchison, and Ito (1997). The book was written based

estate prices). Financial institutions that had lent to real estate companies and developers became beset with loan that were not repaid, or ended up seizing collateral whose market values were far below the book value.

The problem became complicated by the stock price decline, since Japanese banks traditionally hold a large amount of securities. The accounting rule dictated (until March 1998) that the bank balance sheets show the lower of the book value or the market value of securities. The difference between the market and book values (which amounted to be huge during the bubble years of the late 1980s) was latent capital gain (*fukumi*), which was counted as a part of bank tier II capital in the BIS risk-based capital standard. Banks had held securities for a long time, and stock prices had gone up tremendously in the 1960s and 1970s.

The problem was not addressed early or decisively. Mini financial crises, occurred in the last four years, gradually convinced a change is overdue. However, policy has been reactive to a crisis, rather than proactive to prevent it. A decisive action on nonperforming loan problem is needed to prevent a further shrinkage of the Japanese financial institutions and markets.

(2) Mistakes dealing with the problem

A first wave of crises occurred in 1995, when the problem that Japan had created became apparent to financial experts, if not ordinary people. Although small financial institutions had been merged with help of the Deposit Insurance Corporation (DIC) since 1991, it was not until August 1995 when the Hyogo Bank, a bank listed in the stock exchange, was closed for the first time. The problem of housing loan financial institutions (*jusen*) was also resolved in 1995. However, the result was tilted in favor of agricultural cooperatives which had lent to *jusen.* There was a loss of credibility on the part of the bank regulators. It was also in 1995 when a trader in the New York branch of Daiwa Bank was found to have hidden a huge loss. The delayed reporting to the US regulators has cost the Bank an operating license in the United States, and the credibility in bank supervision by the Ministry of Finance was further damaged.

The yen appreciated to 80 yen per dollar in April 1995, and affected the export industries. A pessimistic view on the economy prevailed. The stock price index declined below 15,000 mark. Banks' *fukumi* declined and affected their balance sheets.

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on information up to 1995. Recent materials are added for this article.

Bank lending declined, and further affected the real economy. The official discount rate was cut from 1.75% at the beginning of the year to 0.5% in June. A fiscal stimulus package was also introduced.

With these ample signs of financial distress in 1995, policy responses were less than adequate. First, the regulators believed that, by solving the jusen problem with burdens on banks, a major part of the nonperforming loan problem had been solved. The monetary authorities proclaimed that none of the 21 largest banks would be allowed to fail. The authorities would not be able to maintain the too-big-to-fail policy. Moreover, moral hazard among bank executives became prevalent after the "too-big-to-fail" policy was announced. Second, by denying the seriousness of the problem, the authorities could not prepare a scheme that would inject fiscal funds to solve the problem, or to inject enough funds for deposit insurance corporation. This made it impossible to act decisively—closing down insolvent or near-insolvent banks and sell of assets with losses. Third, the monetary authorities failed to enforce accurate accounting rules. Moreover, the authorities changed accounting rules to hide nonperforming loans.

These mistakes prolonged the nonperforming loan problem, and finally erupted into a full-blown crisis in November 1997.

(3) The Magnitude of the Problem

At the end of September 1995, the volume of non-performing loans amounted to 10% of Japan's GDP and 6% of all the loans held by Japan's depository institutions. It was estimated that the total amount of nonperforming loan made by Japanese banks amounted to ¥27 trillion. These estimates might have been too low, however. Published estimates of nonperforming loans from private sources typically ranged between ¥50 trillion to ¥60 trillion, or about twice the official estimate. These higher estimates of nonperforming loan often included loan overdue between 60 and 180 days (beyond 180 days they are counted in the Ministry of Finance's definition of nonperforming loan), restructured above the official discount rate (the official definition of nonperforming loan counts only those that are restructured with the interest rate below ODR, and somehow estimated an amount of cumulative loans toward interest payments (*oigashi*)).

