４３rd. Project Seminar **2003.2.4**

Speaker **Alicia Giron Professor, Instituto de Investigaciones Economicas, Mexico**

Subject **Japanese Financial System**

Commentator **Masahiro Kawai**

Chair **Takeo Kikkawa**

Giron stressed that she is by no means a specialist on Japan, and that, with but an extremely short time in which to do the research for this presentation, she has relied extensively on a small number of elite interviews and English-language journals.

Giron divided her presentation into five sections: background facts; a chronology of major events from the bubble to the Big Bang; a discussion of deregulation and the development of Japan's capital markets; an overview and commentary on mergers, acquisitions, foreign shares, and overall bank-sector health; and a brief conclusion describing needed policies.

Giron began her discussion of background facts by recalling the outbreak of crisis at Nippon Credit Bank in January and February 1997. With market rumors of the bank's imminent failure current, the bank's share price began to plummet, falling 19% on February 5 alone. The bank publicly denied any possibility of crisis, and the Minister of Finance supported this position, calling failure of NCB "impossible" or "unthinkable." This episode perhaps indicates how little Japan's banking authorities understood the gravity of their situation, to say nothing of their policy options.

Giron then jumped to November, 1999, by which point the priority of the state had shifted from management of bank crisis per se to economic stimulus. On November 11, Prime Minister Obuchi's cabinet approved a 4.17 trillion yen spending package, which the Economic Planning Agency forecast would boost economic growth in fiscal 1999 from 0.5% to 0.6%. This marked the first time the agency had upgraded a GDP forecast in 15 years.

Giron next recalled the sale of the nationalized Nippon Credit Bank to a consortium led by Softbank. The deal was finalized on August 25, 2000, at a cost to taxpayers of nearly three trillion yen. The sale was a step in "opening up the nation's cosy banking sector to ambitious outsiders," and, for Noboru Matsuda, head of the Deposit Insurance Corporation, a measure that "will contribute to the further stabilization and rebirth of the Japan's financial system."

Giron finished her account of background events by jumping to the very recent present. On January 21, 2003, the Nikkei reported that Mizuho Financial Group would raise 1 trillion yen in new capital by the end of March, "asking a few dozen companies -- mostly domestic firms it does business with, including Dai-Ichi Mutual Life Insurance Company -- to buy preferred shares. We see here, she noted, the world's largest bank attempting to reorganize its operations. On the same day, the Nikkei reported that the Council on Economic and Fiscal Policy submitted Prime Minister Koizumi "a revised outline for economic and fiscal reform that pushes back several key targets" including reversal of deflation. Remarkably, the target date for attaining 1.5% GDP growth was pushed back from fiscal 2004 to fiscal 2006. Meanwhile, in late January, HypoVerinsbank of Germany gave up its attempt to acquire Aozora Bank, leaving Sumitomo Mitsui Financial Group, Cerebuss Corp., and GE Capital in the running. The dramatic story of NCB thus seems poised to enter a new chapter, along with the economic system whose crisis it heralded, but the course of change remains anything but clear. The proposed sale of Aozora to foreign institutions, Giron noted, is fully in line with views of rating agencies that merger with foreign banks is the best path to reform for the Japanese banking sector. Giron cautioned against uncritical acceptance of this belief, however. As we have seen in Mexico, the influence of foreign banks does not necessarily increase even the efficiency of banking operations. It would be a great error of economic policy, she maintained, to assume that foreign banks will prove the solution to the problems in Japan's banking sector.

Giron next presented a more detailed chronology of a longer time frame, beginning with the collapse in 1990 and 1991 of the asset bubble. Drawing on recent interviews, Giron explained that the most basic cause of the bubble and of the effects of its collapse was the practice of bank lending on land collateral valued at inflated prices. July 1991 saw the first bank failure, June 1996 the amendment of the Deposit Insurance Law, November 1997 a full blown banking crisis, March 1998 the first capital injection (of 1.8 trillion yen), June 1998 the collapse of Long-term Credit Bank of Japan, October 1998 the Financial Reconstruction Law and the Financial Function Early Strengthening Law, March 1999 the second capital injection (of 7.5 trillion yen), and April 2002 the scheduled (though postponed) lifting of blanket deposit protection. The Big Bang, of course, got underway and has proceeded in this crisis setting. In December 1997, banks were allowed to form holding companies. April 1998 saw deregulation of equity commissions on transactions of over 50 million yen. In June 1998 the FSA was established. From December 1998 banks were permitted to distribute investment trusts through their branches. Securities derivatives have been fully deregulated. From October 1999 banks were allowed to issue straight bonds to fund lending. Commissions on equity trades have been fully liberalised. As of March 2001 banks are allowed to sell insurance policies. From March 2002 banks are allowed to engage in all trust banking business. The most significant impact of financial reforms to date has been the increased involvement of the large commercial banks in the securities industry.

