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Japan's Financial Problems

THE JAPANESE ECONOMY has faced difficult times in the 1990s, and the overall economic situation has grown worse in 1998. One core aspect has been the emergence of an enormous amount of bad debt, now officially estimated to be roughly 25 percent of GDP. Resolution of this problem has proceeded slowly and, as of the summer of 1998, doubts remain concerning the ability or willingness of the Japanese government to deal adequately with it. This paper considers how the problem emerged, evaluates existing policies, and offers some thoughts on probable outcomes.

The Postwar System

From the early 1950s through the 1980s, the Japanese economy operated with a financial system quite different from that of the United States, though probably somewhat similar to those of other countries that deliberately pursued industrialization. To grasp what has happened in the 1990s, it is useful to establish how the postwar system was structured.

The basic shape of that earlier economic system emerged out of government controls imposed during the Second World War, although a number of changes were made in the late 1940s and early 1950s.[1] The hand of government was heavy, inspired by the explicit goal of guiding the economy and a strong mistrust of markets. Core elements of this system included conservative fiscal policies, strong control of financial

1. For the basis in government controls, see Noguchi (1995).

markets, corporate governance emphasizing managerial control, encouragement of company-based unions and so-called lifetime employment (in large firms), encouragement of cartels and other forms of cooperative industrial behavior, enforcement of very strong protectionist barriers on both trade and investment, and the creation of vertical and hierarchical *keiretsu* (enterprise group) relationships. While they did not emerge from any overarching theoretical concept, in retrospect the various pieces of the structure appear to have been mutually consistent or reinforcing.

In the financial sector, the hand of government was particularly heavy for reasons that reflected the desire to guide the economy. Normally, a financial system is composed of a variety of direct and indirect methods of connecting savers to those engaged in real investment—banking, stock markets, bond markets, and various other forms of corporate financial paper. Because of the variations in risk and expected return, there are reasons for a robust system to comprise a mixture of all of these financing methods.

However, financial markets can be a problem for a government that desires to guide industrialization. In bond and stock markets, private institutions make judgments on creditworthiness in deciding to underwrite bond or stock issues, and a myriad individual actors then determine the price of those instruments in the market. The large number of such investors, and their demand for credible assessments from investment banks and rating agencies, make it difficult for a government to manipulate bond and stock markets. Banking and insurance, by contrast, are much easier to influence, because the number of institutions is relatively small and transactions with borrowers are nontransparent. The Japanese government, therefore, chose to emasculate the stock and bond markets in favor of intermediation through banks and insurance companies.

Bonds were easily controlled by establishing very stiff eligibility requirements and granting discretionary authority for approval to the Japanese Ministry of Finance (MOF). This effectively permitted the MOF to allow only a handful of favored corporations—the government-owned telephone company, Nippon Telephone and Telegraph, principal among them—to issue bonds until the 1980s.

The stock market was trivialized by eliminating its role as a market for corporate control. The evolution of rules and customs that separated stock ownership from corporate control, such as mutual long-term shareholding and issuance of new shares to existing shareholders at par value, reduced the stock market to a purely speculative game. Corporate managers were not influenced by movements in share prices, since a falling price did not expose firms to takeover bids; shareholders could not express discontent through the board of directors, since these were composed mainly of the firm's managers; and executive compensation was not tied to stock performance.

The Japanese government then controlled banking and insurance through the regulatory game.[2] With total control of interest rates for deposits and for loans, of the design and pricing of insurance products, and of entry into both industries, the Ministry of Finance was in a position to virtually guarantee profits. Banks were segmented into narrow niches: short-term lending versus long-term, nationwide operations versus regional and locally constrained operations, and lending to large corporations versus small business. In exchange for being granted such protected and profitable market niches, banks and insurance companies saw fit to pay attention to the government's formal and informal signals about the allocation of credit. This stylistic picture is undoubtedly overdrawn; banks made their own decisions on many loans and did not always follow advice or signals. They could also cheat on loan rate limits through the use of compensating deposit requirements for borrowers (but note that the government's tolerance of this practice only increased the banks' profits, by widening the spread between low deposit rates and loan rates). And certainly, the MOF had regulatory goals other than guiding the economy, paramount among them preventing a repetition of the extensive bank failures of the 1920s. Nevertheless, this model of a highly regulated and profitable banking and insurance sector as a vehicle for influencing the allocation of credit seems largely valid.

One outcome of this system was household financial portfolios that relied heavily on savings accounts in banks (plus life insurance policies), and borrowers who relied very heavily on bank loans. Table 1 shows household financial portfolios. In 1977 Japanese households held 74 percent of financial assets in the form of currency and bank deposits,

2. For an elegant presentation of one economic model of the game played between regulators and the regulated, see Wallner (1997).

Table 1. Household Financial Portfolios, Japan and the United States[a]
Percent of financial assets

Item	Japan[b] March 1977	Japan[b] March 1996	United States[c] 1996
Currency and demand deposits	15.6	10.0	3.8
Time and savings deposits[d]	57.9	51.8	21.5
Insurance	13.2	25.4	5.0
Stocks and bonds	13.3	12.8	69.7

Source: Bank of Japan (1977, 1996); *Statistical Abstract of the United States*, 1997
a Based on flow of funds data.
b. Japanese data do not include miscellaneous assets
c. For the sake of comparison, table omits several items included in the U S data but not found in the Japanese data. These items represent 49 percent of total household financial assets in 1996.
d. Japanese data include trusts.

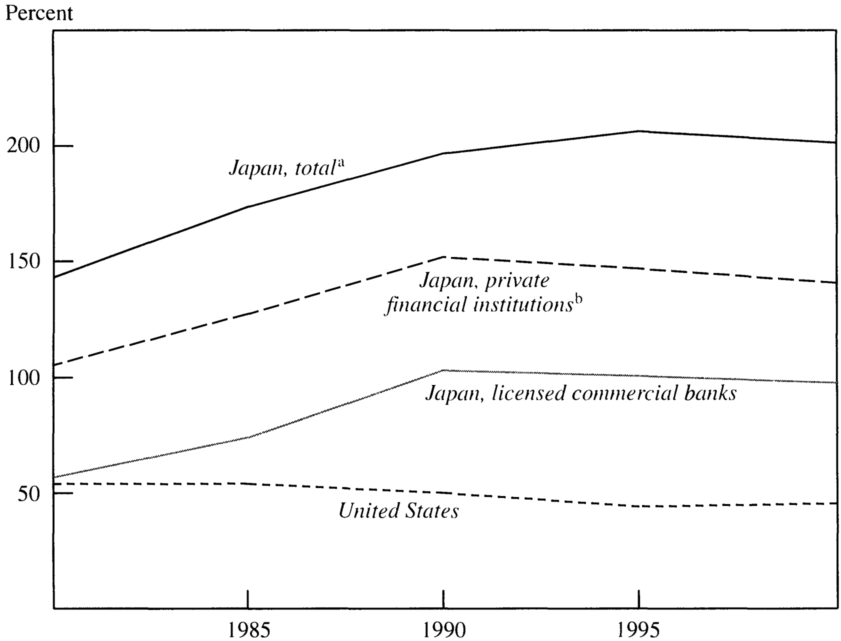
an enormous share that had drifted down only modestly to 62 percent by 1996 (with all of this shift toward insurance, rather than stocks and bonds). The contrast with the United States, where households held only 25 percent of assets in the form of currency and bank deposits in 1996, is startling.

The Japanese corporate sector exhibited a similar dependency on the banking sector. While bank loans represented only 67 percent of American corporate debt in the mid-1970s, they represented 95 percent of Japanese corporate borrowing.[3]

Another difference between American and Japanese financing patterns is the ratio of outstanding loans to GDP. Japanese firms have not only relied more heavily on bank loans than on bonds, but they have also relied more heavily on external borrowing than have American firms. The result, shown in figure 1, is that the ratio of bank loans to GDP has been much higher in Japan. In the United States, outstanding bank loans have been roughly 50 percent of GDP and have declined slowly over time. In Japan, they have been higher and have risen sharply: from 143 percent of GDP in 1980, total loans rose to 206 percent in 1995, declining slightly to 201 percent in 1996. These Japanese ratios include loans by government lending institutions; private sector institutions alone had outstanding loans totaling 105 percent of GDP in 1980, rising to 147 percent in 1995, and falling slightly to 141

3. *Statistical Abstract of the United States*, 1976, p. 477; Bank of Japan (1977, pp. 23–24). The Japanese data exclude trade credit, which is important to Japan but not a net source of funds for the corporate sector.

Figure 1. Bank Loans as a Share of GDP, Japan and the United States, 1980–96



Source: Bank of Japan (1996), *Statistical Abstract of the United States*, 1997.
a. Includes private and government financial institutions.
b. Includes licensed commercial banks, agricultural cooperatives, and local lending institutions.

percent in 1996. The flow of funds data just cited include loans by all financial institutions; other data for outstanding loans by commercial banks licensed by the central government (which exclude some small institutions) in 1996 yield a somewhat lower ratio of loans to GDP of 98 percent.[4] This smaller amount of lending is commonly used by the press in reporting the relative size of the bad loan problem, but it leaves out agricultural cooperatives and other local financial institutions that do not fall under the jurisdiction of the Ministry of Finance.

