

**Some Thoughts on Japan's Financial Mess**

**Hugh Patrick**

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Hugh Patrick is R.D. Calkins Professor of International Business and Director of the Center on Japanese Economy and Business, Columbia University.

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by Hugh Patrick

R.D. Calkins Professor of International Business

Columbia University

Today I want to discuss several related topics dealing with the Japanese economy and financial system. First, as a prologue I consider the growth prospects of the Japanese economy during the next 4 - 5 years. Second, a related issue which will be the main focus of my speech, one of the serious problems that the Japanese economy faces and will continue to face in the next few years is that of non-performing loans of the banking system. Their current "financial mess" will be the main theme of my talk today.

### I. Prospects for Japanese Economic Growth

As you know, the Japanese economy is in its second worst recession since the end of the World War II. But that still is not a severe recession by American standards; having a very low unemployment rate, price stability, and low but positive GNP growth do not seem so bad. But from the Japanese perspective it is really the first recession that entirely induced from internal sources rather than from some external shocks. It is a consequence of what was a very long investment growth boom in the real economy and a very spectacular asset bubble in the late 1980s of rises in stock prices and land prices, which then collapsed beginning in 1990 and has persisted until now. The economy has probably now reached its

trough and will start to recover. But analysts expect that it will recover very gradually, a U-shaped pattern rather than V-shaped, over the course of the next 6 months to 2 years. There is not much consensus among Japanese forecasters about the growth rate for the 1993 fiscal year, ranging from well less than 2 percent to almost 4 percent. That is unusual because in Japan there tends to be a quite strong consensus as to what growth rates are likely to be. My own view is that GNP growth will be slow in 1993 but accelerate somewhat next year.

I do not want to focus on the short-run recovery. Rather, I would like to consider the longer run, over the next five years or until the end of the century. Through most of my professional career I have been very optimistic about Japanese economic growth prospects, and I have always been right. So it is tempting simply to continue that same extrapolation. That is: continue to be very optimistic. The specifics of optimism, of course, change as a country goes through different developmental stages. As a follower country, optimism may mean 10 percent growth; as a country becomes more developed maybe it means 7 percent growth; and as it comes closer to the frontier of technology maybe it means 5 percent growth. An optimistic projection for Japan over the next 5 years would be a growth rate of 3.5 to 4 percent because it really is at the frontiers of technological knowledge, it has absorbed the labor out of agriculture pretty well, and in other ways it is quite mature. So for me the key question is: "Will Japan continue to be

an unusually rapidly growing economy for its stage of development, or will it simply become an ordinary OECD country of 2 - 2.5 percent growth."

Two years ago I would have said that Japan will continue to grow faster than most of the other industrial countries. But I must say, right now, I am beginning to feel more cautious and to give more weight to some of the negative factors. I think you all know what the positive factors are. Japan has a very high level of technological development. If there is any business religion in Japan, it is a religion of technological optimism. All businessmen really believe that technology will solve all their problems, and there is much more commitment to that belief than American or European firms have. Maybe the same belief is shared by Korean firms. So Japanese firms have a high technological level and a high commitment to R&D activities that are, by and large, focused on commercial applications, and that is a very positive force for the Japanese economy. In Japan, also, there are very well-educated, hard-working workers with still some possibilities to allocate them to more efficient uses, and that is another positive factor. In addition, the savings rate remains high and on the whole, economic management, both of the economy and of the individual company, is good.

On the other hand, there are minus factors that are new. Labor force growth will come to an end by about 1995. Aggregate

labor input will become a negative factor as there will be a decline in total hours worked starting from about 1995 on. There will be some changes in age composition: average age of the labor force will go up. There are two ways of thinking about that. One is that older workers are more experienced, have more knowledge and therefore, are more productive. The other point is that younger workers are cheap, full of energy, and flexible. I do not think the change in age composition will affect the labor force as much as it does the savings performance because the Japanese household savings rate has been declining gradually but steadily for twenty years; it reached its peak in 1973. We think of Japan as a high saving country when compared to the United States, but that is simply because the U.S. is a very low saving country. When we compare it to Korea, for instance, the Japanese personal savings rate is lower and probably will continue to decline for straightforward demographic reasons; a higher and higher percentage of the total population will be over 65 and they will save at a much lower rate than people who are of working age.