In November 1997, the government announced new criteria for nonperforming loans, and nonperforming loans problem according to the new criteria. The first category

includes normal, performing loans; the second category includes performing loans with some concerns for the future; the third and fourth categories correspond to nonperforming loans. The sum of second, third, and fourth categories amounted to 79 trillion yen. From 1994 to 1997, banks used various resources to write off nonperforming loans. Japanese banks realized latent capital gains (*fukumi*) to write off nonperforming loans, in addition to use current profits. However, stock prices have come down in the 1990s, and banks have realized some of the gains to help write off nonperforming loan losses.

Japan's banks, once regarded as among the most financially secure in the world, have been continually downgraded by credit rating agencies. In August 1995 Moody's Investor Service released a new rating system for the major Japanese banks that does not incorporate the government support they enjoyed. The new rating system is designed to rate banks on a 'stand alone' basis, without government support, and is a 'measure of the likelihood that a bank will require assistance from third parties such as its owners, its industry group, or official institutions'. According to the new Moody's rating system, no Japanese bank received a rating of A (exceptional intrinsic financial strength) or B (intrinsic financial strength), and the top 50 Japanese banks received an average rating of D (adequate financial strength limited by a variety of factors). In January 1996, Moody's cut its debt ratings of three Japanese banks and that of the Yamaiachi Securities Company.

(4) The Problem of *Jusen* Companies

The *jusen* companies were created in the mid-1970s as subsidiaries of banks, securities firm, and life insurance companies. The *jusen* companies initially expanded to provide consumer credit. Much like consumer finance companies in the US, they borrowed from other institutions since they were not permitted to accept deposits. As the corporate sector reduced its dependence on bank credit after 1975, however, banks began to turn to consumer finance, and in the 1980s, they became aggressive lenders to individuals. In response to the aggressive bank competition for individual loans, *jusen* companies turned to real estate lending in the second half of the 1980s to substitute for the lost consumer lending business.

In April 1990 the Ministry of Finance introduced guidelines to banks to limit total lending to the real estate sector; however, lending by *jusen* companies were exempted. During 1990 and 1991, *jusen* lending increased rapidly as a result of funds provided by agricultural cooperatives and their prefecture federations. Concerns over the quality

of assets held by *jusen* companies were raised as early as 1992, and a 10-year rehabilitation plan was arranged for the seven *jusen* companies in the spring of 1993.[2]

The problem of the *jusen* companies became the focus of an intense political debate in 1995 and even overshadowed the problem of banks' non performing loans. In August 1995, the Ministry of Finance conducted a special examination of the *jusen* problem. Of the total ¥13 trillion of *jusen* assets, non performing loans were estimated at ¥9.6 trillion, of which ¥6.4 trillion was considered unrecoverable and ¥1.2 trillion was considered a possible loss. This is more than one-fourth of all losses incurred by financial institutions to date.

The Ministry of Finance and the suppliers of funds to *jusen* companies agreed to dissolve the seven housing-loan companies, and in July 1996 the *Jusen* Resolution Corporation, now known as the Housing Loan Administration Corporation, assumed the ¥6.4 trillion of unrecoverable loans extended to failed *jusen* companies.

The majority of the funding of *jusen* companies came from the 21 major banks and agricultural credit cooperatives, each providing about the same levels of funding (¥5 trillion for the 21 banks and ¥5.5 trillion for the cooperatives). Other funding sources were regional banks (¥1.1 trillion), life insurance companies (¥0.8 trillion), and others (¥0.6 trillion). Agricultural cooperatives' being the largest supplier of funds posed a major policy issue. If the potential loss of ¥7.6 trillion is divided in proportion to the outstanding loans to the *jusen* companies, the agricultural cooperatives would have to write off more than ¥3 trillion in losses. This was not possible, however, since these cooperatives operated with a small capital base.