With this chronology in mind, Giron proceeded to discuss deregulation and the development of capital markets from a wider perspective. As in other countries, deregulation and liberalization of the financial system occurred throughout the 1980s and 1990s. Moreover, liberalization and deregulation have usually been followed by banking crisis. As the World Bank report of May 1998, *International Capital Markets*, makes clear, in the last fifteen years the world has seen at least 150 banking crises in 70 countries. This is only natural, she argued, given that banking sectors are usually strongly protected by the government; exposing them to competition is very apt to send them into bankruptcy. It is important to recognize, she stated, that banks are generally protected on the reasonable grounds that unlike other industries, they hold the savings of a nation's people and thus cannot go bankrupt without causing grave economic damage to a large number of people. The implication of this, she argued, is that the wisdom of exposing banks suddenly to competition is not simply an economic problem, but primarily a political problem.

In Japan, however, deregulation accelerated tremendously with the Big Bang, which began on April 1, 1998. The Big Bang was adopted in an effort to open up the financial market and thereby strengthen Tokyo's status as one of the world's leading financial centres. Thus, one response to the bank solvency crisis has been further deregulation -- including the Big Bang -- and the encouragement of foreign direct investment and mergers. "Motivated largely by distress," Giron noted, "Japan's large banks have engaged in a series of defensive mergers, accompanied by government assistance in unloading bad debt." In 1990, Mitsui Bank and Taiyo Kobe bank formed Sakura Bank. In 1991, Kyowa Bank and Saitama Bank created Asahi Bank. A potential merger between Daiwa and Sumitomo was undermined when Sumitomo's hard bargaining violated prevailing industry norms, Giron stated. In April 1996, the Bank of

Tokyo and Mitsubishi Bank merged into the then-largest Bank of Tokyo-Mitsubishi.

These "bigger is better" mergers, however, did not solve the large-bank sector's problems, Giron noted, as "gains in microeconomic efficiency were slight and these banks' inability to lend compromised any possible economic recovery."

This has not made mergers less attractive, obviously. As Giron explains, borrowing from Helweg (2000), "a decade into the post-Bubble period, virtually all large Japanese banks have been merged or suggested for merger. Many analysts favor more mergers and deregulation, even while not hopeful that these steps will either solve banks' bad-debt problem or restore Japanese macroeconomic growth."

It is important to note that the wave of bank mergers has accompanied a cutting of longstanding links between banks and non-financial firms. Another striking feature of the merger wave is that, carried out as a defensive measure against crisis, it has not facilitated any expansion of Japanese banks abroad. "Indeed," as Rowley (2000) notes, "Japanese -owned banks' presence in the U.S. market has been cut even while U.S. investment banks -- Merrill Lynch and Ripplewood Holdings -- have successfully entered the Japanese market." This increased presence of foreign institutions in Japan, Giron expects, is but an early stage in a trend that will see tremendous pressure throughout the domestic banking system to carry out mergers with foreign institutions.

The wave of mergers is also consistent with a worldwide trend, which amounts to a major change in corporate governance.

Giron next gave some hard numbers, of failed depository institutions in Japan from fiscal 1992 through December 2001. Eighteen banks, 23 credit unions, and 128 credit cooperatives had failed.

With bank failure a strong and ever-present possibility, lender-of-last-resort functions become a vitally important topic. Giron explained that there are five types of ways in which the state may perform this function in Japan: emergency liquidity assistance to a failed bank, liquidity provision to interbank markets, emergency liquidity assistance to a failed non-bank, provision of risk capital to a financial institution, and emergency liquidity assistance to a temporarily illiquid financial institution.