There are several kinds of structural adjustment problems that the Japanese economy, as well as the Korean economy, will face. One for the Japanese is that they still have not completed the transition out of labor-intensive manufacturing. They still have many workers in textiles, in consumer electronics assembly, in many components manufactures such as subcontractors for automobiles and so forth. Much such production is no longer cost-efficient in

Japan so it will eventually have to move offshore. And that means: "How will that process go, and how will that affect those workers of firms being forced out of business?" It will be a gradual process but it is one that will persist for some time. In agriculture, too, there remains a residue of more workers than warranted by productivity. Japanese agriculture is technically very efficient but the amount of land available to each farm family is so small that it is economically very inefficient. In a sense, Korea's agricultural future can be predicted by looking at Japan's current agricultural problems. So Japan has a problem of structural adjustment out of labor-intensive firms, industries, and activities.

There is a different problem of structural adjustment that is new to Japan. Japanese companies are very efficient in manufacturing production management. But they are not so efficient in white-collar overhead administrative costs. They have too many layers of managers, and in the future there will be increasing pressure to squeeze them down. Moreover there are now too many middle-aged company managers who had entered the companies 20 - 25 years ago, who are now 40 - 50 years of age; their companies do not really need them and yet have an obligation to keep them until normal retirement age. The problem for the companies is how to get rid of them gracefully. In the U.S., we don't do it with grace: we fire them. As a part of the implicit employment contract in Japan, that is not really possible. So what they have to do is to find

jobs for them in their subsidiaries or affiliated companies at lower wages and reduced future prospects. That is going to be a very gradual and difficult process, and it will slow down the adjustments Japanese companies will need to make to become more efficient. In my view, the structure of the permanent employment system will persist, but the degree and nature of commitment will weaken.

## II. The Problem of Non-Performing Bank Loans

In the financial sector, there is a serious problem of the overhang of non-performing, or bad, loans. There is really a financial mess. It was not a mess that was created by government policy loans, unlike the serious difficulties the Korean banking system has had. It is a mess that Japanese banks created by themselves. In the late 1980s, Japanese banks became very aggressive in financing real estate developments, land acquisitions, new commercial projects and the like, and on increasingly generous terms. Most conservative bankers in Japan traditionally made a loan equal to 60 - 80 percent of the value of the collateral. But at the height of the "bubble," some banks were lending at 110 percent, in other words including the first two years of interest payments due in addition to the purchase of the land itself. They participated in, and indeed fuelled with credit, a speculative real estate boom. This resulted in an extreme and excessive exposure by financial institutions in real estate. It is interesting to ask: "Why did this occur, why did almost all

Japanese financial institutions, even the regulators, accept this pattern and degree of lending?" I think the answer is simple: there was a myth in Japan that land prices would never go down, or that if they did go down, the decline would be small, maybe 10 percent, and they would start to go back up again within a year or so. That the land prices might go down 30, 40, and 50 percent, and stay down for 2, 3 or 5 years was not something that any Japanese could conceive of as a real possibility. After all, real estate had always been the safest asset and form of collateral.

Some of my students have asked me about this: "Are Japanese banks in serious trouble?" I say, "Yes." And then they ask, "Will there be a financial crisis?" And I say, "No, because the government will not allow that to develop." And then they ask: "What will happen?" The answer I give is: "Well, there is going to be a very slow, painful process of probably rather inefficient adjustment by the Japanese banks over a considerable period of time." And that is what I want to discuss with you in more detail.

