Restoring Japanese confidence

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Prospects for Japan's financial sector have improved significantly this year but further restructuring is still necessary. In his new year speech, Prime Minister Hashimoto put stabilising the financial sector at the centre of his Government's immediate policy aims. It is easy to see why.

The situation in Japan's financial sector reached a low ebb at the end of last year. The collapse in quick succession of Hokkaido Takushoka, Japan's tenth largest bank, and of Yamaichi prompted a sharp loss of domestic and international confidence in Japan's financial sector. In particular, Yamaichi's hiding of bad loans off balance sheet drew attention to the lack of transparency in the Japanese system and fed worries that others may have broken the rules, with bad loans larger than announced. The Japan premium soared.

Before discussing the Government's response and the outlook it is important to understand the origin of difficulties in the financial sector. There have been two contributory factors. First, the inability to deregulate the financial sector at a faster pace. Second, the bursting of Japan's Bubble in 1990 and the subsequent poor economic performance left the banks and securities firms nursing bad loans.

Regulations governing the financial sector were established after the second world war with one aim in mind, to establish Japan as a leading industrial economy. To achieve this success, barriers were established between different types of banks and financial institutions, limiting the business they could engage in. The specialisation this encouraged proved successful for some time, helped by the booming economy, but regulation constrained competition.

The financial sector should have been deregulated in the 1980s, when the economy was booming and any shake-out could have been handled easily. Yet, because things were going well, there was little pressure to change. The situation altered after the Bubble burst, and the Nikkei collapsed. The financial sector was left nursing bad loans, discouraging deregulation. Instead, big banks had to bail out smaller and more vulnerable ones.

Government action

By the end of last year the deteriorating situation in the financial sector left the Government with a stark choice. Either the Government had to step back and allow a long overdue shake-out of the financial sector to take place, or a huge cash injection was needed to restore confidence. The latter strategy was adopted as the Government feared the problems in the financial sector were dragging down the real economy, which it felt was in relatively good shape, despite weak demand. The aim was to stabilise the financial system and hope this would help to restore confidence in the economy.

To be successful the Government's measures needed to address four areas: ensure liquidity, restore confidence, improve transparency and boost the economy. Some of these areas are now being addressed.

The Bank of Japan is playing a key role, providing liquidity. Money market rates are kept down and through rinban operations the Bank of Japan is contributing to low bond yields. Yet, with monetary growth so sluggish, the Bank of Japan needs to inject more funds.

Restoring confidence

Some of the measures needed to restore confidence amongst domestic depositors and international investors have been announced, but not all of them. The Government has boosted the size of the Deposit Insurance Corporation (DIC). This fund is used to protect depositors' money in the event of a bank or stockbroker going bust, and is also to be used to boost the capitalisation of the banks.

