

## COMMENT

Japanese authorities must take action in the wake of the Yamaichi collapse, says Gerard Lyons

# How to restore confidence



Yamaichi's collapse provided the clearest sign that the long overdue shakeout of Japan's financial sector is underway.

It also marks a dramatic change with the past, showing no Japanese firm is too big to fail.

The negative market reaction to Yamaichi's failure was in sharp contrast to that following the collapse of Hokkaido Takushoku, Japan's tenth largest bank, the previous week. Yamaichi's hiding of bad loans off balance sheet has fed worries that others may have broken the rules, with bad loans larger than announced.

The Japan premium has soared. International concern is justified, but if the Japanese Government adopts the right policies, the future for the financial sector could be very bright. The question is whether the right policies will be announced and in sufficient time.

Two factors led to the present situation. 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 the regulations 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 changed 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.

Bad loans have steadily been reduced. At the end of September the total problem loans of the major 19 banks had fallen to 16.1 trillion yen, down 2.9 trillion yen from a year earlier, and most banks have made provisions for these. Whilst the markets are con-

needs to be done, particularly in three policy areas.

First, public money needs to be used to allow the financial sector to return to normality and ensure problems do not spread to sound financial institutions. The Deposit Insurance Corporation, used to safeguard depositors if a bank fails, needs a significant cash injection.

Public money is needed to remove the bad loan problem once and for all. There are two ways to achieve this. The authorities could boost banks' capitalisation by buying their preferred stock or subordinated debt. Better still, Japan could establish its version of the US Resolution Trust Corporation, which was established in 1989 to finance the bail-out of bankrupt US savings and loans firms. Japan's RTC could take the bad loans off the books of the banks and financial institutions, but to do this it needs sizeable funds, raised through increased bond issuance.

Second, Yamaichi's failure highlights the need for complete transparency and effective regulation. Although this may take some time, an essential first step is complete disclosure by banks and brokers of their bad loans, to ensure none are hidden.

Third, a large fiscal boost is needed to ensure economic recovery, making it easier for the financial sector to adjust and help the Nikkei. Life insurers and banks are vulnerable to a falling stock market, as the level at which hidden profits disappear is much higher than before.

These policy measures will eventually have to occur in order to restore confidence and allow the markets to distinguish between the strong and the weak financial institutions. The longer the delay in their implementation the more likely it is there will be further failures of small brokerages and banks. Despite current problems it is essential that the Japanese Government remains committed to its timetable for Big Bang.

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cerned that this is not the true picture, a more valid concern is that new bad loans will be incurred as a result of lending to the rest of Asia, which reached \$264.8bn at the end of 1996. A third of this was to Hong Kong and \$24.3bn to the collapsing South Korean economy.

So far, the aim of the Japanese authorities has been to maintain public and international confidence in the financial system. The focus has been on guaranteeing depositors' money and providing ample liquidity through the Bank of Japan.

But even this has not prevented short-term rates from creeping up, as concern about counterparty risk has risen. More