It is interesting to note that six months ago, Japanese bankers were scared because they did not really know exactly how serious the bad loan problems were in their banks. They simply did not have adequate information on the actual dimensions of their problems. In the last six months, I think they had a chance to learn and had an opportunity to examine possible ways to resolve their problems. Today, Japanese bankers are more optimistic, or at



least feel that they are now much more in control of the situation, than they felt earlier on.

Another question frequently asked to me is: "Was the assets bubble really caused by Japanese financial deregulation?" The answer to that is: "Clearly no." Certainly deregulation created a more competitive environment and may have stimulated some financial institutions to take on greater risk deliberately as a competitive measure because they thought the reward would be high enough to justify the risk. But I think we know that even in highly regulated system, those who allocate credit can make big mistakes; a country can have serious problems of bad loans in very highly regulated system as Korea did in the 1980s as well as in a quite de-regulated system. That certainly is the experience of many developing countries.

In discussing the Japanese banking system and its bad loan problems, I focus mainly on structural issues rather than recounting some of the scandals and frauds that have taken place. There have been some juicy cases but they are not the essence of the problems. Japanese banks have faced two kinds of problems. One has been to meet the BIS capital adequacy requirements, and the other has been to deal with the non-performing loans and their bad debt. It is useful to separate the banking system into two groups. One group is what is generally termed the "twenty one large banks," which includes 11 so-called city banks which do nationwide banking,

7 trust banks, and 3 long-term credit banks. In addition there are about 130 or so smaller banks that are local and regional in operation, plus hundreds more credit associations and credit cooperatives that are also local.

### Historical Perspective

It is important to provide some historical perspective. Shortly after World War II, the monetary authorities in Japan, the Ministry of Finance and Bank of Japan, wanted to create a very safe, stable, banking system, and they did that through a considerable degree of regulation. In addition, they wanted to provide funds for priority uses, without having the government play a central role in allocating credit to most industries and certainly not to individual firms, but by setting a general policy of relatively low interest rates. They did that by imposing ceiling interest rates on loans and deposits, by restricting bank entry and entry in terms of new branches, and by segmenting financial markets: different categories of financial institutions for different types of financial markets. In some ways, that financial structure closely resembled the recent Korean financial structure. The difference, however, was that the Japanese banks were mainly responsible themselves for determining their loans: to whom they would lend and under what conditions. Nonetheless, the spread between the ceiling on deposit rates and loan rates was sufficiently wide that even the most marginal banks were profitable; this was the way in which the system ensured the

safety, not only of the system but also of every individual bank.

But that wide spread implied that there were inefficiencies and costs in the system. The main cost was that interest rates to depositors were very low so that depositors were implicitly taxed by the system. As a side effect, because of the priority given to lending to large firms, small firms had to pay high interest rates even though they had good collateral in the oligopolistic, local loan market they faced. In that sense, they also were exploited. There were various adjustment mechanisms on the loan interest rate side, particularly the use of compensating balances as a way of raising the effective interest rate close to a market rate. I think that is a very desirable mechanism to overcome regulatory restrictions on efficient credit allocation through market-like mechanisms, and I was disappointed to learn that the Korean government recently outlawed that here because alternative mechanisms of allocating credit, based on political connections or bribes paid to loan officers or techniques of that sort, are certainly inferior. Despite this quite regulated rate interest system in Japan, on a whole the financial system was relatively clean and honest. There was not a lot of corruption in it. And I think the part of the reason was because the loan rates were more or less adjusted through informal mechanisms.

As the financial system and the economy grew, the banks were very stable; they collected deposits, the only financial asset readily available to savers, and provided the funds to industry. They were really a conduit for the dramatic growth of Japanese private savings, converting them into productive business investment. And because the economy was growing rapidly, wages were increasing, and inflation rates were low, the public developed great confidence in the government regulatory authorities and thought the bankers were doing a great job too. The public perception, the first 20 or 30 years of the post-World War II period, was that the banking system was high quality. As a consequence, people had complete trust in the system and there was no need for deposit reserves or insurance. Moreover, even though banks were supposed to have a net worth ratio of 10 percent to assets, in fact the Ministry of Finance never enforced that. Banks were growing very fast and they relied on the retention of profits to increase equity. But that equity never became more than 2 - 4 percent of the balance sheet of the banks. So the banks were highly leveraged, which of course added to their profitability.

