insight JAPAN

The quarterly magazine of today's Japan

ISSNNO966–8071 • DECEMBER 1998 • Vol.7 No.3 • £2.50/¥780

Japan's natural environment: the city

Japan tackles its problems

When Japan's economic bubble burst in 1990 the economy faced both demand and supply side problems. The demand side problem was the weakness of spending. The supply side problem was the need to deregulate and open up key areas of the economy to greater competition. One area where change was needed was the financial sector. In the early nineties the Japanese Government addressed the demand side problem through a succession of spending packages. However, little attempt was made to address the supply side problem. Thus, whenever one fiscal package wore off, the economy was still weak and another stimulus was needed.

The lesson was that fiscal policy could not solve all Japan's problems by itself. Demand and supply side problems need demand and supply side solutions. Now, the Government is addressing both problems. However, deregulation and supply side changes can make the immediate economic situation worse, pushing unemployment higher and adding to uncertainty. But as supply side change is necessary this means the Japanese economy has to get worse before it gets better.

The financial sector will be heavily affected by supply side change and will have a significant bearing on Japan's economic performance in coming years. There are two problems. The immediate problem is the credit-crunch, as banks are unwilling to lend; the next credit crunch is prolonging the recession. Second, once the credit crunch is over the problem will be a shake-out of the financial sector, as small and some big stockbrokers and banks are squeezed out by increased competition.

The credit crunch is a typical example of how a vicious cycle can develop when an economy is in trouble. When Japan's bubble burst in 1990 it left the banks with bad loans, which continued to rise. This eventually led banks to restrict lending, hurting small and medium sized firms. Meanwhile, failures in the financial sector dented consumer confidence, exacerbating economic weakness. As the economy stays weak, bad loans mount, further forcing banks to restrict activities.

One way to stop this vicious cycle is to pump money into the banking sector, but the amount required could be large. The true extent of the banks' bad loan problem is not clear. Over the years, when some stockbrokers and banks have failed, their debts proved to be higher than previously admitted. This cast doubts on the accuracy of the bad loan picture, even though those firms that fail are more likely to be the ones who try and cover things up.

The Japanese authorities have pushed for increased openness and transparency in the financial sector. This has already resulted in a change to the reporting of bad loans. Under the old reporting system, total bad loans in the financial sector were ¥24.98 trillion (£125 billion). A newer, stricter definition similar to that used in the US pushed bad loans up to ¥35.2 trillion (£170 billion). To complicate matters further, a self-assessment by Japanese banks shows ¥76.7 trillion bad loans.

Change the rules, and win

Those who make the rules are most likely to win the game. In figure skating American Janet Lynn, whose free-style technique dazzled spectators and judges alike, nonetheless lost the 1972 Sapporo Olympics competition because an Austrian skater bested her in the dull but compulsory circle-tracking requirement for all skaters. What happened subsequently? The rules were changed in favour of the Americans, enabling skaters to jump and dance instead of tracing circles in the ice. No wonder the top skating medals have since gone mostly to Americans.

While American skaters benefited from a rules change, Japanese athletes competing in the Nordic combined event, which involves jumping and running, suffered from one. After a talented Japanese jumper had repeatedly won top awards in international championships despite his weakness in cross-country running, the event's standard-setting body altered the rules, reducing the number of points previously allocated to the event's jumping segment.

In sports, such alterations usually do little harm to the vast majority of us. Indeed, they sometimes make sports even more entertaining to watch, as was the case with figure skating. But when it comes to changing the rules of international business and finance, one cannot - certainly the Japanese cannot - remain disinterested.

Ten years ago, the Bank for International Settlements (BIS), referred to often as a 'club of central bankers' and located alongside the main railway station in Basle, Switzerland, changed the rules of international finance. Today the International Accounting Standards Committee (IASC) and International Organisation of Securities Commissions (IOSCO), both proponents of Anglo-American accounting principles, are changing other rules. Ten years from now, because of these rule changes, no one will be talking about 'Japanese-style capitalism' because capitalism in Japan is likely to have become indistinguishable from capitalism in the West.

It was 1988 when the seeds of Japan's current banking troubles were planted. In that year, the BIS-hosted Basle Committee on Banking Supervision, chaired by then British central banker Peter Cooke, established a concordat pertaining to capital adequacy ratios required for internationally active banks. The concordat said international banks must maintain reserve capital equal to at least 8 per cent of assets, such as their loan portfolios.