With this, Giron turned briefly to politics. Why does Koizumi enjoy such a high support rating in spite of the fall in the stock market and continuing deflation? The answer may lie in part, she suggested, in the fact that many people -- those with stable incomes and no housing loans -- may benefit more than suffer from deflation. However, as deflation destroys people's accumulated wealth, one still expects it to take a higher toll on cabinet approval ratings.

Now, to the all-important question of policy: Giron discussed the challenge to the current orthodox view of macroeconomic policy, that the responses to crisis conceived in the 1980s should be applied with equal confidence today. But Joseph Stiglitz has argued that the prescription of restrictive fiscal policy and negligible inflation is out of place. Mexico prior to its crisis of 1994 and 1995, and East Asia prior to its crisis of 1997, were famed as successful applications of the model; but both collapsed into severe balance of payments and financial crisis. In the case of Japan, it is difficult to see current economic difficulties as not due largely to the legacy of the collapse of asset prices and the overhang of debt and capital reflected by the nonperforming loans.

With this in mind, Giron tentatively recommended "aggressive monetary expansion and targeted fiscal stimulus combined with financial cleanup." She went further than this, however, and provocatively called for nationalization of the banks (or at least state assumption of their NPLs), called attention to the crucial importance of money creation, noting that the single monetary policy device of lowering interest rates seems incapable of guaranteeing that the banks perform this function, and Bank of Japan intervention to combat deflation. None of these recommendations, she noted, should be taken as denying the need for reform beyond measures guaranteeing economic expansion; better lending practices and performance by the banks are clearly needed.

In any case, Japan poses a new phenomenon which we are unable to confront with standard economic theory. The Japanese crisis, she argued, calls for the development of new theory. As an example of the considerations such theory must accommodate, we can cite the challenge of the aging society, and the apparent lack of effect of unprecedentedly loose monetary policy. This need for revising our basic theories is reflected in the changing ideas of Ministry of Finance officials concerning the effects of the collapse of the bubble on economic growth. She cited a former MOF official, who explained that for several years into the 90s he was convinced that economic stagnation reflected the working out of the debt overhang legacy of the 1980s but has since come to view the aging population as a more powerful drag on growth.

A successful policy response to Japan's banking crisis is, of course, crucial to the equilibrium of global economic, political, and social forces. At the same time, the international environment affecting Japan's prospects is complex and dangerous, given the three-year old slump in financial markets, the lingering effects of the Asian crisis (especially in the Philippines and Taiwan), the perilous state of China's banking system and its likely consequences for China's participation in international commerce, the Latin American situation, and appreciation of the euro.

Giron concluded by apologizing for her rudimentary knowledge of Japan.

Professor Kawai served as discussant. He began his remarks by stating that had he had as little time to research and present on Mexico he would not likely be as successful as Giron had been in discussing Japan. He expressed regret, however, at the lack of testable hypotheses in her presentation.

There is a great deal of debate, he explained, on many aspects of Japan's recent and current financial system.

First of all, there is little consensus among economists on how the bubble started or on its role in the stagnation of the Japanese economy, he claimed. Some argue that the bubble was a result of overly expansionary monetary in the latter half of the 1980s, others that it was truly a bubble, due to unwarranted expectations concerning the future of the Japanese economy. Now, why the bubble collapsed is a less debatable question. Policy makers hated the bubble and devoted concerted effort to destroying it. Monetary policy became tight at the end of the 1980s. Lending restrictions were also tightened. Tax measures were also introduced to stem speculation. What happened in the post-bubble period, however, is open to debate. For example, was monetary policy too restrictive in the early 1990s? I and many other economists believe that the Bank of Japan continued fighting the bubble several years after it had collapsed, failing to recognize the magnitude of the consequences of the collapse of the bubble.

Why the Japanese economy continued to stagnate throughout the 1990s is yet another question, Kawai explained. This phenomenon may be completely independent of banking sector phenomena, due to more basic structural weaknesses in the economy, reflected, for example, in the decline of productivity growth. Finally, the question of why NPLs remain of such magnitude over ten years after the bubble has more recently justly attracted attention.

Kawai moved on to consider three issues suggested by Giron's talk related to the evolution of financial crisis and financial system crisis. First, we may take from Giron's talk, he said, a division of Japan's recent financial history into three periods: the bubble, the early 90s following its collapse, and the period since 1997. The reason for dividing the post-bubble period in two is that financial system crisis really occurred in 1997. Prior to 1997, serious problems with the banking system were evident, but fiscal policy sustained the economy. In 1996, the economy seemed to have a chance of recovery, which would have made the banking sector problem less acute. After 1997, however, the nature of the crisis was different.