#### Deregulation and Liberalization

In the mid 1970s the system started to be deregulated and liberalized, which was inevitable as well as desirable. It was a consequence of the shift of the economy to a somewhat slower growth rate and a slowdown of business investment while personal savings remained very high. Hence, the 1970s and 1980s were characterized as an economy in which private domestic savings tended to be larger

than private domestic investment: a typical Keynesian case of insufficient private domestic demand. Initially, that was offset by government deficit financing; and when the government started issuing large amounts of bonds, it forced a market-based system for long-term interest rates. On the short-term side, some firms had surplus funds and they were pressing for some competitive rates, so the repurchase (gensaki) market became very active. Gradually, then, market pressures forced the system into considerable deregulation. As you know, in the 1980s Japan's savings surplus continued and increasingly showed up as a current account surplus as Japan exported its savings to the rest of the world.

On the whole, the deregulation and liberalization process has been quite effective. The main criticism was that it was too slow and too piecemeal; it has taken 15 years, although it was always moving in the right direction. However, there were a couple of by-products of the deregulation and liberalization process. One was as Japan created more competitive markets, those banks that were weak became exposed. That has been a problem particularly among smaller banks; they lacked economies of scale or their markets were local so that they were too undiversified into whatever local conditions were. And in some cases the problem has been mismanagement. A lot of the smaller banks were not managed well and a few of them allegedly even were controlled by the underworld (yakuza).

Deregulation also affected the performance and strategy of large banks. The smaller banks among them felt they were at a competitive disadvantage compared to larger city banks. Accordingly, there were some mergers among them in order to achieve greater regional diversification, and economies of scale and scope. It was not due to any particular weakness, but a deliberate corporate strategy in response to the perception that in the long run larger scale would be essential. Hence deregulation made clear that there were some problems related to differences in banks' performances and capabilities.

A second consequence of deregulation was that it reduced the value of collecting deposits. Having a branch office that collected a lot of deposits was a gold mine in a regulated system with very low deposit interest rates and a wide spread. That was also the case in Korea when banks could lend money at a much higher interest rates than deposit rates. What this meant was that in a regulated system if there was a weak bank which the regulatory authorities wanted to merge into a larger bank, that weak bank had a large dowry in the form of its branch offices which were highly profitable deposit collecting institutions. Therefore, it was attractive for a strong bank to absorb a weak bank. However, with increasing deregulation and resultant competition for deposits, there are no particular rents accruing to having a branch office; as a consequence, the franchise value of branches has gone down. In fact some banks are even beginning to close down branches they

regard as marginal which, 10 years ago, would have been unheard of in Japan. What that means is that now a weak bank does not have large cheap deposit balances to make it an attractive candidate for merger. In recent cases of merger or other resolution of problems of troubled banks or other financial institutions, the Ministry of Finance and the Bank of Japan have had to step in with various concessions, including loans at very low interest rates, in order to bail them out.

#### Meeting BIS Capital Adequacy Ratios

In terms of the BIS capital adequacy ratios, Tier 1 capital has to be 4 percent of equity, and Tier 2 can be composed of various other forms of capital. Part of the international negotiations in the 1980s involved allowing 45 percent of the unrealized capital gains of Japanese banks in their securities portfolio to count as assets. The reason was that, back in the 1950s and 1960s, as one element in developing relationships with customers, Japanese banks had bought shares in their customer companies at very low prices. Stock prices were low in the 1950s, 60s, and 70s in Japan. As stock prices rose, banks developed huge unrealized capital gains which did not show up on their balance sheets because the shares were valued at purchase cost. The Japanese banks (and the Ministry of Finance) argued that the after-tax value (45 percent) of these unrealized capital gains should be allowed to count as Tier 2 capital since they could be liquidated at any time. What that meant was that during the stock market boom