Besides being compatible with the government's desire to influence or guide the direction of industrial development, control of the financial system was consonant with broader aspects of Japanese society (or social values, as conceived by a paternalistic government). Information

4. Bank of Japan (1997, pp. 55, 347).

traditionally has not flowed freely in Japanese society, except within group settings characterized by close personal relationships. Heavy reliance on banking, with its confidential information relationships, rather than on open bond and stock markets, was thus consistent with and reinforced those tendencies. The evolution of the "main bank" system—to provide the corporate oversight that equity holders could not or did not provide—created long-term personal relationships between lenders and borrowers akin to the vertical *keiretsu* relationships between product manufacturers and the suppliers of their component parts favored by government and the private sector. All Japanese social groups depend on ceaseless attention to the nuances of personal relationships, and bankers are no exception. In this model, bankers who had access to the internal financial accounts of borrowers still did not trust the official accounting figures and developed elaborate personal contacts, lubricated by frequent wining and dining, as well as dispatching retiring bank employees to hold management positions at borrowing corporations.

The heavily controlled Japanese financial system performed its function of connecting savers to investors rather well in the 1950s and 1960s. Households put their savings in bank deposits and insurance policies, and the banks and insurance firms, in turn, extended loans to industry. The economy grew quickly—averaging almost 10 percent annually from 1950 to 1973—suggesting that the system did not generally misdirect funds to unproductive uses. One can understand the present nostalgia in Japan and the continuing belief among many that the basic system should not change.

However, the structure also carried risks: a high-growth, bank-centered economic system implied dangerously high debt-to-equity ratios in the corporate sector as a whole and especially in the banking sector. Not many years ago, economists focused on explaining why the "overloan, overborrowing" features of the banking sector were not dangerous.[5] But in retrospect, Japan could easily have experienced in the 1950s and 1960s the kind of acute problem that faces South Korea today. A combination of international capital controls, willingness to use monetary policy swiftly to defend the currency, and the absence of other countries simultaneously following the same development strat-

5. See, for example, Suzuki (1980).

egy shielded Japan from serious problems. When the economy survived the external oil price shocks of the 1970s rather well, confidence in the robustness of the existing system only increased.[6]

The success of the system depended greatly on the honesty and integrity of a well-trained bureaucracy, capable of acting rationally toward the goal of economic development. In the high-growth years, the bureaucracy appeared to fulfill these requirements, keeping graft and corruption to relatively low levels, while basing most decisions on analysis (even if relatively simple) of the appropriate allocation of resources to achieve rapid industrialization. In the private sector, the system also depended on the ability of banks to make sensible loan decisions—to behave prudently in initial loan decisions and then monitor closely and skeptically. Since much of the relationship between government and the private sector is opaque, as is the bank-borrower interface, the potential for abuse is high.

Emerging Difficulties

Even as confidence in the validity and strength of the overall economic system was increasing, however, the seeds of the problems of the 1990s were sown. The oil shock of 1973 hit just when the Japanese economy was moving out of the era of 10 percent potential growth; emerging industrial maturity dictated a lower growth rate in the future, and the oil shock merely accentuated the transition. Lower growth implied important challenges: a chronic excess of desired savings over desired investment levels, and rising pressure for deregulation from banks stuck in narrow market niches and disadvantaged by the shifts in financial flows.

The shift in macroeconomic balances accompanying the slowdown in growth imposed new demands on the economy. If society desired to save more than it desired to invest, other balances would have to compensate in order to realize the ex ante savings surplus. For the rest of the 1970s, the government provided the offset by running a large fiscal deficit, which reached a peak of 6.5 percent of GDP in 1978. The issuance of large amounts of government bonds to finance this deficit

6. See, for example, Suzuki (1981); Schmiegelow and Schmiegelow (1989).

Table 2. Average Annual Growth in Bank Loans to Selected Sectors in Japan
Percent

Year	*Total*	*Manufacturing*	*Real estate*	*Overseas*
1976–80	9	5	7	11
1981–85	11	6	18	25
1986–90	11	0	20	5

Source: Bank of Japan (various years)

led directly to the gradual breakdown of tight control over interest rates, as banks balked at the low rates at which the government tried to float increasing amounts of debt. The ripple effects of freeing bond rates from control eventually brought decontrol of other interest rates as well.[7]

Faced with shifting demands for funds in the market, financial institutions also grew discontented with the very narrow niches assigned to them. Loan demand from traditional manufacturing clients grew more slowly in the economic environment of the 1980s. Searching for new growing markets for loans, Japanese banks moved in two important directions: into real estate and overseas. In both cases, the Ministry of Finance accommodated the discontent with regulatory changes. It encouraged large commercial banks to create nonbank subsidiaries (a set of firms known as the *jūsen*) to engage in real estate lending. And it presided over piecemeal changes in foreign exchange controls, which were ratified by revision of the Foreign Exchange Control Law in 1980 and driven further by the Yen-Dollar Accord of 1984, a bilateral agreement with the U.S. government on further financial deregulation. By the mid-1980s, foreign direct investment into and out of Japan were completely liberalized (although some complaints of informal barriers on inward investment remained), Japanese banks and insurance companies could lend abroad and establish branches abroad, and controls on foreigners' portfolio investment into Japan had largely been eliminated.[8]

The outcome of slower growth and deregulation during the fifteen-year period 1976–90 is displayed in table 2. Total bank lending expanded at a relatively even pace over the three five-year subperiods,

7. I describe this reluctant decontrol of interest rates in Lincoln (1988, pp. 130–210).
8. Lincoln (1988, pp. 234–65).

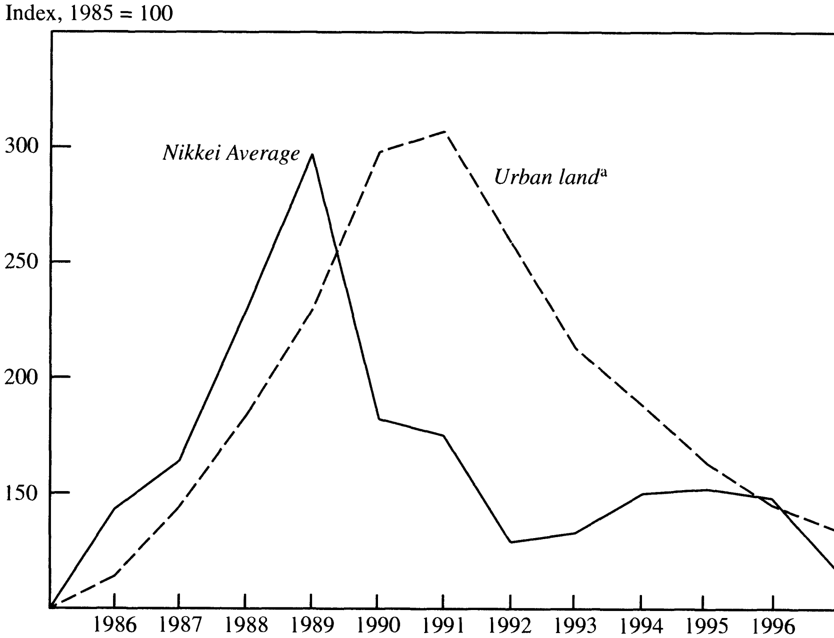
but the sectoral pattern underwent dramatic change. Lending to manufacturing was growing at a rather modest rate of 5 to 6 percent in the first two subperiods but was flat in the second half of the 1980s. International lending grew very rapidly in the first half of the 1980s but substantially more slowly in the second half (perhaps because more overseas lending was handled completely offshore). Real estate, by contrast, continued to accelerate: from 7 percent annual growth in the second half of the 1970s, it was up in the first half of the 1980s at an annual rate of 18 percent, and at a 20 percent annual rate in the second half of that decade.

Rapid entry into real estate and international lending turned out to be very risky moves. In both cases, Japanese banks were dealing with unfamiliar loan markets. To evaluate borrowers, they relied on established routines: weak financial analysis, strong personal relationships, and a weather eye to government signals. While this approach may work in evaluating an existing long-term relationship with a major manufacturing firm, it is fraught with danger in new markets. In addition, the banks continued to believe in an implicit guarantee of profitability from the Ministry of Finance. No financial institution had failed in the postwar period, entry to the industry had been blocked (except for minimal entry into Japan by foreign financial institutions), profits remained high, and deposits continued to pour in from the public. This combination of factors was almost guaranteed to lead to problems.[9]

The structural changes dovetailed with macroeconomic developments in the mid-1980s. Faced with the possibility of recession in the wake of the enormous appreciation of the yen from spring 1985 to 1987, the government responded with monetary ease. Although the government could have used an expansionary fiscal policy, the Ministry of Finance deliberately opposed any departure from its long-term goal of eliminating the large fiscal deficit that had emerged in the 1970s. Monetary ease did have the intended impact of propping up the economy: annual real economic growth averaged 5 percent from 1987 through 1991. Arguably this exceeded Japan's long-term potential growth and it certainly resulted in very tight labor markets. Under normal circumstances this would have led to higher inflation, but yen

9. For an unflattering description of the lack of analytical skill in Japanese financial institutions, see Dattel (1994).