Politicians and Ministry of Finance officials suggested that banks should shoulder a more than *pro rata* share of the *jusen* losses. The precedent for this approach had already been set when banks were required to provide a more than *pro rata* share in schemes for dealing with failing institutions (the Cosmo Credit Cooperatives, the Kizu Credit Cooperatives and the Hyogo Bank) in July and August 1995. Banks not related to these institutions were asked to contribute to the loss-sharing scheme by contributing capital or by making below-market-rate loans to banks that assumed the

[2] Lending to *jusen* companies was structured so that 'parent' banks (major shareholders in the *jusen* companies) were required to reduce the interest rate on outstanding loans to 1.5% and agricultural cooperatives (and their prefectual federations) were to receive 4.5% interest income from *jusen* companies.

assets of the insolvent institutions. The argument made to justify these requests was based on the public-good characteristic of the financial system and on the need to maintain stability, and to ask responsibility beyond the legal framework. The policy of requiring unrelated bank to contribute directly to bailout schemes was referred to as the 'all-Japan' rescue scheme.

In December 1995, the government proposed a resolution plan for the seven insolvent *jusen* companies. The plan has two shortcomings. First, the sharing of the burden was not equitable. Rather, it reflected the political strength of the agricultural sector. The Banking Bureau Director General of Ministry of Finance had secretly signed a memorandum of understanding with his counterpart at the Ministry of Agriculture during the debate over cost sharing of the financial crisis. The heavier burden on banks also reflected the public perception that 'founder banks' (banks that had set up *jusen* companies as subsidiaries) were providing personnel to manage operations and were referring potential borrowers (who turned out to be high-risk customers) to *jusen* companies. Second, the political opposition to using tax funds was strong.

The perception of increased risk in Japan's banks at large resulted in a 'Japan premium' in the Eurodollar market --- a premium over the London interbank interest rate required of Japan's banks. The premium increased further when Daiwa Bank was discovered to have covered up derivative losses, amounting to at least $1 billion, resulting from a 'rogue' trader in New York.

The *jusen* problem also reflect problem of smaller institutions in Japan, such as agricultural credit cooperatives. These are: a) Credit cooperative have diversified significantly away from their traditional specialization on loans to farmers related to agricultural operations; b) Some credit cooperatives have strong ties to the local community and to local politicians; c) Credit cooperatives hold significant amounts of real estate related loans; d) They are not regulated and supervised by the Ministry of Finance or by the Bank of Japan, and local regulation and supervision are uneven in extent and sophistication. Significant risk resides in these small institutions because of the substantial uncertainty as to where they stand in Japan's deposit-guarantee system.

Thus, by the end of 1995 the *jusen* problem, the problem of non performing bank loans and the risk exposure of large numbers of small financial institutions were seen as major and unprecedented policy issues. The financial debacle in Japan is at least as

great as the collapse of the savings-and-loan industry and the related banking problems in the US.

(5) The Regulatory Response to the Problem of Non performing Loans

On August 18, 1992, the government announced a temporary rule change that allowed corporations to defer reporting stock-portfolio losses until the end of the fiscal year (March 1993), permitted other accounting innovations that delayed or concealed the impact stock price and land price declines on reported assets, allowed banks (in special cases where a loan default would have adverse social effects) not to report interest concessions as taxable income, directed the Postal Life Insurance System to support the stock market via funds provided to trust banks, postponed sales of government-held shares of Nippon Telegraph and Telephone, and Japan National Railways, used administrative guidance to encourage institutional purchases of equities and discourage institutional sales of equities, and provided less-than-candid estimates of the magnitude of the problem of non performing loans.

The Cooperative Credit Purchasing Company (CCPC) was the first visible effort to deal with the problem of non performing loans. The CCPC now appears to have been set up primarily to provide accelerated tax benefits to the large banks without requiring the banks to directly write off loses and acknowledge the losses in their public reports. Banks were required to lend to CCPC the amount equivalent to the value of assets, so if the assets are finally sold to the market from CCPC with losses, banks are still held responsible for the losses.

(6) Banks' Response

Japan's banks have been increasingly setting aside funds in special accounts to eventually write off loses. Special provisioning by 21 banks increased from ¥1.9 trillion in March 1993 to ¥3.0 trillion in March 1994, and to ¥4.3 trillion in March 1995. Sumitomo Bank took a more drastic step, charging losses of ¥826 billion to write off bad loans and showed losses in its annual report for the period ending March 1995. But despite varying degrees of problems with nonperforming loans, Japan's banks continue to pay dividends. Dividends per earnings actually increased when the decline in earnings was taken into account.