of the late 1980s, Japanese banks were able to expand their capital base very easily. And they needed to do so because in the mid-1980s, and especially after the BIS agreement was signed in 1987, the equity ratio of Japanese banks was very low; they needed to raise additional equity directly and they also needed Tier 2 capital. What the stock market boom did for Japanese banks was to make it possible for them to sell new equity issues directly, or sometimes in convertible bond forms. It also increased their unrealized capital gains, making it very easy for them not only to achieve their capital base requirements but to grow very rapidly during the period.

Once the bubble burst and stock prices went down, Japanese banks suddenly were under pressure in meeting their BIS requirements and had no room to grow. They had to contract their balance sheets in order to adjust to the reduced value of their capital gains; and it was no longer attractive to issue new equities. In the last two years Japanese banks have reduced assets, paid off borrowed money, particularly in the Euro-money markets, reduced their share in foreign business, shifted their asset portfolio to buying more government bonds which are risk-free and therefore do not count against their BIS ratio, and raised Tier 2 capital through issuing subordinated debt sold mostly to related insurance companies. In the future, Japanese banks will have to be like all other banks in the world in that they will have to raise new capital at market cost. This means that Japanese banks will



not have any particular competitive advantage such as they had in the 1980s.

#### The Real Problem: Bad Debt

The real problem for the banking system is a bad debt problem, or non-performing loans problem. In Japan, a loan is defined as not performing if the interest has not been paid for 6 months or more. There has been a major increase in the number of non-performing loans. Banks aggressively increased loans, particularly to real estate projects in the late 1980s and early 90s, and by the late stages of the real estate speculative bubble they made loans which could not generate sufficient cash flow from rental use to cover the interest costs, much less other operating costs. Suddenly, the banks were told by their borrowers: "I am sorry we cannot even pay the interest, much less pay off the loans themselves." Under normal circumstances, the banks would simply take the collateral and sell it, and borrowers would take the entire loss. But because the value of the collateral has decreased so much, it was not only the borrowers who would have to take losses -- the banks themselves were exposed to substantial losses. About a quarter of Japanese city bank loans outstanding are to real estate, construction, or non-bank financial institutions which they control and in turn, made loans for real estate projects.

The amount of loans involved is huge. As a part of their aggressive lending policies, banks set up subsidiaries or

affiliated companies, non-banking financial institutions, that were not deposit collecting institutions but mainly borrowed from banks and credit associations and related to real estate companies; in many instances they had virtually no equity. In some cases, the equity of the non-bank financial institution was one third of one percent, and borrowed funds were 99.7 percent. Of course the degree of exposure varies substantially by bank.

The real estate speculative boom was mainly an urban phenomenon, particularly Tokyo and Osaka, and the banks located in the big cities were the ones that participated disproportionately in the speculative activity. Banks in the smaller cities and towns did not have the opportunity to make potentially enormous profits but also did not have the opportunity to take huge losses. Thus, many banks in rural areas have not suffered the same kind of problem as banks, large and small, in large cities; but they had other problems such as management inefficiency. The banks which specialized in real estate development finance were much more exposed; that was particularly true of the seven trust banks which are very large banks indeed, have historically specialized in real estate projects, and are now in serious trouble.

The amount of loans formally recognized as non-performing is large. The Ministry of Finance's recently released estimate for 21 largest banks is on the order of 12.7 trillion yen, or about 115 billion dollars. For the city banks as of the March 1993 annual settlement, about 3 percent of their loans are in the non-

performing category. For the trust banks, they are 7 percent. Moreover the range is considerably wider among trust banks; some do not have much reported non-performing loans, but one bank has 15 percent, a serious exposure. On average, non-performing loan exposure is less than the total net worth of the city banks or the trust banks, but there are probably several trust banks that have negative net worth if one had accurate information on their true loan position.