Figure 2. Stock and Land Price Indexes in Japan, 1985–97



Source. Japan, Statistics Bureau (1997), *International Financial Statistics* (1997)
a. Real estate prices in the six largest cities.

appreciation had put manufacturers under strong price pressure, because they either needed to absorb a large part of yen appreciation in order to maintain market share abroad or faced new pressures from imports at home. Rather than general price inflation, Japan got asset inflation, as shown in figure 2. With limited growth in demand for funds by manufacturers, banks lent more for real estate and stock market investments during the period of monetary ease. In the late 1980s, even traditional borrowers became involved in these markets, including manufacturing firms speculating on the stock market and department stores developing golf courses. The Nikkei Average index of stock prices tripled in value from 1985 to the end of 1989, while urban real estate prices in Japan's six largest cities tripled between 1985 and 1991.

By 1989, even the MOF acknowledged that the bubbles in real estate and stock prices were unsustainable and it moved to let the air out. At the time, MOF officials seemed very confident that they could engineer a modest price decline in the two markets, hurting only ''evil'' speculators. In the event, all of the gains since 1985 were eliminated (see figure 2), leaving mountains of bad debt. Loans directly for stock market activity became nonperforming with the decline in the market. But in addition, loans for real estate development were often based on assumptions about the future value of the land, rather than on the estimated cash flow from its use. And in the case of plant and equipment loans, banks are reputed to have been more interested in the value of the real estate collateral than analysis of potential profit from the real investment. Thus firms were able to borrow for risky or low-return projects simply on the basis of the real estate collateral. The plunge in stock prices started in early 1990 and was over by the end of 1992, whereas land prices (at least urban land prices, measured in the most commonly used index) began to fall after 1991 and were still falling in mid-1998.

Identifying the magnitude of these bad debts is complicated, because of the very lax requirements for reporting nonperforming loans in Japan. As recently as September 1997, the Ministry of Finance announced that the banking sector held ¥28 trillion ($234 billion at then-current exchange rates) in nonperforming loans; but late in 1997 it admitted that by a broader definition, problem loans totaled some ¥77 trillion ($586 billion), which begins to approximate what private sector analysts had believed for some time.[10] This latter amount represents about 11 percent of all outstanding private bank loans in Japan (using as the denominator the broad flow of funds number for loans rather than the narrower commercial bank figure), and as a ratio to GDP is 16 percent. In the summer of 1998, the new Financial Supervisory Agency (FSA), split off from the MOF, recalculated the value of problem debt as ¥87.5 trillion ($630 billion at current exchange rates), which should be added to ¥35.2 trillion ($253 billion) already declared bad, making a total of ¥123 trillion ($880 billion).[11]

10. ''MOF Admits Banks Hold ¥76.7 Trillion in Bad Loans,'' *Asahi E-News*, January 14, 1998; ''September Problem Loans Rise to 28 Trillion Yen: MOF Study,'' *Nikkei Net*, December 23, 1997; both articles accessed on the worldwide web.

11. ''FSA Tally of All Shaky Loans, at ¥87.5 Trillion, Is a Stunner,'' *Japan Digest*, July 10, 1998, p. 2. Loans are classified into four categories in Japan, from healthy (1) to completely in default (4). Categories 2 and 3 represent loans that are performing but have some risk of default, and those that have been restructured or on which the borrower is making only partial payment. The shaky loans reported by the government

This raises the ratio of bad debt to total bank loans to over 17 percent, and the ratio of bad debt to GDP to 25 percent.

Note that while all of these figures are only for banks, insurance companies and securities houses also harbor large financial losses. Japanese insurance companies rushed into the U.S. Treasury bond market in the period 1983–85 (due both to deregulation permitting them to invest overseas and their government's guidance toward Treasury bond purchases) when the yen was trading in the 220 to 260 range against the dollar, and then rode the exchange rate down. Securities firms invested on their own accounts in the stock market and lent money to other speculators through nonbank subsidiaries. Figures on these losses do not exist. Life insurance and securities firms may also be in some danger from real estate investment losses. One small life insurance firm (Nissan Life), one small securities firm (Sanyo Securities), and one large securities firm (Yamaichi Securities) failed in 1997.

More bad news may be on the way. Japanese banks have been major lenders in Asia, representing 32 percent of international loans to Asian developing countries in the summer of 1997—and 54 percent of loans to Thailand alone. Officially, Japanese lending to Asian countries totaled some $125 billion in the summer of 1997.[12] An unknown portion of these loans is either nonperforming or will become so, and the extent to which any bank has actually declared such loans to be nonperforming is unclear. But if Japanese banks behaved with the same lack of prudence as they did in other markets, the prognosis is not good. While the magnitude of lending to other Asian countries suggests that any amount of bad debt would look quite small relative to the situation with domestic bad debt, these problems come at the margin and mainly affect a small subset of large banks for whom the additional losses will be substantial.

As is to be expected, the bad debt problems of the 1990s have also revealed numerous examples of unethical or illegal activity. The revelations of indiscretion and malfeasance have been shocking—at least in their frequency, even if the behavior seems quite unsurprising. It

are in categories 2 and 3; the additional figure represents category 4 loans reported separately by the commerical banking industry association.

12. Bank of International Settlements, "The Maturity, Sectoral and Nationality Distribution of International Bank Lending," January 1998, pp. 12, 19. Data are for the first half of 1997.

appears that favored investors at securities firms were given guarantees of high positive rates of return on their equity portfolios (an embarrassed government continues to refuse to release the Nomura Securities "VIP list," which includes politicians and career bureaucrats).[13] Huge loans went to small businesses for speculation in real estate and the stock market, as evidenced by the infamous bankruptcy of small restaurant owner Mrs. Onoue in Osaka, who defaulted on debts worth $3 billion, with the supposedly staid Industrial Bank of Japan as her largest lender.[14] Large banks eagerly introduced crooked clients to subsidiary banks or credit cooperatives, in order to keep questionable loans off their own books while hopefully benefiting from the illicit business relationships revealed when some of these credit cooperatives went bankrupt.[15] Financial institutions and other corporations continued to pay off *sokaiya* (racketeers who threatened to reveal negative information at annual shareholder meetings). Ministry of Finance officials gave banks advance warning of "surprise" inspections in exchange for lavish entertainment and other favors.[16] Those examinations were often perfunctory at best, enabling firms to hide imprudent, unethical, or illegal activities, as in the Daiwa Bank scandal in New York.[17] It has been alleged that the Ministry of Finance explicitly approved of—or even gave administrative guidance recommending—illegal schemes to hide financial problems at Yamaichi Securities.[18] And officers of the Bank of Japan have been implicated in providing advance information on the bank's market operations

13. See "The Weekly Post Special 3: TWP Obtains Confidential Document from Nomura Security Fraud Case," *The Weekly Post* (Japan), July 14, 1997; "Investigation Must Reach VIP Accounts," *The Weekly Post*, September 22, 1997 (both articles accessed on the worldwide web). Because of the scandalous nature of this issue and the likelihood that such VIP lists include prominent bureaucrats and politicians, reporting has been left mainly to the sensationalist weekly magazines.

14. "Osaka Tea House Mistress Onoue Gets 12 Years For Her Extravagant Fraud," *Japan Digest*, March 3, 1998, p. 2.

15. The same was true of the *jūsen*: "the banks typically 'introduced' to the *jūsen* borrowers that the banks themselves couldn't touch, and in at least one case did so with clearly fraudulent intent" ("HLAC Plans to Sue Four Banks That Got *Jūsen* to Make Risky Loans," *Japan Digest*, January 26, 1998, p. 1).

16. "MOF Bribery Scandal Reveals Backroom Financial Deals," *Nikkei Net*, January 27, 1998 (accessed on the worldwide web).

17. "Banks Took MOF Inspectors to Dutch Red Light District, Vegas Casinos," *Japan Digest*, January 30, 1998, p. 2.

18. "Prosecutors Raid Finance Ministry Securities and Banking Bureaus," *Japan Digest*, March 9, 1998, p. 2.

to contacts in the private sector.[19] These scandals paint a picture of widespread routine corruption and incestuous relations among financial firms, their clients, government officials, and politicians.

In fact, these colorful anecdotes are critical to the question of how to deal with the banking crisis. Bad debts may be the consequence of an unanticipated drop in real estate values, through no fault of the banks involved. Or bad debts may result from unethical or illegal behavior. Japan is experiencing a combination of both problems. Because some banks and other financial institutions behaved particularly egregiously during the past decade, any reasonable solution to the current bad debt debacle must involve either closing these institutions or (for those that may appear salvageable) at least removing their management. And the issue is further complicated by the complicity of the Ministry of Finance in condoning, encouraging, or even recommending unethical and illegal actions by the banking sector.