"What if a bank fails to meet the required capital adequacy ratio," one Japanese financial bureaucrat asked rhetorically back

from both sides now GERARD LYONS

These figures are sizeable and explain the banks' cautious behaviour. But the credit crunch is exacerbated by the banks need to achieve 8 per cent international capital adequacy requirements. There must be at least 8 per cent capital to cover assets. If a bank has not reached the 8 per cent target it has either to boost capital or reduce assets. Bank lending is a casualty, leading to the credit crunch.

A weaker yen, as seen in the last year, makes this situation worse. Japanese banks have a high proportion of assets overseas. When banks calculate their capital adequacy requirement they calculate their overseas assets in yen terms and add this to the value of their domestic assets in Japan. When the yen weakens this increases the value of overseas assets. Whenever the amount of assets rises the size of capital needed increases as well. Therein lies the problem. If banks don't have enough capital they will be forced to shrink their loan book. Thus a weaker yen is not good for Japan's economy, contrary to popular perception, as it exacerbates the credit crunch.

In response to the credit crunch, the Bank of Japan has cut interest rates but it cannot address the problem by itself. Hence the importance of the latest ¥50 trillion Government package which aims to inject money directly into the banking sector and thus increase bank capital without a need for them to restrict lending. It should prevent the credit crunch from getting worse, but it is no guarantee the crunch will end. As long as economic pessimism persists, people and firms may be cautious about borrowing and banks wary about lending.

The credit crunch may be Japan's main immediate problem, but it is not the only hurdle the financial sector faces. The second big hurdle is a shake-out in the financial sector, which could result in the disappearance of small and medium-sized brokers and banks, as they are swallowed up by bigger banks. It will also lead to mergers among bigger banks. The shake-out of Japan's financial sector is a natural development that has been seen in other countries.

Japan's financial sector was established after the war, with one aim in mind, to help the manufacturing sector spearhead Japan's economic revival. To achieve this, strict compartments were established between different types of banks. By the late eighties it was already evident the old system needed to change. Now there is too much capacity in the financial sector and greater international competition will exacerbate this situation.

Overall, the financial sector will have a key influence on Japan's economic performance. The immediate problem is the credit crunch. Even though public money will be injected into the banks, this will continue. And even once the credit crunch is overcome, excess capacity in the financial sector points to a necessary shake-out that could have a painful side-effect on the Japanese economy, but will eventually result in a leaner and fitter banking sector.

Dr Gerard Lyons is Chief Economist at DKB International, a subsidiary in London of Dai-Ichi Kangyo Bank, Tokyo

---

TOMOHIKO TANIGUCHI

then, "no one knows for sure who will appear to penalise the errant institution."

That was a testament to the bureaucrat's ignorance. To set the rules is to set the parameters in which the market operates. I suspect that Cooke and Paul Volcker, then chairman of the US Federal Reserve Board who joined the Basle Committee, knew market forces would act as enforcer of the rules. They are doing so right now, in fact, with regard to failing Japanese financial institutions by striking down their credit ratings and, ultimately, forcing some out of business. Early victims include Yamaichi Securities, Hokkaido Takushoku Bank and Long Term Credit Bank, and the list is likely to get longer.

An American scholar later looked into how the argument for a minimum capital reserve requirement proceeded inside the Basle Committee and noted that the concordat was largely the creation of a US-UK joint initiative. Europeans showed at the outset little interest as their banks were sufficiently capitalised. The Japanese were very reluctant to agree because, on the contrary, their banks were severely under-capitalised and, indeed, it is well documented that the US pushed for the requirement as a means of subduing Japanese banks, which were rapidly expanding their businesses in the US. The US Congress was concerned that since the Japanese banks were required to hold far less in capital reserves than US banks, they might outperform their American counterparts on their own soil, as well as around the world. To standardise the capital adequacy ratio, therefore, was in effect a means to keep the Japanese genie in the bottle.

And it worked to an even more remarkable extent than Volcker and the others might have expected. At one time it looked like no big deal for Japanese bankers to fulfil the 8-100 equation. As a compromise struck between Japanese financial authorities and the Basle Committee, Japan's banks were allowed to count half of unrealised gain from their stock holdings as capital reserves. As long as share prices increased in pace with lending, Japan's banks had no problem meeting the capital adequacy ratio requirement.

Then in 1990, Japan's speculative property market bubble burst, deflating dramatically the value of the banks' property and other holdings. Now, with the Nikkei Index in the doldrums with little prospect of a surge, the 'hidden reserves' of Japanese banks have virtually evaporated. As a consequence, they must either enhance their equity capital or trim assets. The former is hardly possible under current market conditions (thus legitimising