The bubble and collapse of the bubble hurt three major sectors: real estate, construction, and distribution (such as the department store and supermarket sectors, which had expanded during the bubble period). These sectors were supported by continued fiscal resources throughout the 1990s. And because of growth in 1996, the government concluded that the economy was in decent shape. In 1997, fiscal restraint was introduced, the economy started to lose steam, and the financial sector was also affected. 1997 was also the year of Asian crisis. As Giron explained, however, the Asian and Japanese crises are really separate events, though the argument could be made, Kawai said, that the Japanese financial market system was one of the causes of the Asian crisis through its overextending loans to Asia.

Kawai noted that even though the financial system was clearly in crisis from Fall 1997 through early 1998, deposits never flew from the banking sector. Some weak commercial banks saw deposit flight, but not the banking sector as a whole. Some large financial institutions found themselves unable to obtain liquidity on the interbank market, but the Japanese financial crisis is peculiar in the sense that there was no deposit flight into, say, foreign currency assets. Japan has a huge pool of assets, and the people somehow seem to believe that domestic assets are safe. While there was nonetheless undeniably a crisis, the absence of a bank panic may be one reason the government decided not to nationalize major banks besides Nippon Credit and the Long-term Credit Bank.

Another debatable aspect of Japan's banking crisis and recent changes in its financial sector concerns problems in the corporate sector. The banking sector problem reflects problems with borrowers; if borrowers are bad, commercial bank portfolios become bad. By the end of the 1990s, problems in a substantial part of the three sectors above were addressed. Nevertheless, substantial restructuring in these and other sectors, including even manufacturing (witness Nissan) was needed. Essentially, a substantial part of the bubble-related industries have been taken care of by the commercial banks. Still, new nonperforming loans continue to arise. This, Kawai maintained, is not really a legacy of the bubble. Collapse of the bubble creates many problems for large borrowers because of lack of collateral, but this is not the primary cause of the emergence of new NPLs. They have emerged because of the stagnant economy, deflation, and other causes.

Thus, problems in the financial sector have to be seen as the mirror image of problems in the productive sector. Analysing the NPL problem also requires, though, that we understand the distinction between the "stock" problem and the "flow" problem which the NPLs indicate. The stock problem is that commercial banks have a large stock of nonperforming loans. These can be eliminated, and banks' balance sheets thus cleaned up, by transfer to asset management companies like the RCC or the IRC, public entities. But even if this is done, a serious "flow" problem will exist: many of banks' borrowers are competitively weak. Similarly, the government may come in and recapitalize banks, but if the underlying corporate sector is bad, and there are thus few good companies to lend money to, the banks cannot restore their own soundness. This flow aspect of the Japanese economy, Kawai explained, has been extremely weak and vulnerable for at least the last five years. Thus, the policy issue is how to resolve the stock problems of the banks and at the same time restore the soundness of flow of the economy.

The policy problem is compounded, or institutionally complex. At one and the same time it presents problems in the banking sector, which the FSA must address, deflation, which the BOJ must combat, fiscal policy and tax policy problems which the MOF must address, and a need for industrial restructuring strategies led by METI and other ministries with jurisdiction over various productive sectors. While FSA has to be aggressive in pushing banks to reduce NPLs, to take care of stock problem, revitalizing the corporate sector is very important. Thus, other ministries must ensure industrial sector restructuring, and the BOJ has to stop deflation and create mild inflation. ("Mild," Kawai explained, means that while inflation of 10% or 20% is not desirable, inflation of perhaps 2% or 3% is needed; nominal GDP must grow for the problem to be resolved.)

Giron interjected at this point that she and her colleagues some years ago had done a study of the Mexican banking sector and found NPLs growing faster than GDP from 1991 through 1993 -- in other words, at a time of high optimism for Mexico's future in advance of the conclusion of NAFTA. "Only crazy academics", she said, were concerned with NPLs at that time. But the course of the Mexican economy since has borne out the truth of their concerns. Having ignored the problem for several years, the government eventually took measures to "clean up" bank balance sheets; but these effectively ignored problems in the real economy which the NPLs reflected.