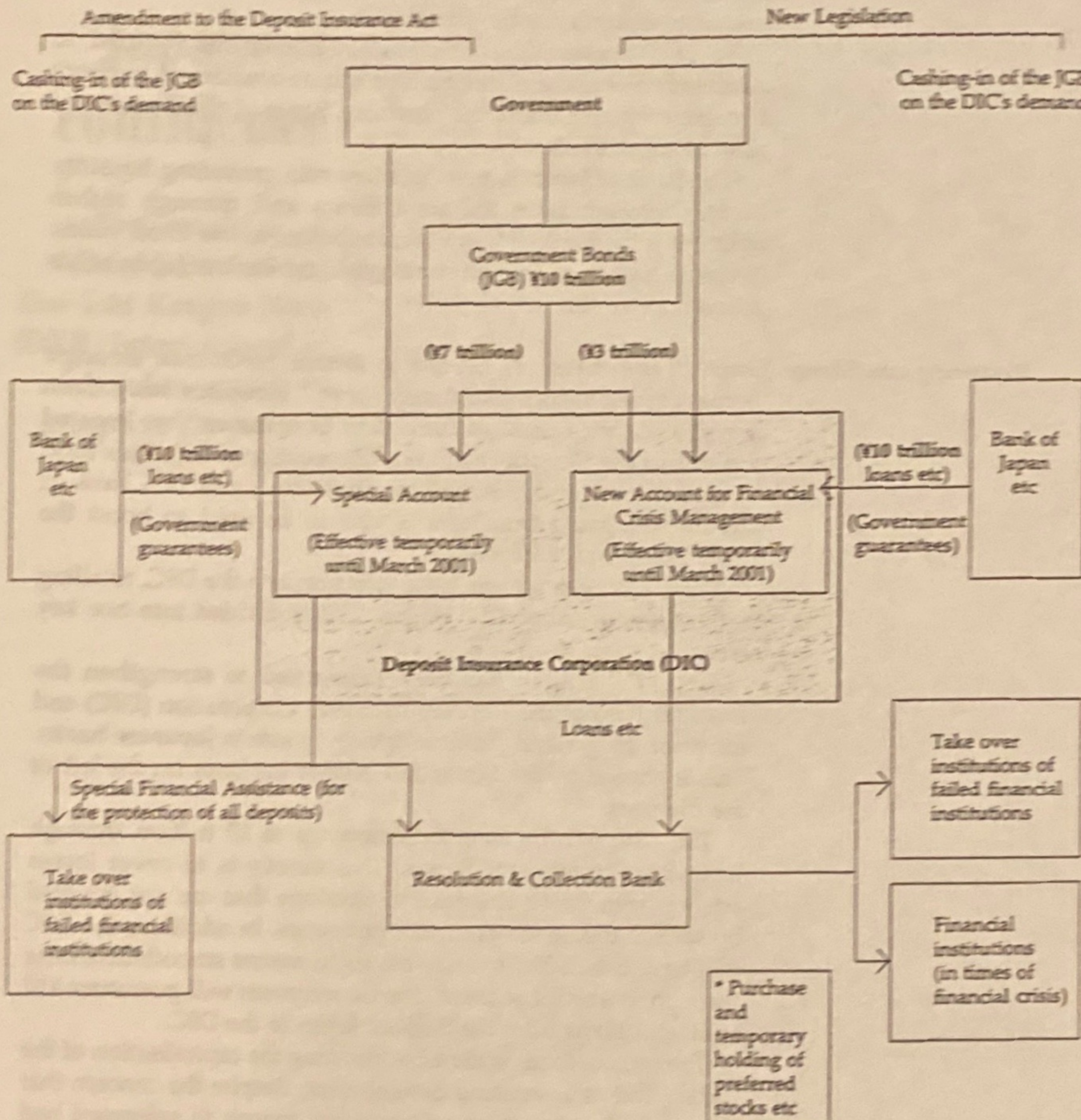
There has been a huge fiscal injection into the DIC, totalling ¥30 trillion, or about $250 billion. This is divided into two key areas.

First, ¥17 trillion has been earmarked to strengthen the financial base of the Deposit Insurance Corporation (DIC) and convince the general public its money is safe in Japanese banks. This is shown by the boxes and connecting lines on the left of the diagram.

The DIC will be able to borrow up to ¥7 trillion through Japanese Government Bonds. This money is to cover losses arising from failed financial institutions that are not covered by special insurance premium payments. In addition, the DIC will have the ability to issue bonds to ensure smooth financing through its special account. The Government will guarantee ¥10 trillion in loans from the Bank of Japan to the DIC.

The second focus is aimed at boosting the capitalisation of the banks. This is a welcome development, despite the concern that this could be seen as using taxpayers' money to safeguard bad banks, a classic moral hazard problem as bad behaviour would not be penalised. The aim is to ensure banks can meet capital adequacy requirements, and in the process ensure international confidence is maintained. Another important intention of this policy is to prevent a credit crunch. Faced with a deteriorating environment there was already evidence at the end of last year of a credit crunch, with banks selling assets, shrinking their balance sheet and restricting loans. Avoiding a credit crunch is crucial for ensuring an early rebound in economic activity.

Framework of emergency measures for stabilising Japan's financial system



*Requiring unanimous approval after a thorough review by a newly established neutral "examining body".