Part of the problem has been that banks have not fully disclosed their bad loan situation. What they have disclosed is only a part of their problem. For instance, most banks make new loans to finance the interest on outstanding loans which certain borrowers cannot repay. Then the loan is not considered non-performing. It is technically a performing loan although it is not worth much. That is a dilemma that seems to be increasing in Japan. Some estimates are that non-performing loans are a 25 - 30 trillion yen problem, instead of 12 or 13 trillion yen problem. Some suggest the problem may be even larger. However, that does not mean that these non-performing loans represent 100 percent losses they cannot be repaid in full or cannot be serviced, because often they are backed by some collateral.

The problem is that no one is really sure what the exact value of collateral is, on average, because the real estate market has dried up. And no institution wants to sell in today's real estate market because they fear the price is too low so that if they just

wait for a couple of years, it will go back up. Or they fear that if they start selling, prices will go down further so that the rest of their real estate-based loan portfolio will be worth even less. Accordingly there is no real market test of how serious the problem is. Rough estimates are that collateralized real estate could be sold at about one-half its collateralized value, so that perhaps half of the loan value could be recaptured.

### Two Alternative Strategies for Coping

There are two ways, both for institutions and as a matter of public policy, to deal with the bad loan problem. One is to write off the loans as rapidly as possible, and take the hit quickly; set aside loss reserves, write down profits, and stop paying dividends. That has been the approach of many American banks with bad loans. The other approach is to continue to carry the loan on the bank's books, and re-negotiate the terms of the loan at a very low interest rate in order that it not be classified as non-performing. However that is costly because the bank has to forego interest income and has lower profits for a longer period of time than otherwise.

In Japan some extraordinary bank loan re-negotiations have been taking place. The Japan Housing Loan Corporation re-negotiated its several trillion yen of borrowings from banks, agricultural cooperatives, and other financial institutions. Its 9 major banks agreed to extend their existing loans, amounting to

billions of dollars, for 10 years at zero interest rate, and to make additional loans available at below market rates in order to keep the company in operation. This practice, while preventing the problem from surfacing as non-performing loans, means the profit rate of banks are inevitably reduced because they have to finance these loans and earn negative interest: their cost of funds are of course substantially higher than the loans rates they are receiving.

Why would Japanese banks prefer to hide many of their bad loan problems rather than writing them off? One reason is that if the underlying problem is that of bad management of the borrowing companies, then the bank can simply get rid of their management, restructure, and over time rehabilitate fundamentally profitable companies, so it does not make sense to put them out of business. That is the essence of the main bank system's approach to handling companies in distress. Another reason is that banks expect (or hope) that land and real estate prices will go up again eventually; the collateral for their loans will have sufficiently high value that they will take or little no loss.

Japanese banks are unlikely to grow rapidly during the next 5-10 years. Accordingly, they are not likely to generate large profits to use to diminish the size of their current problems. Therefore the second strategy, "the Japanese gradualist approach," the banks are currently pursuing is a potentially costly and risky

strategy. It is costly because, as I said before, of the negative interest spread. It is also costly in a different way in that it diverts management attention. It devotes bank management talent to dealing with problem companies and loans, rather than having that talent go out and create good, new business. The advantage of writing off bad loans is that the bank does not have to bother with them anymore. There are other problems as well. In order to keep these bad loan companies alive, the banks have to lend to them not only the rolled-over and renegotiated old loans but new money on low terms. Eventually that will tend to result in a reduction in the credit rating of these Japanese banks, which will significantly affect their cost of funds. There is tremendous lack of transparency in all these arrangements. The public does not really know how many loans are being re-negotiated at what terms, bank by bank; accordingly there is a tendency to fear the worst and therefore to charge a risk premium for making funds available to these banks.