Responses

Since 1994, the government of Japan has taken a number of measures to deal with the banking problem, but as of mid-1998 these had been insufficient. It was a difficult challenge, since the magnitude of the bad debts greatly exceeded that faced by the U.S. financial system in the 1980s and missteps might lead to systemic failure. Nevertheless, it is distressing that in the five years since the government began to move on the issue, the general perception among analysts is that the problem has become worse. Given that the existing financial system was firmly rooted in Japanese social patterns of long-term personal relationships, group solidarity, and nontransparent connections, it should not be surprising that the government moved cautiously. Equally important are the strong vested interests built over the past fifty years—especially powerful local business supporters of politicians who feared that a reformed financial sector that engaged in more rational allocation of credit would cut them off. The government's response falls into two categories: an indirect approach through macroeconomic stimulus and direct efforts to bail out the banks.

19. "BOJ Exec Allegedly Gave Bankers Advance Word on Money Market Operations," *Japan Digest*, March 9, 1998, p. 2

One obvious element of cleaning up the financial sector is to restore a positive economic growth path, which reduces the probability that existing loans will become nonperforming and increases opportunities for new lending. This assumes that macroeconomic weakness is not caused by a credit crunch stemming from the bad debt and balance sheet weakness of the banking sector.[20] There was some talk of a credit crunch in 1998, but whether or not these allegations were correct, such did not appear to be the case earlier. From 1992 through 1994, the economy experienced a slowdown in growth as a result of tighter monetary policy and the collapse of stock and real estate prices. With extensive prodding from the domestic business sector and foreign governments, the Ministry of Finance and politicians supplied fiscal stimulus in 1994 and 1995—a temporary cut in income taxes passed in 1994, plus spending increases in both years. In consequence the economy finally showed signs of recovery in 1996, expanding at a strong rate of 3.9 percent.

Sorting out what is happening to fiscal policy can be particularly difficult for Japan. The basic budget process is fairly straightforward: the central government formulates an annual budget for a fiscal year running from April through the following March, which is usually passed by the Diet in late March or early April. This basic budget is generally augmented by one or two supplementary budget bills in the fall. In the press, though, the government publishes flashy announcements of "stimulus packages," which neither refer to the regular annual budget nor correspond in any strict sense to developments in the supplemental budgets. These packages include proposals for both tax and spending measures that do become incorporated in a supplemental budget and miscellaneous off-budget measures that may or may not have any fiscal meaning. Therefore a large stimulus package can be very misleading if it either contains few measures that actually affect the fiscal balance of the government or supplements an initial budget that may have been very restrictive.

Between 1992 and 1995, the government announced seven stimulus packages, as described in table 3. Taken at face value, these could have been supposed to expand the government deficit by 12 percent of GDP. Estimates of the actual stimulus, or *mamizu* (clear water), amounted to a much lower 4.5 percent of GDP. But even this figure does not take

20. For a strong argument supporting this assumption, see Posen (1998).

Table 3. Fiscal Stimulus Packages in Japan

Percent, except as indicated

	Advertised package		*Actual stimulus*	
Date	*Amount*[a]	*Share of GDP*	*Share of advertised package*	*Share of GDP*
Mar. 31, 1992	390	0.1	0.0	0.0
Aug. 28, 1992	10,700	2.3	39.6	0.9
Apr. 31, 1993	15,230	3.3	33.4	1.1
Sep. 16, 1993	6,418	1.3	23.4	0.3
Feb. 8, 1994	6,020	1.3	0.0	0.0
Apr. 14, 1995	4,800	1.1	56.3	0.6
Sep. 20, 1995	12,810	2.6	62.5	1.6

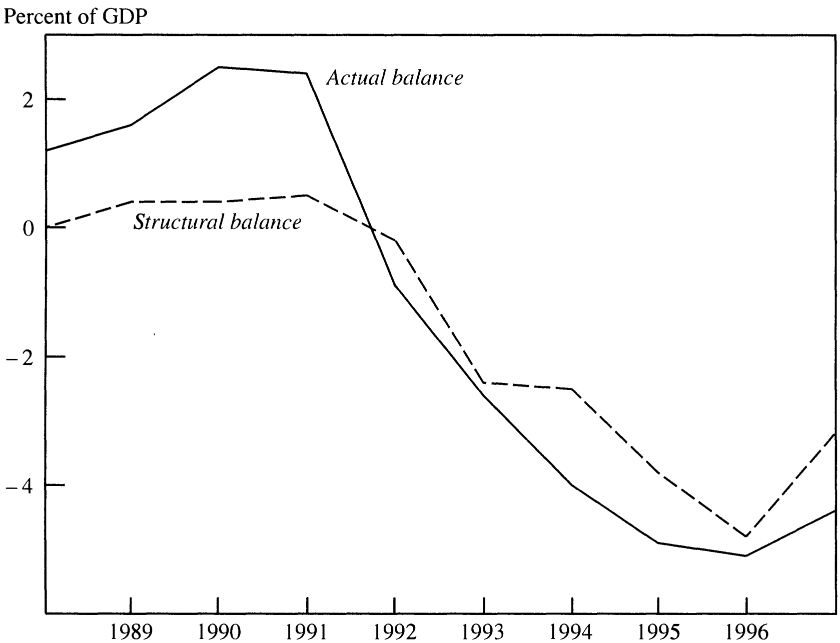
Source: Posen (1998).
a. Billions of yen.

into account the four regular annual budgets of this period, to which the supplemental measures would be added.

Because of the difficulties in sorting out announcements, supplemental budgets, and annual budgets, the only accurate means of evaluating fiscal stance is from the ex post general government balance. Figure 3 shows the actual general government balance and one estimate of structural change in the overall government balance. The actual balance shifted from a surplus of over 3 percent in 1991 to a deficit of 4 percent in 1995 and 1996. The estimate of the structural balance shifted from a surplus of 1.5 percent to a deficit of just under 4 percent in 1996, for a total movement of 5.5 percentage points of GDP across five years (though the estimate of change in the structural budget deficit depends on the methodology used to determine potential growth).

But this injection of fiscal stimulus was suddenly reversed in 1997. The Ministry of Finance chose, effective April 1, to end the income tax cut introduced in 1994, increase the nationwide sales tax (from 3 percent to 5 percent), and raise other government fees, including the copayment required of individuals in the national health care system. As estimated in figure 3, the reduction in the structural deficit from fiscal 1996 to fiscal 1997 was on the order of 1.8 percentage points of GDP, and this fiscal retrenchment may have had an additional negative psychological impact on households and businesses. Rather than continuing a path of recovery, the economy was again relatively stagnant in 1997: 0.9 percent growth in the calendar year and -0.2 for the fiscal year; and private sector forecasts for 1998 were all negative. The ap-

Figure 3. Japan's Government Balance, 1988–97



Source: Posen (1998).

parently strong performance of the economy in 1996 may have been exaggerated. By midyear it was clear to the public that the consumption tax would rise in 1997; expectations of higher taxes in the future led to increased housing investment and other purchases in the second half of the year. But the positive impact of fiscal expansion in 1995 and 1996 and the negative impact of retrenchment in 1997 strongly suggest that the current macroeconomic problems are the result of fiscal policy choices in 1997 rather than weakness in the banking sector.

Macroeconomic weakness, by contrast, matters greatly to the financial situation in Japan. A weak economy produces more bad loans, due to bankruptcies and further declines in the price of real estate used as collateral for loans. Banks are also affected by stock market declines, since they are permitted to hold up to 5 percent of the shares of any company and therefore have large stock portfolios. Large banks engaged in the international market are further affected by stock market declines, because the capital adequacy ratio of the Bank of International Settlements (BIS) permits them to include a percentage of the value of their stock holdings in the capital base.

Japanese banks have also argued that yen weakness—another consequence of the weak macroeconomic performance of the economy (mainly through the increasing disparity between low domestic interest rates and foreign interest rates)—hurts them by increasing the size of their foreign currency loans in yen-denominated terms. The government and the banking sector have been fixated on keeping major banks above the 8 percent BIS capital adequacy ratio standard for banks engaged in international bank lending. Since this is not a simple ratio of net worth to total assets, an exchange rate depreciation inflates the yen-denominated value of total assets without affecting the numerator; for BIS purposes, capital is measured as a bank's own equity capital plus subordinated bonds, reserves, and 45 percent of unrealized gains on securities holdings.[21] But this concern is rather peculiar, given the fact that yen depreciation has a positive impact on the yen valuation of cash flow from investments abroad.

