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Japan's banks finally start to feel better

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Japan's banking and financial sector finally appears to be past the worst, after a turbulent few years. Policy easing, since last spring, involving lower interest rates, increased government spending and a weaker yen, pulled Japan back from the brink of depression and financial meltdown. Since then, the big banks have announced record half-year profits. However, the sheer scale of the bad loans held by Japan's banking sector suggests it will be some years before they return to complete health. And this long convalescence for the banks is still vulnerable to any economic relapse.

Excessive lending in the late 1980s, particularly to the real estate sector, and the subsequent collapse of the economy, has been the main cause of the banks' problems. It left them with sizeable bad loans. But even if the Japanese economy had been doing well in recent years, deregulation would have triggered a shake-out in the financial sector. After the Second World War the banking and financial sector was established with the aim of supporting industrial growth. Interest rates were regulated and financial barriers separated the functions of different types of banks and other financial firms. In recent years, these barriers have been removed, lessening the distinction between financial firms and adding to competition. Even in good times, this process would have resulted in change. The fact that Japan has been in recession has resulted in this shake-out being severe, with a large regional bank and a number of important credit institutions going broke in the past fifteen months. Merger mania has also started to affect the big banks. Already Mitsubishi and the Bank of Tokyo have joined forces, to create the world's largest bank. Some of the other large banks could follow suit.

Following the bursting of Japan's economic bubble and subsequent recession, the amount of bad loans soared. Many companies to whom the banks lent went bust, were unable to pay their loans or had to renegotiate the terms of the initial loans. Such was the extent of this problem that, at the end of September 1995, the total amount of bad loans held by the Japanese financial sector had reached ¥37.39 trillion (or £230 billion). This is a phenomenal figure, and it has been like a lead weight around the neck of the banks. It has constrained them immensely in recent years. To compound the problem, much of the collateral the banks hold for their loans has been in the form of land – and land prices have continued to fall until they are now little more than half of their 1990 level.

THESE PROBLEMS ADDED TO THE ECONOMY'S WEAKNESS. During recent years bank lending was sluggish. It is still not clear whether this was the result of bad loans limiting the banks ability to lend, a so-called 'credit-crunch', or whether the sluggish lending simply reflected the fact that few companies and individuals wanted to borrow because of the recession. The likelihood is that it was both. Certainly the banks have been reluctant to lend to the property sector. Now these problems are being overcome and a small rise in lending is already underway.

The improving performance of the big banks since last spring suggests that the amount of bad loans is now finally set to fall. In the first six months of this fiscal year, from April to September 1995, the banks reported exceptionally good profits. The total operating profits of all Japanese banks was ¥3.37 trillion (£21 billion) during this six month period. At an annual rate this would be equivalent to ¥6.74 trillion (£42 billion), which is way above the annual average operating profits of ¥4.04 trillion (£25 billion) seen during the five previous years of economic weakness. The banks have benefited enormously from low interest rates. The likelihood is that interest rates will remain low for some months, allowing the banks to continue to enjoy good profits.

Bad loans, at present, account for about 5.3 per cent of total loans. But this disguises a diverging picture. The big banks, like DKB, appear to be in a healthy position. The bad loans of the city banks are about 4.8 per cent of their total loans. But this ratio rises to 7.3 per cent for the three long-term credit banks and to 10.2 per cent for the trust banks. Even within these groupings there are wide discrepancies. Whilst the big banks will be able to write their bad loans off quickly in coming years, the problem will persist for some time for many smaller banks and other financial firms.

INDEED, IN LOOKING AT JAPAN'S FINANCIAL SECTOR it is still necessary to distinguish between the 21 big banks and 'the rest'. Although the big banks are sorting out their own problems, they are likely to be asked to come to the rescue of some of the small banks and financial firms. There has already been some evidence of this with the seven *jusen*, or housing loan corporations. These lent heavily at the height of the property boom and have been nursing huge losses every since. The banks, who had some exposure to the *jusen* have had to foot some of the bill for bailing them out. So too did the general public. As public opinion suggests people are not happy with this, it may be difficult to use public funds again for such a cause, but the likelihood is it will not be needed. In return for maintaining a favourable policy environment to help the big banks recover, it will be expected that they will act as guardians of the smaller banks.

This will smooth the transition to a new financial set-up, dominated by bigger domestic banks. But, in turn, Japanese banks will start to face greater competition at home, as foreign banks and financial firms gradually begin to gain greater access to the Japanese market. All this is another sign of the continuing dramatic change underway in the Japanese economy. After many casualties along the way, the outcome will be a leaner and fitter financial sector. ☐

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