The banks could pursue more aggressive remedies. More aggressive organizational restructuring, such as selling assets and subsidiaries (branches or foreign operations) or cutting personnel costs, could reduce operational costs.

(7) Assisted Mergers and Deposit Insurance Corporation

In 1991, the regulatory authorities, for the first time in the postwar period, officially assisted mergers of insolvent depository institutions with stronger institutions, using the resources of the Deposit Insurance Corporation (DIC), the larger of Japan's two deposit-insurance agencies. Since 1991, however, the DIC has publicly assisted a small number of problem institutions, and the two more recently assisted institutions have exhausted the DIC's reserves. The details of the assisted mergers reveal a disturbing pattern about the ability of Japan's regulatory authorities to effectively administer deposit guarantees and limit 'moral hazard'.

The scheme that the DIC can assist has evolved over time. Before 1993, the payoff (liquidating the bank and pay off the depositors, up to the deposit insurance amount) was the only option for DIC. After 1995, the DIC was allowed to make a "gift" to a white-knight institution that will merge an insolvent institution, up to the amount that is equivalent to the payoff. There are several cases that the payoff equivalent was not enough so that other contributions from "related" institutions were sought. (See Cargill, Hutchison, and Ito (1997, ch. 6, esp. Table 6.4) for cases of assistance.) A resolution took time because individual cases had to be handled differently. Then in 1997, the law was amended again to remove the ceiling of payoff equivalent. The coffer was replenished by government capital injection (pledge), and insurance premium increase. It was also amended that merger of two institutions can be assisted (one does not have to be insolvent). These steps are progress in broadening the scope of deposit insurance. However, the supervision side is lacking in the DIC (Financial Supervision Agency is a different entity), and there is a fear that a blanket guarantee by the government is causing moral hazard.

(8) Banking Crisis of November 1997

In November 1997, the Hokkaido Takushoku Bank, one of the 19 largest banks, and the Yamaichi Securities, one of the Big Four securities companies, failed. The immediate cause was that these insitutions could not get funding for overnight loans in the call market (interbank market), because the market regarded that it was too risky to lend to these institutions. Although both institutions were known to be weak, the failure was a surprise. The government had announced in 1995 that largest banks would survive, as well as all deposits would be safe. Despite its promise, deposits to the Hokkaido Takushoku Bank had continued to be withdrawn in 1997.

The market interpreted that the failures of the two large financial institutions as a

sign that the government had lost a grip on the financial market. The stock prices of other weak financial institutions plummeted in Tokyo and the 'Japan premium' soared to 100 basis points in the international market. It was feared that other collapses of financial institutions in Tokyo would disrupt functions of the world financial markets.

The government belatedly promised to strengthen the deposit insurance corporation by issuing 30 trillion yen government bonds for protecting deposits from failed institutions and for injecting capital to banks. The government was belatedly realized that only fiscal authorities can help the financial system.

The government also allowed banks to adopt an accounting method which may hide the unrealized capital losses from securities holdings. This was designed to clear the capital adequacy requirement at the end of March 1998, as the average stock prices slumped at around 16,000 yen. This was another cosmetic face lift.

(9) How to use 30 trillion yen effectively

Although a plan to appropriate 30 trillion yen was a response to the panic which followed the Hokkaido Takushoku Bank and the Yamaichi Securities. Of 30 trillion, 13 trillion was to be used to inject capital to solvent, but thinly capitalized, banks, while 17 trillion was to be used to protect depositors in insolvent, failing institutions. In March 1998, a first wave of capital injection, amounting to less than 2 trillion yen, was carried out to 21 banks (18 large banks plus 3 regional banks). However, due diligence, which was supposed to be a pre-condition, was less than adequate. The inadequacy became apparent, when the Long Term Credit Bank, which received capital injection, became attacked in the market in June, and was forced to seek a rescue merger.