With the renewed downturn of the economy after the spring of 1997, the problems of the financial sector increased. The government has traditionally preferred to deal with the failure of financial institutions quietly, intervening informally to work out the takeover of a failing institution by a stronger one. That appeared to be its approach after 1992. Although a few small institutions (the seven *jūsen*, several credit cooperatives, and a small regional bank) were permitted to declare outright bankruptcy, even these small failures represented a departure from fifty years of government policy. But in 1997, Nissan Life, Sanyo Securities, Yamaichi Securities, and the midsized Hokkaido Takushoku Bank failed. At this, the press reported that market rules were in play and financial institutions would have to sink or swim on their own.[22]

Nevertheless, in the wake of these failures, the government was under pressure to act to prevent an uncontrolled rash of financial col-

21. See Ito and Szamosszegi (1998, p. 11).

22. See, for example, "Sanyo Goes Under; Convoy System Ends," *Asahi E-News*, November 4, 1997 (accessed on the worldwide web). Even in this case, something of the traditional approach remained; the MOF forced other financial institutions, including the other major securities firms, to contribute to a rescue fund for paying back Sanyo customers.

lapses. Its initial strategy combined recapitalization of banks, small regulatory moves to dress up balance sheets, and measures to artificially prop up stock and real estate values. Early in 1998 the Ministry of Finance designed, and the Diet passed, a ¥30 trillion ($240 billion) bank bailout plan, of which ¥17 trillion ($135 billion) was to increase the Deposit Insurance Corporation's fund to reimburse depositors of insolvent banks and ¥13 trillion ($103 billion) was to recapitalize banks through the purchase of new issues of preferred shares and subordinated bonds. Deciding that capital adequacy ratios are an inherently sensible concept, the Ministry of Finance announced a weaker, 4 percent adequacy ratio for domestic banks not involved in international lending, effective from spring 1998, but meeting even this standard was sufficiently difficult for so many banks that, at the end of 1997, the ministry indicated that enforcement would be "flexible."[23]

While recapitalizing banks is a necessary part of fixing the problems of the financial sector, the specific approach adopted by the Japanese government in early 1998 presents three problems that have raised skepticism about the wisdom or practicality of the policy. First, propping up weak banks with government funds injects moral hazard, especially since access to these funds was not made contingent on changes in management personnel. As noted above, some of these banks have particularly weak or dishonest management. This became a political issue, as the public appeared unwilling to have its money spent on a recapitalization scheme that would protect negligent or dishonest managers.

Second, an infusion of government money might further enhance moral hazard because the government would be extremely unwilling to permit recipient banks to fail—and thereby suffer embarassment or loss of face. This dilemma has already arisen in the debate over what to do with the Long Term Credit Bank (LTCB). The bank received an infusion of capital in early 1998, as the government attempted to force a reluctant Sumitomo Trust to absorb the LTCB, once bad loans had also been stripped out. Having already poured money into the LTCB, the government appeared to prefer to add more money, rather than letting the bank declare bankruptcy.

23. "MOF to Ease Implementation of Banking Rules Set for April," *Nikkei Net*, December 23, 1997 (accessed on the worldwide web); "To Avoid More Bankruptcies, MOF Eases New Capital Rules for Banks," *Japan Digest*, January 6, 1998, p. 2.

Third, the government proceeded without knowledge of which banks were in greatest need of a capital infusion, or else it was unwilling to put the money where it was needed most, out of fear of alerting the public as to which banks were in greatest difficulty. This continued a pattern of patronizing behavior that assumed the public was not capable of responding rationally to accurate information. That is, the Japanese government worried that the public might interpret an infusion of new capital not as a sign of the increased safety of a bank, but as a signal that the bank was in such bad condition that it would fail, thus leading to a catastrophic withdrawal of deposits.

In actuality, only the largest twenty-one banks in Japan received funds, through issues of preferred shares and subordinated bonds totaling ¥2.1 trillion ($15 billion) in March 1998, reportedly enough to raise the BIS capital ratio of the nine ''city'' banks (nationwide commercial banks) by about 1 percentage point.[24] One wonders whether, rather than to rescue the banking system, the real intent was to ensure that the large banks would not lose their ability to make international loans (and perhaps also to bring down the embarrassing ''Japan premium'' in international interbank lending). Because of these doubts and criticisms, the rest of the ¥13 trillion earmarked for capital infusion still had not been disbursed by the fall of 1998.

In early 1998 the government sought additional means to assist the banks. Since banks are affected by movements in the stock market, such measures included propping up stock market prices. A portion of social security funds, postal saving funds, and postal life insurance funds is routed through two subsidiary organizations of the government with a mandate to make portfolio investments in the private sector. Roughly 14 percent of social security funds are routed to the *Nenkin Fukushi Jigyodan* (public welfare service public corporation, or PWSPC), and 2.5 percent of postal savings and 11 percent of postal life insurance funds are routed to the *Kan'i Hoken Fukushi Jigyodan* (postal life insurance welfare corporation, or PLIWC).[25] The govern-

24. ''Top Japanese Banks Set Out Plans for Public Funds Injection,'' *Nikkei Net*, March 5, 1998 (accessed on the worldwide web); ''Public Funds Will Raise Banks' BIS Ratios 1%, but That May Not Be Enough,'' *Japan Digest*, March 6, 1998, p. 2.

25. In FY1994, the PLIWC managed ¥9 trillion ($90 billion at 1994 exchange rates) in postal life insurance funds, representing 11 percent of postal life funds, and ¥5 trillion ($49 billion) in postal savings funds, representing 2.5 percent of postal

ment-owned organizations then place these funds with financial institutions to engage in portfolio investment. The funds can be quietly invested in weak financial institutions or used to prop up overall stock market prices—dubbed by the Japanese media a PKO (price-keeping operation). In mid-March 1998, for example, the Liberal Democratic Party (LDP) agreed to use up to ¥1.3 trillion (just over $10 billion) in postal savings funds to prop up the stock market during the remainder of the month.[26] Moreover, in early 1998 the Ministry of Finance imposed stringent controls on short selling in the stock market, with the obvious intent of reducing downward pressure on share prices.[27]

Other policy measures involved changes in accounting that made bank balance sheets look healthier than they were in reality. Japanese firms have traditionally shown assets at purchase cost on their balance sheets, thus injecting an element of unreality to accounting results. Under new rules, financial institutions revalued real estate holdings (mainly the long-held land on which their offices and branches sit) to market value in 1998, but were not required to do likewise with their stock portfolios; many financial institutions hold shares purchased near the peak of the stock market and have been permitted to keep these assets listed at their original high purchase prices, rather than marking them down to current value.[28]

Finally, the government has discussed using public funds to buy real estate and thereby prop up land prices or buy asset-backed securities, representing the bad debts of banks, at above-market prices.[29] But while the government might be able to generate a small change in land prices by accelerating purchases of land for future public works projects, this cannot continue in the long run.

This set of policies can be described as an effort to continue a tra-

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savings funds. For the same period, PWSPC data show that it managed ¥21 trillion ($200 billion) of social security funds, or roughly 14 percent of social security funds. These data are from the annual financial statements of the respective organizations.

26. "Public Funds to Be Used to Buoy Stocks," *Asahi E-News*, March 13, 1998 (accessed on the worldwide web).

27. "MOF Will Tighten Control on Short Selling to Prop Up Share Prices," *Japan Digest*, January 8, 1998, p. 2.

28. "LDP Would Have Government Buy Mortgage-Backed Securities at Above-Market Values," *Japan Digest*, February 11, 1998, p. 2.

29. "LDP Would Have Government Buy Mortgage-Backed Securities at Above-Market Values," *Japan Digest*, February 11, 1998, p. 2.

ditional approach. Banks were protected from failure, while it was hoped that a rise in stock and real estate prices would eventually reduce losses on bad loans. Meanwhile, the government expected public confidence (and deposits) in commercial banks to rise, in light of the implicit guarantee of an end to bank failures, infusion of government capital, and reinforced deposit insurance funds. Unfortunately, these policies did not have the expected outcomes. Rather than restoring public confidence they appear to have eroded it, as rumors about banks on the verge of collapse continued. Given the failures of bank management, it should not be surprising that policies to prop up banks indiscriminately and leave management untouched would be viewed skeptically.

Households have a risk-free alternative to commercial banks in the form of the postal savings system, and deposits have gradually shifted toward this option. From fiscal 1994 through fiscal 1996 (ending March 1997) total deposits in commercial banks were almost flat, whereas deposits in postal savings continued to increase, raising its share in total domestic deposits from 29 percent to 32 percent.[30] During fiscal 1997, deposits in commercial banks actually rose by about 2 percent, but they still fell behind the 11.4 percent gain in postal savings deposits.[31] While these data do not support the popular view of a major flight of money out of commercial bank accounts into postal savings, there has been at least a modest shift in the relative share of funds invested as postal savings, suggesting that the public does not entirely believe government promises to avoid bank failures and is drifting slowly toward safer assets.

Faced with continuing criticism of its banking policies, the Japanese government announced a new plan at the beginning of July 1998, a close variant of which should pass the Diet in the fall. This plan included several proposals: creating a secondary market for the securitization of bad loans; further tightening accounting rules to more closely conform to those used by the U.S. Securities and Exchange Commission; strengthening bank supervision through the new Financial Supervisory Agency (created in June 1998 and officially independent of the Ministry of Finance), which was to begin an intense inspection of the

30. Bank of Japan (1997, pp. 57, 190).

31. Bank of Japan (1997, p. 57) for commercial banks; "Postal Savings Rose 11.4%, Postal Insurance 7% in FY '97," *Japan Digest*, July 31, 1998, p. 4.

major banks; and creation of the "bridge bank" system. Of the various initiatives, the most important is the bridge bank concept, involving a new mechanism to handle failed banks. Under the proposal, a failed bank would be placed under a government-appointed receiver, who was to arrange an acquisition. Should that effort not suffice, the failed bank would become a bridge bank under government control. As such, it would continue to make loans to "sound" borrowers, dispose of bad loans, receive equity funds from the ¥13 trillion fund established for bank capitalization in early 1998, and continue to seek a takeover bank for its remaining assets. Bridge banks may exist for two years, with the possibility of extensions for three additional years.[32]

In proposing a mechanism for dealing with the consequences of bank failure rather than relying on ad hoc methods, the government has taken a useful step forward. Nevertheless, the proposed plan (as under discussion in the summer of 1998) has a number of potential problems.