The gradualist approach is also risky for another reason. Suppose the real estate market in Japan does not turn up significantly in the next 5 or next 10 years, and suppose prices remain more or less where they are now. After all, Japanese real estate prices are still high by international standards. If that happens, those banks which support real estate companies with low, even zero, interest rate loans will have to pay twice at the end of the period because the collateral will not be worth any more than it is now, and the loans will have to be written off eventually

anyway. Many of the projects, particularly for commercial and office buildings that were started in 1989 and 1990 are just now being completed and coming on to the market. For the first time in urban areas Japan will have considerable surplus office space; as a result, the rental rate for new office space has dropped by up to 50 percent in recent months. That means these projects are generating less cash flow than expected, which means their underlying economic value is being reduced, and it will be more difficult to justify even current price levels, much less the prices expected when the project was initiated.

If the banks understand this, and indeed they do, why don't they simply write off bad loans as fast as they can? Aside from the answers already noted, the regulatory authorities have encouraged the gradualist approach. Japan's Ministry of Finance, like those throughout the world, does not like to lose tax revenue from reductions in bank profits. So it makes it difficult for Japanese banks to write off losses until they have actually been taken, under quite restrictive definitions of actual loss. As an ameliorative device, they have created a new institution that will buy collateral at approximately market prices from the banks, using funds borrowed from the banks equal to each specific transaction. In that way, the bank can write off its loss in order to obtain the tax benefit immediately. Some in the financial community hoped that the government would even provide low interest rate loans to fund this institution, but (to my surprise) the rest of the

business community complained. Peak business organizations in effect publicly said: "We don't see why the government has to use the taxpayers' money to bail out rich banks and bankers. Bankers get paid 30 percent more than we do, why don't you (bankers) cut your own costs before you start talking about using our taxpayers' money?" So direct government funding is out of the question for the present; nonetheless, if more severe problems should develop, this new institutional mechanism for pumping in government funds is now in place.

I think part of the reason for pursuing this "gradualist" approach is that the Ministry of Finance is very reluctant to see all these bad loans exposed. Reluctant because they are fearful that it will lead to bank runs, or some other forms of perceived decline in the safety of the banking system, and because it would be embarrassing since the bad loan problems make clear that they did a poor job of bank monitoring and supervision. The regulatory authorities evidently believed the same myth that land price declines would never be a serious, systemic problem.

The costs of bad loans have to be borne by someone. Of course the borrower, corporate or individual, is the most immediate loser, since the borrowings have to be paid not only from the realized value of the specific real estate collateral but any other assets committed against the loan. But the bad loan problems are so severe, as already noted, that the borrowers will be able to repay



only in part. Banks are the next in line of those bearing the costs. These costs are shared by shareholders through lower profits and lower prices of bank shares. They are also shared by the tax authorities (and indirectly by all taxpayers) in the form of lower corporate taxes on the reduced bank profits. It is not clear how much further that the sharing of costs (losses) will go, though I feel quite sure banks will not be allowed to fail. Certainly depositors are not going to lose any money in Japan, any more than in the United States, even if a bank is liquidated, because that would severely undermine the integrity of the entire financial system. No country can afford to allow depositors to take losses, as a result of a de facto bank failure, particularly by any bank of significant size. Then the question is to what extent the losses will be funded either by taxpayers' money (infusion of government funds) or by reduced profits and even reductions in bank equity.

The performance and degree of bad debt exposure among banks in all categories vary considerably. Some may well be de facto insolvent, though the extremity of their difficulties remain hidden. I expect there to be further consolidation of the Japanese banking industry, but through mergers rather than formal failures and liquidation. A number of smaller banks and credit associations will merge, weak into strong. While there may be few further mergers among city banks, it is likely that several of the weakest trust banks will be absorbed by city banks or other large financial

institutions. However, since these mergers are much less attractive to strong banks than before due to the decline in franchise value of deposit collecting branch offices, in order to make these negotiations possible the Ministry of Finance and Bank of Japan will have to provide substantial subsidies in one form or another: loans from the Bank of Japan at the low official discount rate; tax breaks; possibly even low interest loans through the Ministry of Finance's Trust Fund Bureau, utilizing postal savings accumulations. Already in a couple of cases of small financial institution rescue the deposit insurance fund has made outright grants in order to cover shortfalls. Of course these arrangements not only are specific to each case, they are not made public, a continuation of the lack of transparency on the part of the regulatory authorities. Nonetheless, we can be sure that the authorities will do whatever is necessary to prevent the emergence of a financial crisis through fear (much less actuality) of an explicit bank failure. Indeed, they probably will err too much on the side of caution (and subsidy).