(10) Capital-Adequacy Requirements

One issue that complicated resolution of Japan's banking problems concerns stock price fluctuations and the application of capital-adequacy requirements. Japan's banks commonly hold stocks of their large corporate customers with which they have long term cross-shareholding relationships in the same enterprise groups. Since these stocks have typically been held for some time, they contain unrealized capital gains that are not reported on balance sheets. The latent capital gains (*fukumi*) have been a huge buffer in the capital position among the Japanese banks that had been relatively undercapitalized.

In 1988, at the time of the adoption of the Basle capital-adequacy requirements, the

Japanese monetary authority negotiated successfully for latent capital gains to be counted as a part of near-capital (tier II capital). This was expected to make it easier for Japanese banks to meet the Basle requirements and looked reasonable in 1988 and early 1989, before the bubble burst. As stock prices plummeted, banks suddenly faced a shortage of capital because latent capital-gains fell significantly.

Whenever the stock prices declined sharply, banks became squeezed. This stock-market induced credit crunch happened in 1992, 1995, and 1997. Although the decline in stock prices in 1992 were largely offset by issuing subordinated debts (*retsugo sai*), bank lendings were cut after 1995.

(11) Deposit Guarantees

Before the start of liberalization in the mid 1970s, Japan's deposit guarantees were supported by an extensive set of constraints on portfolio decisions. From the 1950 to the early 1970, financial system was one of the most regulated and administratively controlled in the world. These controls limited the ability of financial institutions to assume and manage risk; at the same time, they left the deposit-guarantee system untested.

Japan has relied upon administrative guidance by the Bank of Japan and the Ministry of Finance to monitor institutions, impose regulatory discipline, intervene in financial markets and force mergers. This is an activist approach in implementing deposit-guarantee, and the degree to which Japanese regulatory authorities are willing to regulate financial institutions is far greater than in most countries despite almost two decades of liberalization. Japanese financial regulation has historically been predicated on a 'no-failure' policy and has not relied on a deposit-insurance framework that explicitly recognizes the possibility of failure. As a part of the 'no-failure' policy, deposit guarantees are interpreted broadly. It is illustrative that Sumitomo Bank's announcement in Jan. 1995 that it expected to become the first major Japanese bank to report an annual loss in the postwar period was regarded as a major attitudinal change on the part of private banks and the Ministry of Finance.

Until recently, Japan's deposit-guarantee system has not been tested because of a variety of reasons. Its macroeconomic environment has been conducive to a smooth and gradual evolution toward open and competitive markets. Price stability generated only a small gap between regulated and unregulated interest rates and thus provided few incentives to innovate. The absence of open money markets limited the means to

innovate; and regulation and administrative guidance have been quite binding.
The major part of Japan's deposit-guarantees is that offered by the Deposit Insurance Corporation for banks and other deposit taking financial institutions other than credit cooperatives, which protects up to 10 million yen per person per a bank. However, an explicit commitment by the government to protect all deposits until year 2001 has been added to calm the market in 1995. There exit another deposit insurance for specialized depository institutions, mostly credit cooperatives and an explicit deposit-guarantee commitment to the Postal Savings System.

The Deposit Insurance Corporation and the much smaller Savings Insurance Corporation have counterparts in many countries. However, the Postal Savings System --- the largest financial institution in the world --- is a less understood financial intermediary. The system, established in 1874, has come to play a major role in Japan's public sector activities, especially in the postwar period. It is regulated by the Ministry of Posts and Telecommunications, placing the ministry among the three major financial agencies in Japan (after the Ministry of Finance and the Bank of Japan). In 1992, the Postal Savings System even began to publicize the fact that postal deposits were more secure than bank deposits.

The Postal Savings System has been a focal point of discussion during the past two decades. Two issues seem particularly important in the context of the deterioration of the financial system in the 1990s. First, a significant part of the flow of funds is likely to be allocated on the basis of strong political connections rather than on the basis of economic criteria. Postal savings funds are easily accessible to the Ministry of Finance to bail out troubled financial institutions, especially the housing-loan companies. The Ministry of Finance in 1992 even directed the Ministry of Posts and Telecommunications to use funds from postal life insurance to support equity prices in the Tokyo stock exchange.