First, it does little to allay suspicions that the government's goal is to prevent the failure of any bank. Even though the FSA is to engage in stringent inspection of banks and, presumably, to close those that are clearly insolvent, markets are not convinced that it will do so. Early statements by the new government of Prime Minister Keizo Obuchi fueled this skepticism by emphasizing a "soft landing," in which few, if any, banks would be closed.[33] And it was reported that an early draft of the legislation relied on banks to declare insolvency voluntarily.[34] This drift in policy is distressing, given the need to eliminate irresponsible, insolvent institutions and their managers.

Second, the emphasis in the bridge bank plan is on continuing the provision of loans to "sound" borrowers. In Japan's relationship-heavy banking sector, the rationale for this bias is to alleviate a potential credit crunch—even creditworthy borrowers whose traditional lender has failed might experience trouble in finding another bank to extend credit. Understandable as this goal is, suspicion remains that the real outcome will be the continued flow of credit to borrowers who are not creditworthy, especially those with connections to LDP politicians.

32. Japan, Government-Ruling Party Conference (1998).

33. "Obuchi, Miyazawa Agree to Aim for 'Soft Landing' in Bank Sector Reform," *Nikkei Net*, July 30, 1998 (accessed on the worldwide web).

34. "Bridge Bank Bills to Require Banks' Self-Declaration of Collapse," *Nikkei Net*, July 29, 1998 (accessed on the worldwide web).

Such lending may be extensive, so that the bridge bank plan could hinder rather than promote the broader structural changes needed in the economy. Suspicion of this aspect of the plan by opposition political parties could delay or obstruct passage of the necessary implementing legislation.

Indeed, even though there may be some theoretical justification for the existence of a credit crunch resulting from balance sheet weakness and financial institution bankruptcies, the actual situation remains unclear. In the spring and summer of 1998, bank lending was running at slightly more than 2 percent below year-earlier levels.[35] But whether this reflects more than the result of macroeconomic weakness is difficult to discern. At the very least, this small decline in the magnitude of lending seems at odds with the conventional wisdom in Japan that the country is experiencing a widespread credit crunch.

Third, although the government's intent was to impress markets with a newfound resolve to attack the bad debt problem quickly, the plan permits the shutdown of individual banks to take place over considerable length of time. The maximum period of initial supervision by a government-appointed receiver is not defined, and the subsequent bridge bank could remain in existence for up to five years. Rather than tackling the real problems of bad debts and insolvent banks, the plan suggests an intent to delay their resolution as long as possible.

It seemed probable that some version of the bridge bank plan would pass in the fall of 1998. Having suffered a decisive loss of seats in the upper house of the Diet in an election in July, the Liberal Democratic Party appeared to be willing to compromise with the opposition parties in designing the legislation. But it is unlikely that any concessions would really address the plan's basic flaws.[36]

Evaluation

The scale of the problems in Japan's financial sector far exceeds the U.S. savings and loan (S&L) crisis of the 1980s. Under the best of

35. Jeffrey D. Young and Tomoko Fujii, ''Economic and Market Analysis; Japan: Issues and Prospects,'' Salomon Smith Barney, August 13, 1998, p. 6.

36. See Robert Alan Feldman, ''Japan: Shallows, Miseries, and Brinkmanship,'' Morgan Stanley Dean Witter *Global Economic Forum,* September 8, 1998 (accessed on the worldwide web).

circumstances, the cleanup will be costly, and will involve a combination of closing the worst banks, shoring up other banks with government capital, and disposing of nonperforming loans throughout the banking system. Since systemic risk is certainly present, choice of policy is especially important. Over the next several years, the government is likely to avoid an uncontrolled collapse of the financial system. Certainly, the vast scale of the Japanese banking crisis might suggest that a policy of caution and slowness is justified. But there are several reasons why its ability to resolve these problems in a manner that restores the sector to health remains in doubt, notwithstanding the new bridge bank plan.

First, too much emphasis is still placed on propping up all financial institutions, regardless of their past behavior or current financial condition. But if the public does not believe that this is either desirable or possible, the government will lack the political support needed to do so. The public might also continue to vote with its pocketbook, demonstrating its lack of faith in the government's promise of blanket support to financial institutions through the continued leakage of deposits to the postal savings system. Moreover, as emphasized above, the banking system needs both a bailout and the elimination of the banks and managers most culpable in the unethical and illegal dealings of the past decade.

Second, the macroeconomic situation has not improved much over the course of 1998. In April 1998 the government announced a ¥16 trillion ($114 billion) fiscal stimulus package, which at face value represented 3 percent of GDP, larger than any previous package. However, skeptical analysts pegged the real portion of this package at about ¥7 trillion for fiscal 1998, or just over 1 percent of GDP.[37] Moreover, the government had actually begun the fiscal year with an initial budget that would have withdrawn fiscal stimulus from the economy, further dampening the net change in fiscal stance from fiscal 1997, once the supplementary measures were added to the initial budget. In the fall of 1998, the Obuchi government appeared likely to propose additional stimulus, including a permanent income tax cut (although this would not take effect until fiscal 1999). These measures should keep the reces-

37. Robert Alan Feldman puts the fiscal impact of this package at ¥7.4 trillion for FY98, and an additional ¥1.7 trillion spread over subsequent years; "Japan Struggles to Stay Stagnant," memorandum, Morgan Stanley Dean Witter, May 1998, p. 9.

sion from deepening, but most forecasters anticipate that the economy will shrink in 1998 and remain sluggish through 1999. In this environment, the stock and real estate markets are unlikely to rise. It would be unrealistic to expect that the problems in the financial sector will ease because of rising capital adequacy ratios from higher stock prices, or better chances of loan recovery due to higher real estate prices.

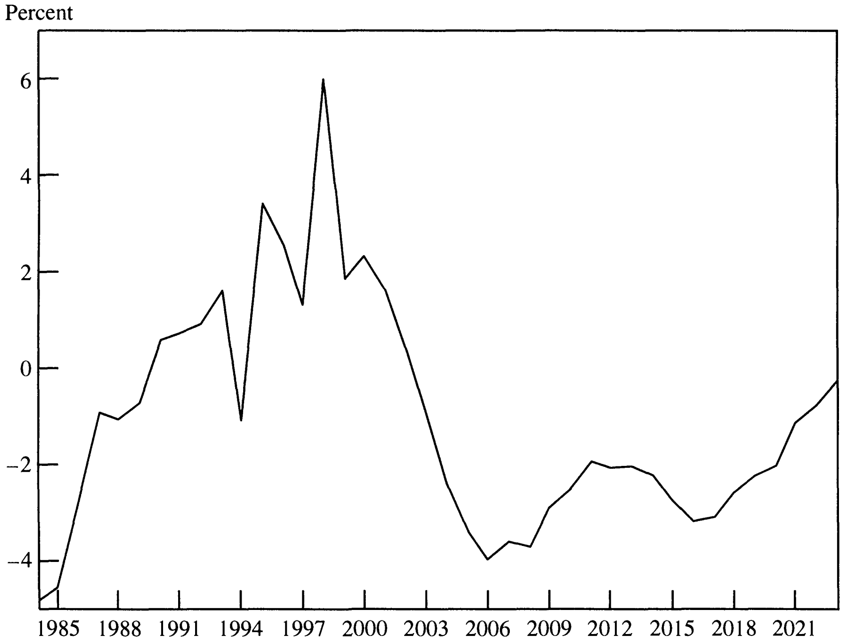
Third, a longer term perspective also suggests that real estate prices may not rise much from present levels. Japan has experienced a low and falling birth rate for more than two decades. In 1997 the birth rate hit a low of 1.39 children expected over the lifetime of each woman.[38] Total population is now expected to peak in 2008, and the total number of households will quite possibly peak earlier. In Japan, many single adults live either in company dormitories or in their parents' homes. Most marry between the ages of twenty-five and twenty-nine, at which point they become new households, needing housing. Figure 4 shows what will happen to the absolute size of this segment of the population over the next twenty-five years (under the generous assumption of zero mortality of all persons now aged between zero and twenty-eight). From 2001 until the end of the period, this segment of the population will shrink; the total decline in absolute size between 1996 and 2021 will be 35 percent. Therefore the housing component of real estate demand should become flat or start to decline in the near future. Clearly, one cannot rely on the recovery of the real estate market over the medium term as a means of overcoming the bad loan problem.

Nevertheless, there have been a few positive developments. First, some steps have taken place to securitize bad debt, principally through sales to American financial firms. In the ten months ending June 30, 1998, foreign investors acquired loans with face value of ¥4 trillion ($29 billion) at prices reported to range from 5 to 10 percent of face value.[39] This should contribute to the removal of nonperforming loans from banks' books, although the amounts involved so far are very small relative to the total of bad loans in the system. Even this strategy may run into some problems, however. The price at which purchasers are willing to pick up bad loans may continue to be very low because of

38. "Birth Rate Hits Another Record Low, As Women Marry Later, Divorce More," *Japan Digest*, July 11, 1998, p. 5.