Giron expanded on this theme by arguing that the "restructuring" of the productive sector that should perhaps concern economists most is the restructuring being wrought without a plan through globalization. One of the causes of the Asian financial crisis, she argued, was the growth of exports from China; and the ongoing transfer of Japanese companies' production facilities to China and Latin America is another source of stress on the world financial system. Thus, in addition to breaking the post-bubble era into smaller periods, we also need to analyze the productive economy into individual markets and sectors to some extent and study how they are differently affected by competition in international trade. A recent IMF meeting in Hong Kong, she recalled, had produced an announcement that the world needs a new financial architecture. As if on cue, the Hong Kong stock market "failed" the following October (1997).

At this point, the floor was opened to the audience. One audience member who had studied the explosion of nonperforming loans in Mexico contrasted the speed with which the problem was handled in Mexico to the tremendous prolongation of the problem in Japan. She hypothesized that what made the difference in Mexico was the pressure exerted by external actors, in particular Spanish and US banks, and the international financial organizations. The contrast between the cases, and the hypothesis are strengthened, she noted, by comparison of the mergers that took place in response to crisis in the two countries. In Mexico, "big banks took over small banks and assumed clear managerial authority." In Japan, on the other hand, banks of comparable scale have merged with each other, and managerial responsibility has been left extremely vague.

Giron responded by questioning the significance of any comparison of these two countries. As the questioner suggested, she said, the profound interest of US investors and the US government in Mexico makes it radically different from the Japanese case. The Mexican crisis of 1994 and 1995 threatened US mutual funds holding *tesobonos*. The two governments responded to this problem by a "deal" between their presidents, under which the US government transferred money to Mexico which was effectively paid out to US banks and mutual funds once the situation had stabilized. Giron went on to argue that "interdependence" between Mexico and the US is so close as to make devaluation almost a non-viable policy option for Mexico. Devaluation makes it impossible to obtain needed imports and immediately stimulates inflation, to which the central bank inevitably responds by tight monetary policy, making growth impossible and thus making the foreign reserves painfully acquired over the years extremely vulnerable to any hike in US interest rates. Japan, with its immense reserves, is in an altogether different situation, she concluded.

Kawai basically supported the questioner's hypothesis, but went on the explain that the decisive constraints that have allowed Japan to act less quickly than Mexico are not all external constraints. Japan has had "huge wiggle room." Thanks to fiscal reforms and extraordinary bubble-era tax revenues, Japan had restored fiscal balance in the 1980s, and has been willing to use fiscal resources to respond to crises and stagnation in the 1990s. Foreign reserves, domestic savings, a trade surplus, and other such resources have allowed Japan to put off hard decisions about how to respond to the banking problem. Meanwhile, policy makers have generally believed that economic growth would pick up and thus make the problem smaller. While the descent into crisis of 1997 showed them that something had to be done, even this is not comparable to the sharp constraint of negative growth we have seen elsewhere, such as Argentina. Politicians' attempts to protect their contributors are made easier because things can get a good deal worse without producing a massive social crisis.

It should also be recognized, Kawai noted, that Mexico didn't solve its bad loan problem by cleaning up bank balance sheets. Loans were effectively transferred to the state, but they remain largely uncollected with no final action on the borrowers having been taken. (Giron confirmed this statement.) During the Asian crisis, policymakers from the crisis countries and the IMF were considering setting up Mexican-type state-run asset management bodies, but abandoned the idea in part on the grounds that the Mexican solution had not addressed basic problems.

In the Japanese case, a decision seems to have been taken to clean the banks' balance sheets first, and to proceed with more aggressive corporate sector restructuring once this banking measure has restored some stability and created some breathing space for painful reforms.

The audience-member's question stimulated presenters and other attendees to agree tentatively to carry out comparative study of the Mexican and Japanese cases, perhaps for presentation at a later symposium.

Shortly before the conclusion of the symposium, another audience member returned to the issue of Japanese bank mergers. The mergers have created a serious problem of corporate governance, he claimed, because the holding-company governance structure adopted by at least three mega-banks has made it much harder for stockholders to bring suit against bank directors for inappropriate lending activities. Nobody at the symposium claimed the expertise necessary to address this issue. It was, thus, deferred, hopefully to be addressed at a symposium in the near future.

（記録　Jonathan Bloch）