Second, the existence of Postal Savings System in essence allows a dual system of complete deposit guarantees and ensures that Japan will not easily be able to solve the conflict between liberalization on the one hand and deposit guarantees that encourage risk taking. Postal Savings System thus stand at one end of the deposit-guarantee system. At the other end are large city and regional banks that for all practical purposes are regarded too big to fail.
At some point Japan will need to deal explicitly with the Postal Savings System because of its size and its potentially destabilizing role in the deposit-guarantee

system. Privatization, apparently the most efficient long-term solution, is bound to run into stiff political opposition.

(12) Lessons of the Non performing Loan and *Jusen* Problems

In the context of the growing public awareness of the nonperforming loan and the *jusen* problems, as well as intense international pressure, the government in Dec. 1995 initiated a series of reforms. Six legislative bills were introduced and passed by the Diet. Unfortunately, reform of the supervisionary framework was omitted from this round of reforms. Some observers question the effectiveness of any reform as long as the Ministry of Finance --- whose indecision is primarily responsible for delayed response to the *jusen* problem --- remained the primary financial regulatory authority. Documents show that the Ministry of Finance made the first on-site examinations of *jusen* companies in 1991-92 and found that 67% of loans made to the largest 50 borrowers were already non performing. *Jusen* companies were, however, allowed to operate, because it was assumed that land prices would rise in the near future. As land prices continued to decline, nonperforming loans held by the *jusen* companies increased by 75% in the next four years.

(13) Moral Hazard

Moral hazard --- incentives to assume more risk because deposit guarantees remove depositor discipline as a constraint on risk taking by depository institutions --- is a serious problem despite a general unwillingness by Japanese regulatory authorities to recognize that fact. The two credit cooperative suffered from a classic case of moral hazard in their last two years. Deposits at both institutions increased from ¥139 billion in March 1992 to ¥244 billion in November 1994 (an annual rate of 32%), while lending increased from ¥137 billion to ¥225 billion (an annual rate of 22%). The majority of the new loans made during the period were ultimately classified as nonperforming. The total nonperforming loans of the two credit cooperatives increased from ¥250 billion (out of total loans of ¥1,371 billion) in March 1992 to ¥1,769 billion (out of total loan of ¥1,990 billion) in March 1994. Moreover, unrecoverable losses increased from ¥65 billion in March 1992 to ¥1,118 billion in March 1994. Not only did the two credit unions aggressively expand deposits to make new, higher-risk, loan during their decline into solvency, total non performing loan increased sevenfold and unrecoverable losses increased sixteenfold between March 1992 and March 1994. In addition, rapid increases in deposits were made possible by offering above-market deposit rates.

Another moral hazard was apparent after 1995. Efforts by large banks to write off nonperforming loan were not enough. Dividends were still paid out, and management stayed. No major consolidation and restructuring took place until the crisis of November 1997.

(14) Big Bang

The aftermath of asset inflation has revealed serious problems in Japan's financial system and structure of regulation. In many ways, Japan's regulatory authorities appear to be committing the same policy errors that US policymakers did several years earlier. Japan's deposit guarantee system remains bimodal, makes little effort to impose discipline on depositors or shareholders, and relies on a passive regulatory attitude. The Japanese government announced that a new regulartory regime would emerge by March 2001, when the blanket guarantee for deposits will end. A new financial supervisory authority, which is spun off from the Ministry of Finance, is created.

The big bang policy, a comprehensive deregulation of financial markets, was announced in November 1996. The first step was taken in April 1998 by deregulating the Foreign Exchange Law and regulation. Now anyone can trade and transact foreign exchanges, without being brokered by authorized banks. With the deregulation, Japanese residents can open accounts in foreign institutions abroad directly. With a competition from abroad, financial institutions (Japanese and foreign) in Japan also became aggressive in pursuing 1200 trillion yen of household saving. The MMF and foreign bonds, which offer higher yields than yen deposits, became popular. Exodus of saving is believed to be partly responsible for yen depreciation after April 1998.