39. "Foreigners Scoop up ¥4 Trillion in Bad Loans at Bargain Basement Rates," *Japan Digest*, July 15, 1998, p. 2.

Figure 4. Growth Rate in Cohort Aged Twenty-Five to Twenty-Nine in Japan, 1985–2023[a]



Source: Japan, Statistics Bureau (various years).
a. Growth rates after 1996 are calculated from data provided in 1998.

the greater doubt that land prices will recover substantially from current levels, for the reasons noted above. Furthermore, to foreclose on bad loans and sell the real estate collateral is very difficult in Japan, both because of the poorly developed nature of real estate markets, which are encumbered with strong tenant rights and high transactions taxes, and because of the involvement of *yakuza* (Japanese mafia) gangsters. Nevertheless, the very recent emergence of a market for selling bad debt is a positive step, and the participation of foreign institutions in developing this market could increase pressure to sell the underlying real estate collateral.

In addition, the problems of the financial sector have become sufficiently urgent that the government appears to have lost its general antipathy to the participation of foreign firms. Just a few years ago, it was virtually unthinkable that an American financial institution could acquire a Japanese firm. But over the past year, there have been several visible transactions: Merrill Lynch has acquired retail branches from defunct Yamaichi Securities, GE Capital has purchased several small finance firms, and Travelers has acquired what appears to be a minority but de facto controlling interest in Nikko Securities.[40] A long-term solution to the problems of the financial sector will involve major restructuring, and competition from foreign institutions provides substantial incentive for domestic firms to change.

Another part of the long-term solution is a basic move away from heavily bank-centered finance. That trend may be underway with rising issues of corporate bonds in 1997 and 1998. The fact that bond issues are increasing rapidly also suggests that concerns about a credit crunch are overdone; large creditworthy firms that might be facing constraints from bank lenders appear to be substituting bonds for loans.

Conclusion

Japan's financial problems are very serious and have been festering for eight years since the peak of the stock market bubble. The government's initial attempts to pursue a traditional quiet, opaque solution by providing guidance for absorbing failed institutions into strong ones is entirely understandable. No one understood the magnitude of the problem, and this approach had worked well in previous decades. With a paucity of strong institutions willing to bend to Ministry of Finance pressures, though, the possibility of uncontrollable strings of failures has grown and, in turn, has generated a demand for stronger policies. The plans that emerged over the summer of 1998 respond to that demand. But even these have attracted considerable skepticism. Some of this skepticism is warranted. The plans have some structural flaws and are certainly vulnerable to arbitrary and politically motivated decision-

40. "Bank of Tokyo–Mitsubishi Fails in First Round of Big Bang," *Asahi Shimbun*, July 1, 1998 (accessed on the worldwide web); "GE Capital To Buy 80% of Mitsubishi Group's Ryoshin Leasing," *Japan Digest*, July 30, 1998, p. 4.

making that might not be in the best interest of cleaning up the financial mess. And any plausible solution to Japan's financial problems will come at considerable cost to taxpayers, who are justifiably concerned that their money may be spent on propping up the wrong banks for political reasons.

Comment and Discussion

Benjamin M. Friedman: Not so many years ago, my Harvard colleague Ezra Vogel wrote a best-selling book with the arresting title *Japan as Number One*. The notion accurately captured the popular view of Japan at the time, and it also reflected the considered opinion of a sizable fraction of the knowledgeable scholarly community, as the western world fretted over its ability to compete successfully against the myriad advantages (as they then seemed) that the Japanese economy enjoyed. Today, Professor Vogel's sequel might be called something like *Japan as Number Twenty-Seven*—or maybe some even larger number.

Nowhere has this about-face in attitudes toward Japan been more striking than in the financial arena. People all over the world still buy Sony radios, Toyota automobiles, and Seiko watches. Japan's manufacturers have increasing cost problems, to be sure, but these are no worse (and probably a lot less severe) than those of their counterparts in other mature industrial economies. By contrast, the once vaunted Japanese financial system, which "revisionist" thinkers hailed for creating so many competitive advantages for Japanese industry, and which even mainstream western economists closely studied as a consistent provider of lower cost capital, is now widely perceived as a cripple standing in the way of any serious prospect for Japan's economic recovery. Watching in the newspapers the steady climb of official estimates of the volume of bad loans on the books of Japanese banks, as the Ministry of Finance keeps revising its figures upward, is reminiscent of the changing cost estimates of major weapons systems bought by the U.S. Defense Department under the old cost-plus procurement system.

How did this astonishing turnaround take place? Was it merely an accident triggered by the bubble in Japanese real estate and stock prices? Or was Japan's financial system fundamentally flawed to begin with? As a matter of public policy, was excessive supervision and regulation a major part of the problem? Or, as in the case of the U.S. savings and loan debacle, was the problem too little supervision and regulation? Most important, looking forward, what should Japanese public policy do now to clean up the mess and get the economy growing again?

Edward Lincoln argues that, over time, Japan's economy underwent structural changes that left its idiosyncratic and inflexible financial system increasingly far behind. He therefore largely sidesteps the question of whether this system was optimal, or even useful, in the conditions that prevailed during the first quarter century or so after World War II. (There is some literature, including research by David Sharfstein, David Weinstein, Yishay Yafeh and others, suggesting that it was not.) His point is instead that the international competitive environment changed in the 1970s and 1980s, and the Japanese financial system was not well suited to contribute to the functioning of the Japanese economy under the newly prevailing circumstances. Following a highly useful review of the resulting mismatch between the financial system and the economy, he concludes in short, that "this combination of factors was almost guaranteed to lead to problems."

While Lincoln argues, therefore, that the problems Japan now faces in this sphere reflect endemic flaws, not just the accident of the asset price bubble, he does point to the collapse of Japanese stock and real estate prices as the immediate trigger for what went wrong. His accounting of the volume of nonperforming loans, including not only those at the banks but also the questionable assets of insurance companies and securities firms, confirms the widespread belief that Japan now faces a significantly larger problem compared to the size of its economy than the United States did at the height of the S&L collapse. What he does not say, but is presumably true, is that Japan's problem is larger in yet another way, because of how far real estate prices have fallen. The U.S. Resolution Trust Corporation (RTC), which liquidated over 700 savings and loan institutions, eventually realized—through repayments and the sale of the collateral that it seized—nearly 80 cents on the dollar of the total portfolio of loans and other assets that it took over. As a result, on net it took the RTC "only" $85 billion to close

S&Ls that together had over $400 billion of assets on their books at the time they were taken over.[1] The RTC's recovery rate even on the *real estate* it sold was apparently in the range of 60 cents on the dollar. In Japan, realizations from sale of real estate assets at today's prices would surely fall well below the RTC's experience.

Although Lincoln never says it in so many words, he seems to think—and I agree—that as in the U.S. savings and loan situation, Japanese banks ran into problems not because they had too much regulation and supervision but because they had too little, or at least too little in the right places. He usefully notes the absence or weakness of restrictions on the banks' entry into new and unfamiliar areas like real estate development and foreign lending in the 1980s. He also catalogs the laxness or outright corruption of supervisory attention to nonperforming loans, once these began to accumulate. He might also have noted, in this regard, the contrast between the United States, which at last count had over 9,000 full-time bank examiners on the payroll of the Federal Reserve System, the Comptroller of the Currency, and other federal regulatory bodies, as well as state-level banking agencies, and Japan, which has less than 300, of whom many are poorly trained and many others work in revolving-door relationships with the banks that they are supposed to supervise. To be sure, Japan has far fewer banks. But the relevant measure for this purpose is not the number of banks but the number and complexity of loans. As Lincoln emphasizes, bank loans bulk far larger in the Japanese economy than in the United States.

A more fundamental issue, which bears not only on how Japan's current distressed economic and financial situation arose but also on what to do about it, turns on the connection between macroeconomic weakness and an incapacitated credit system. Lincoln argues that Japan's macroeconomic weakness today is due not to any kind of credit crunch but to other factors, primarily contractionary fiscal policy. He therefore goes on to argue that the best way to help the Japanese banks is to get the economy growing again. His analysis thus stands in direct opposition to the view that the best way to lift the Japanese economy out of its current situation is to get the banks lending again. While I do

1. The more familiar estimate of $155 billion as the cost of the S&L clean-up includes this sum for the RTC plus another $70 billion dispersed by the Federal Savings and Loan Insurance Corporation.

not want to overstate the difference of opinion, I do disagree with Lincoln here.

I certainly accept the view that contractionary fiscal policy is responsible for a major part of Japan's weak economic performance over the past half dozen years. As Adam Posen effectively argues in his new book, expansionary fiscal policy has not worked in Japan because it has not been tried—and to the limited extent that it was tried, in 1995, it did work.[2] But macroeconomic phenomena that occur on a large scale and that persist for the better part of a decade rarely have unique causes, and Japan's stagnation in the 1990s is no exception. By now, Japan's economic decline recalls the early nineteenth century story in which a paddle steamer puts in at a Hudson River village, boards passengers, splashes off again to great applause by the assembled crowd, disappears around the next river bend . . . and promptly sinks. Why did the disaster occur, one is led to ask? Alas, we shall never know: there were too many survivors.