NOTE:

1. Special Account is to protect the deposits that exceed ¥10 million. New Account for Financial Crisis Management is newly established to purchase and hold temporarily preferred stocks issued by financial institutions, aiming to stabilise the financial system.
2. In addition to the accounts mentioned above, DIC has the Ordinary Account that serves to protect deposits up to ¥10 million.

Source: Ministry of Finance

The new legislation is aimed at easing any financial crisis by allowing Government backed purchases of subordinated debt, or preferred stocks from banks. A new account at the DIC will allow such stocks and bonds to be acquired via the Resolution and Collection Bank (RCB). ¥13 trillion will be available for this, ¥3 trillion in Government bonds and ¥10 trillion from the Bank of Japan, guaranteed by the Government. A new independent seven person Examination Board will decide on such purchases.

In addition to these direct measures another key development has been the decision to allow banks to revalue land assets at current market price and not book value, allowing any profits to be non-taxable. Although land prices have fallen significantly in recent years they are still way above the level at which banks bought them. This, and the recent rally in the Nikkei, should ensure all major Japanese banks meet international capital adequacy requirements.

Transparency would help

Although the Government's injection of funds into the financial sector is welcome, there was a strong case for opting instead for a shake-out in the financial sector through the market mechanism. Yet, for this to have succeeded, complete transparency of information would have been essential, so no bad loans are hidden by banks and no securities firms can hide losses in the same way as Yamaichi.

There has been a significant attempt to improve transparency, with new figures on banks' bad loans. The new figure of ¥76.7 trillion is almost three times higher than the previously released figure, not because the previous figure was wrong but because a stricter definition is being used. The new figures are based on a self-assessment by banks of their own asset quality. Thus the common but unproven market perception that banks under-reported their bad loans under the old system could also be applied to the new numbers. Furthermore, the criteria used to construct the new data may vary between banks, with some being stricter than others. And, just to complicate matters further, there was a wide time span when banks conducted their self assessment and compiled their results, stretching between March 31st and September 30th. Economic optimism deteriorated dramatically during this six months.

Under the new system loans are divided into four categories. Category IV is the worst category where loans have no value or are non-collectable. The amount of Category IV loans is ¥2.695 trillion. Category III covers credits where banks expect losses but it is difficult to say when the losses will occur, or how much they will be. The amount is ¥8.724 trillion. Category

II is a broad category where the loans may have some risk, depending on the case by case exposure. Many of these will be recoverable. This will include some Past Due Loans which were counted as bad loans under the old system. The amount of Category II loans is ¥65.289 trillion. There are ¥548.156 trillion of loans in Category I, the best classification.

Japanese banks are also heavily exposed to any problems in Asia. Latest BIS data shows that at the end of June 1997, Japanese banks had lent $276.2 billion to Asia. The biggest exposure of $87.4 billion was to Hong Kong, whilst $84.6 billion had been lent to the three troubled economies of Thailand, Indonesia and South Korea. A conservative assessment suggests Asia's problems will increase the size of bad loans by one-tenth.

Economic boost

The fourth essential measure is the need to use fiscal policy to boost the economy. A stronger economy clearly improves prospects for the banks. Japan, as the world's largest saver, has sufficient money to sort out its own problems. With demand sluggish, the key is whether people and firms will regain confidence to spend. If they do not spend, then it requires a fiscal boost, either to encourage the private sector to spend or, if that does not happen, for the Government to spend.

Wimbledon scenario

Despite recent problems the Japanese Government should remain committed to its timetable for Big Bang. In Japan recently there has been much talk of the Wimbledon effect, where Tokyo may be able to compete as one of the world's major financial sectors, but it could be dominated by foreign players. This is possible, but it is also very likely that the major Japanese banks and securities houses will be able to compete effectively.

Already there is excess capacity in Japan's financial sector, and this is likely to be increased by a fresh injection of foreign capital ahead of Big Bang. As was the case in London, there is likely to be further restructuring, involving a necessary shake-out. It may be painful, but it will eventually result in a leaner and fitter Japanese financial system.