The current deterioration of the financial system may force the Bank of Japan to give increasing consideration to prudential objectives in formulating policy --- and those objectives may conflict with domestic price stability. The newly created Financial Supervision Agency has a difficult task in implementing a stringent standard, and force banks to take actions. Concerns with prudential policy are always present. However, the willingness to directly subsidize the banking sector on the basis of vague arguments of systemic risk has imposed serious costs on the economy at large. With failures of Hokkaido Takushoku Bank and the Yamaichi Securities, no banks and securities firms feel safe under the market pressure. Combined with a new regime of financial supervision, the Japanese financial system is undergoing significant changes.

Without strengthened supervision regime, the big bang will result in a big failure.

IV. Asian Countries: Some Parallels ?

It has been shown that a currency crisis and a banking crisis occur simultaneously in a mutually reinforcing manner. (Goldstein (1997), Kaminsky and Reinhart (1995)) A country with banking crisis is often develops into a currency crisis, either by capital flight or being attacked by speculators. A currency devaluation often put banks with foreign-currency denominated liabilities into a serious trouble. East Asian countries were no exceptions.

Thailand had problems with the finance company industry (a form of nonbanks). Finance companies were just like *jusen* in Japan, in terms of their funding, investment, and how they got into trouble. (For the structure of banking systems in Asia before the crisis, see Institute of Global Financial Studies (1998).)Asset prices in Thailand increased sharply in 1993–1994. Then, with a prospect for growth waned, the asset prices plummeted in 1996. By the end of 1996, one commercial bank (Bangkok Bank of Commerce) and several finance companies developed serious nonperforming loans problem. The Bangkok Bank of Commerce failed The Bank of Thailand supported them with emergency loans through the deposit insurance fund. However, eventually 16 finance companies were suspended in late June (just before the devaluation of July 2), and 42 more suspended in early August (just before IMF support package). (See Ito (1998) for details.) Those which lent to finance companies were affected by failures of them. This is also like Japanese banks that lent to jusen.

Korean banks were extending loans to chaebol group firms. As chaebols expanded into industries which were not previously covered by their operations, banks were forced to lend money to them. When the “diversification strategy” failed, banks were left with nonperforming loans. Another route of problems was through merchant banks (nonbanks). They escaped banking regulation and lent to real estate sectors.

In summary, the banking problem in Asia is either a trigger or a complicating factor of the currency crisis. It is easy to say that over-presence of the banking sector increased the vulnerability, and that the equity and bond markets were underdeveloped. However, for developing countries, human capital in the financial sectors is limited, and it is a difficult choice whether banking or securities industries should develop first. The Asian experience poses this question.

In the case of Japan, it is more inexcusable. As the economy was integrated into a global system, a better policy should have been devised earlier. On the one hand, regulation was too much. Segmentation into banks, long-term credit banks, trust banks, smaller financial institutions, securities firms, life-insurance companies, and

non-life-insurance companies should have been ended earlier. Basically, the "Big Bang" should have taken place ten years earlier. "Gradualism" allowed rent-seeking financial institutions to make crucial mistakes during the bubble years. On the other hand, regulation was too little. Financial deregulation should have been accompanied by strengthened supervision and a legal framework. For example, Japan should have had a framework to fail banks. That is the total plan is ten years late with benefit of hindsight, or at least five years late without benefit of hindsight.

V. Concluding Remarks

In this paper, I have described the challenges that Japan and Asia currently face. Japan with negative growth has few options to lift the economy. The weak banking system is limiting the options of monetary and fiscal policy.

Despite the large devaluation, Asian export booms are yet to come. Japan, a large absorber of Asian exports, is struggling to restore its growth. The weakened banking system cannot provide financing for viable industries. Asian exporters suffer from credit crunch.

Restoring a robust financial sector is a number one priority for Japan and many Asian economies.

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