Over the past ten years, the Brookings Panel has heard numerous papers outlining the ways in which the extension of credit facilitates production, unemployment, investment, and consumption—and conversely, how a dysfunctional credit system can impede nonfinancial activity. Whether Japan's economic downturn caused the banks' credit problems or a credit crunch that arose for other reasons (most obviously, the popping of the asset price bubble) caused the downturn is a chicken and egg problem that will probably occupy researchers for years to come. But by now the two are mutually reinforcing. As Joe Peek and Eric Rosengren, among others, have shown, if the situation in Japan today does not constitute a credit crunch, it at least looks very much like one. Restoring economic growth, through fiscal policy as both Lincoln and Posen suggest, or through monetary policy as Paul Krugman's paper in this volume suggests, would clearly help to restore the health of Japanese bank balance sheets and, in turn, the viability of Japan's credit provision mechanism. But independent steps to rebuild the banking and credit system would also help to foster renewed economic growth.

What might those steps be? More specifically, does the bridge bank plan recently proposed by the Ministry of Finance offer a real chance

2. Posen (1998).

of doing the job? The experience of the Resolution Trust Corporation in the United States offers several highly useful lessons for Japan. First, and most important, delay is costly. Research after the fact (for example, by David Ely and Nikhil Varaiya) has shown that the most powerful factor determining the per dollar cost of resolving the insolvencies of individual institutions was the number of months that elapsed between the identification of an insolvency and its resolution.

Second, the negative effect of collateral sales on real estate prices was mostly less than market participants had feared. In some local and regional markets, there even appears to have been a beneficial effect from eliminating the widely perceived "overhang" of assets held by the RTC and due for sale. This experience reinforces the first lesson, in that it undercuts one of the standard arguments for delay.

Third, eliminating insolvent institutions improves the competitive environment for those that survive. The reason is that insolvency, even when not formally recognized, greatly magnifies the familiar perverse incentives created by moral hazard under limited shareholder liability. The lesson to be drawn here is that regulatory forbearance is counterproductive. Once again, moving forward forcefully and rapidly is warranted.

Finally, one of the greatest successes of the U.S. experience in this regard was that the government did not have to go into the banking business on an ongoing basis. One of the chief concerns that observers of Japanese policy have expressed about the MOF's new bridge bank plan is that it explicitly authorizes government ownership and management of any failed banks for up to five years. In the event, might five become seven, and then seven become ten? The U.S. government has also, in effect, owned and managed banks in recent years: Continental Illinois in the mid-1980s, Bank of New England in the early 1990s. But the cases are few, the government clearly saw its ownership as temporary—which in the event it was—and it left management squarely in the hands of private sector professionals whom it appointed.

Can Japan carry out an effective program to clean up the balance sheets of its banks, eliminate unsound institutions, and restore its credit system to a condition that will support rather than impede more general economic recovery? Of course it can. Japan remains a rich country by any standard, and the public resources needed to recapitalize the banking system are well within reach. More fundamental, in a real economic sense the losses have already been incurred, and the wasted resources—since that is what loan losses ultimately represent—are already gone. The loss of wealth represented by the decline of real estate and stock prices has already occurred. It remains simply to recognize that all this is so and move forward. In a Robinson Crusoe model, or the multiperson equivalent that economists conventionally call a representative agent model, there would be no reason whatever for not doing so.

But the current impasse in Japan represents a spectacular example of the failure of Robinson Crusoe, or representative agent, thinking as applied to matters of actual economic policy. In this case, recognizing the losses that have already occurred means closing down, or at least restructuring, key institutions. That presumably means expropriating shareholders and, what is apparently more problematic in the Japanese context, identifying specific individuals as responsible for their institutions' failure and removing them. Nothing clears the air more effectively than for the shareholders of an insolvent bank to be told the truth—namely, that the value of their investment is zero. Nothing better teaches the importance of good performance on the job than to see blatantly poor performers suffer the consequences personally, rather than continue to reap rewards, as is so often the case.

To an outsider, Japan appears to be the kind of homogeneous society that, in principle, ought to be able to take difficult decisions and move forward. Such, however, is not the case. A puzzling question, from a political economy perspective, is what internal social tension prevents the Japanese from moving effectively to resolve these problems. But that is clearly the subject for another paper.

General discussion: Participants engaged in spirited discussion about whether radical or gradual remedies should be applied to Japan's banking problem. Alan Blinder observed that differences in cultural and economic conditions made it difficult to use U.S.–style remedies in Japan. He noted that the disappearance of Yamaichi Securities was a much bigger shock to Japanese confidence than the disappearance of Smith Barney, or even Merrill Lynch, would be here. Because bankruptcy is much harder to accept in Japan, a strategy of closing down technically insolvent banks would have to be implemented slowly, and so would delay the return of a normally functioning banking system. Blinder reasoned that the financial problems would be resolved faster if Japan adopted a softer approach, keeping dead institutions alive through infusions of capital and new management, or mergers with good institutions. George Akerlof added that it was dangerous to apply U.S. experience with the Resolution Trust Corporation directly, because Japan's problem is so much bigger, and because banks play such a key role in the Japanese financial system. The resolution of the S&L crisis had little, if any, impact on asset prices, and the RTC realized 70 to 80 percent of loan values when it sold properties. He worried that a radical approach to the problem of failed banks in Japan might make the current situation worse by driving down asset values, and so add to the problems of all institutions. He concluded that it was important to proceed slowly with bank reform. Charles Schultze reasoned that the huge size of Japan's financial problem relative to the size of its economy forced a trade-off between growth and reform. Since many present managers would have to be replaced in any radical reform of the banking system, reform would risk impeding recovery. Since the short-term priority should be to get the economy growing again, he therefore believed that reform should be gradual.

Martin Baily disagreed with these calls for caution. He argued that Japan needed fundamental structural reform that would replace its traditional approach to doing business and lending money with one that was oriented to market pricing and shareholder value. He acknowledged that the Japanese economy had enormous success in the early postwar decades, but questioned whether the system had served Japan well more recently, even before the present crisis. He pointed out that Japanese growth slowed dramatically in the 1970s; at that time, GDP per hour worked was about one-half of the U.S. level, and it has since reached only about 60 percent of the U.S. level. Baily reasoned that Japan has missed many investment and growth opportunities because of the way banking and business are organized. Specifically, he cited the need to develop and apply risk assessment skills in the banking system, where making the required shift may, in many cases, mean changes in leadership positions in banking and commerce.

Barry Bosworth recalled that Sweden's real estate boom of the late 1980s and the early 1990s looked very similar to the Japanese boom. Sweden also ended up with all its banks bankrupt and faced a policy problem similar to Japan's. It moved all bad loans into a single bank that was jointly owned by the government and other banks and injected subordinated debt, which counted as capital, into the system. The Swedish authorities did not assume that the bank managers were bad, and provided strong incentives for them. If the debt was not repaid in five years, it would convert into equity and be sold in the market, taking control of the bank away from its present managers. He noted that the Swedish banking system is now healthy again. Lincoln believed the Swedish way would not work for Japan because, besides the boom-bust cycle in real estate in which everyone got hurt, Japan's banks suffered from very unethical behavior by managers. He thought it was important to replace bank managers in Japan, so that the public would see that these people were being punished.

Robert Litan offered a specific plan for dealing with the banking problems. He judged that because a large number of Japanese banks would be severely undercapitalized if their assets were marked to market, the only potential buyers would be foreign banks or Japanese nonfinancial institutions, such as Toyota. He saw this as one reason why the authorities are temporizing with plans like the bridge bank, hoping to achieve gradual reform as some banks become healthy and able to absorb the bad loans in the system. Another reason is the fear that more bankruptcies will undermine the confidence of households, making them fear job losses and increase saving. As a solution, Litan suggested a massive swap of equity for nonperforming debt. This would require both relaxing the law that now keeps banks from owning more than 5 percent of any individual company and finding a way to assure that future loans are made as arm's length transactions. To remove cronyism from future lending, Litan recommended that an RTC–type institution take over the delinquent loans and apply an objective formula for the terms of debt-for-equity swaps.

David Laibson questioned the widespread view that bank-based corporate governance systems were to blame for the Pacific Rim crisis. He noted that such systems used to be seen as producing a long-term perspective, generating more R&D, and better information because they were built on trusted personal relationships. Now that Japan is in trouble, the same characteristics are seen as drawbacks. Laibson argued that this new assessment was flawed, in that it compared a poorly functioning bank-based system to a first-best equity-based system. Rather than simply blaming the system, he suggested a different framework for analyzing the financial problems of Japan and other Pacific

Rim economies. He noted that during the 1970s, economists abandoned their traditional view that financial markets were prone to manias, crashes, and panics, and adopted the view that financial markets were efficient. However, he found the evidence that investors are not rational or sophisticated pretty overwhelming, and noted that they tend to extrapolate their own investment experience into the future. For example, those younger than fifty-five forecast 20 percent annual returns in the equity markets over the next five years, while those over fifty-five forecast annual returns of only 11 percent. Laibson suggested that in Japan and the rest of East Asia, the spectacular recent performance was inappropriately extrapolated. Such unrealistic investment expectations would have caused allocation distortions under either a bank-based or an equity-based system.

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