### III Concluding Comments

Let me summarize by saying that the Japanese bad loan situation is roughly comparable to the U.S. bank problems of loans to less developed countries in the late 1970s and in the early 1980s, or to current U.S. real estate loan problems. Both were handled by rapid write-offs and establishment of loan loss reserves. The Japanese case is not as bad as the U.S. savings &

loan association crisis which had to be handled by massive infusions of government funds. The process of adjustment will be somewhat different in Japan in that it will be more gradual and piecemeal. Japanese banks will also have to rely on maintaining a wide interest spread in order to generate substantial operating surpluses to cover the costs of losses actually taken as debts are written off plus the hidden but very real costs of negative interest rate spreads on renegotiated loans that otherwise would be non-performing. However, financial markets are highly competitive for lending to large, top quality firms, which are able to issue bonds or borrow from insurance companies or other financial institutions. Thus, to maintain wider spreads banks will have to shift their loan portfolios increasingly from top-flight ones to smaller and less well known companies where the bank's monitoring capabilities are better able to evaluate creditworthiness than is the marketplace.

One of the interesting things to come out of this financial mess has been some reduction in the credibility of the Ministry of Finance. In the past, the Ministry of Finance in Japan has been close to God, popularly regarded as close to infallible. But now some Japanese are saying: "They didn't really do a very good job. There's all of these problems that have emerged and obviously the regulatory authorities were not very effective supervisors." Bankers also have suffered some loss of reputation. There have been not only the general problem of bad loans but also some

spectacular cases of very strange, non-transparent arrangements, kickbacks, and even fraud. For example, one woman, an owner of a restaurant in Osaka, was able to borrow the yen equivalent of 2.5 billion dollars from banks, using certificates of deposits and bank stock as collateral; how she was able to do so is rather mysterious. As stock prices declined, collateral was fraudulently handled, and eventually her entire house of cards collapsed with substantial losses to her prestigious lenders. Such scandals, and there have been a number, have sullied the reputations of some banks, securities companies, housing loan companies, and the senior managers involved.

The restructuring of otherwise non-performing loans, mainly to real estate companies and a variety of non-bank financial institutions, is proving to be particularly complex and difficult. Bank exposures are particularly large, both directly and through their subsidiary non-bank financial institutions which were little more than conduits for the funds of banks. In many of these bad loan cases, the main bank relationship is not strong, and a large number of financial institutions are involved as lenders. There is a tremendous amount of in-fighting, twisting of arms (and provision of carrots as well) by the regulatory authorities, and utilization of political connections, in determining how losses will be shared. Credit associations and agricultural cooperatives, which had increasingly become major lenders with some official encouragement, have been uncooperative in so far as being willing to take

reduction in the interest rates on their outstanding loans to these institutions in trouble. They say: "We are just innocent bystanders and you guys (banks) told us to come in and make these loans. So you handle the problem and take the loss." These negotiations are not very transparent. So it is difficult to know what is actually going on, and how large the amounts of renegotiated loans at negative spreads are. They surely will become even larger over the course of the next year or two.

In conclusion I think there are cautionary lessons to be learned from the Japanese case, and they are quite obvious. As in all cases of speculative bubbles, greed overcomes fear, and rational business analysis is replaced by euphoria and the myth that prices will not decline. That was the case in the Japanese real estate financing in the late 1980s and it has created serious problems now for the banking system. That could happen in other countries as well. Even Korea is not immune.