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The Causes of Japan's Financial Crisis

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The Causes of Japan's Financial Crisis

Abstract to come

Introduction

A mere decade ago Japan's financial system, and especially its banking system, was not only the largest but the strongest in the world. Nine of the world's top ten banks in asset size were Japanese; the Big Four Japanese securities companies were the world's largest; and its life and casualty insurance companies were likewise huge. Banks had ample, low cost, deposit funds and the highest credit ratings. The largest were expanding their international operations vigorously, and performed 34 per cent of the world's international lending business, more than banks domiciled in any other country.

Today presents a completely different picture. Japan's financial system is weak and in disarray. Banks no longer rank among the world's top ten, and their credit ratings have declined dramatically. Two of Japan's top 21 banks have already collapsed, as has one of the Big Four securities companies, and a mid-sized life insurance company. This is not only unprecedented in Japan's postwar history, until the 1990s it was unthinkable.

This paper focuses primarily upon the problems of the Japanese banking industry, although the analysis applies in many respects to the securities and insurance industries as well. It does not consider Japan's fiscal mess: its budget deficits, tax system, government fiscal and loan programs, or the special account debts that cannot be serviced. This is a

comprehensive overview rather than a detailed analysis of specific issues or topics. It provides the groundwork for the conference *Financial Reform in Japan and Australia* by addressing two themes: the 'postwar' financial system and its implications; and causes of the current banking difficulties.

The objectives of any financial system in a market-based economy are threefold: the safety of the system in order to prevent bank runs and monetary panics; its effectiveness in mobilizing savings and allocating them to productive, efficient uses by financial intermediation through banks or capital (stock and bond) markets; and efficiency in the provision of financial services, best achieved in a highly competitive system. These objectives can be in conflict, depending on how the system is organized and what constitute the rules of the game. The achievement of these objectives depends on the overall economic environment, including the level of economic development, the degree of competition, and the extent of global financial market integration.

In designing the postwar financial system, the regulatory authorities, essentially the Ministry of Finance, always placed great emphasis on system safety, and maintained or built upon the wartime bank-based financial system.

The postwar financial system

The basic characteristics of the financial system in the era of rapid growth until the mid-1970s are well known.[1] It was essentially a bank-based system, with deliberately underdeveloped stock and bond markets. Risk-averse savers had few alternatives to holding savings deposits; and rapidly growing corporations had to rely heavily on bank loans to finance their extraordinarily high rates of fixed investment. The structure of banks was stable and classes of bank were segmented by function and size of customer. Deposit-taking institutions included city banks, long-term credit banks, and trust banks, which together comprised the Big Banks, lending mainly to large corporations; and local or regional banks, mutual savings banks, and credit associations and cooperatives, lending mainly to medium and small businesses and individuals.[2] The system was also stable in that there was no new entry, and virtually no failures or other exits; the few failures were of small, badly managed, inconsequential institutions which were readily and rapidly absorbed by larger banks.

In effect, the essence of the regulatory regime was to guarantee that banks would not fail, so their management, stockholders and depositors were protected. This was achieved by interest rate controls, with wide spreads between deposit and loan rates, so that all financial

institutions made profits. Moreover, a 'convoy' system was maintained whereby the assets of all banks grew at about the same rate, and their relative ranking did not change over time. In this system interest rate competition was not allowed and other forms of competition were muted. Moreover, it was the responsibility of the strong to take care of the weak. Should a troubled small financial institution have to be merged into a larger one, any losses were more than offset by the franchise value of the branches thus acquired.

The system was based on close, symbiotic relationships between the powerful Ministry of Finance and the big banks, securities companies, and insurance companies. These collusive arrangements were based on the leadership of the Ministry of Finance through administrative guidance, price setting, protection, and restriction of competitive impulses. Accordingly, it was a system of implicit guarantees against losses for banks and depositors.

The development of the main bank system in many respects epitomized the stereotype of large bank-big business relationships, though in practice given the industrial structure, most of the banking system's credit was lent to medium-sized and smaller businesses. The main bank system overcame severe problems of inadequate information and difficulties in analysing the many new projects embodied in the process of rapid postwar economic development.[3] The main bank monitored its main industrial clients, established and maintained *de facto* lending syndicates to them, and had a special responsibility to step in and provide financial and managerial assistance in times of trouble. While all Big Banks had some main bank clients, the major main banks were Mitsubishi, Sumitomo, Mitsui, Fuji, Sanwa and Dai-ichi-Kangyo, notably with relationships with their respective *keiretsu* members, and the Industrial Bank of Japan, with a wide range of main bank relationships.

This postwar system was very safe and it carried out its financial intermediation role well, but it was not very efficient. Savers bore most of the costs because of low interest rates on their deposits and lack of alternative financial instruments. They correctly perceived, however, that their savings were fueling the process of rapid growth, and their reward was in wage increases, not interest yields on savings.

The postwar system could not last forever. As companies and banks thrived and grew much larger, they became stronger and more independent and many chafed under the restrictions of the system. The most important cause of the demise of the system however, occurred in the mid-1970s, when Japanese growth slowed and Japan shifted from being an economy in which private investment demand outstripped private saving to one in which *ex ante* private saving became greater than *ex ante* private investment.

This shift is fundamental in understanding the performance and macroeconomic policies of the last 20 plus years. Japan has been and is a demand-deficient economy, in which private saving continues to be larger than private investment demand. This change has dramatically affected the financial system and especially the banking system, and fundamentally undermined the highly regulated and controlled stable postwar financial system. The supply of funds suddenly become ample, interest rates declined, and pressures for a system of market-based interest rates became irresistible.

Accordingly, the Ministry of Finance came under increasing pressure to deregulate the financial system: to allow market-determined interest-rates, the creation of new financial instruments, development of a vigorous, competitive bond market, the breaking down of market segregation, and in general increased competition for all financial institutions and in all financial markets. However, the deregulation process has been steady but very gradual, beginning in the late 1970s and still continuing. A great deal of progress had been made by the early 1990s, and currently the 'Big Bang' of comprehensive financial reform, announced in late 1996 and due to result in completely 'free, fair, and open' financial markets by March 2001, is supposed to bring about the final stage of deregulation. While there are likely to remain a few unresolved issues, notably the postal savings system, for the most part this final deregulation process is proceeding on schedule.

In other words, Japan has been moving to a competitive, market-based system of banking and capital markets. Financial institutions are now under great pressure to cut costs, increase efficiency, and develop new financial products in order to compete. The new environment creates new kinds of risks, with new opportunities and dangers to taking risk, including interest rate risk for assets and liabilities, exchange rate risk, and credit risk since companies are also in a more competitive environment.

The ways in which the Ministry of Finance has handled, or mishandled, this long-run deregulation process and the concomitant changes in financial markets laid the groundwork for the current banking and financial mess.

Basic causes of current banking difficulties

Japan's current banking difficulties, which indeed have persisted since the early 1990s, developed over a considerable period of time, with a number of forces at work. Four causes were particularly important. They were failure to create a prudential regulatory system, the

creation and then bursting of the stock and real estate market bubbles, globalisation, and the high rate of financial innovation.

Before considering the causes, however, it is important to define the nature and extent of the problem. While Japanese banks have a number of problems, the fundamental problem is that the banking system has a huge amount of actual and potential non-performing (i.e. bad) loans relative to its capitalisation and bad loan reserves. Moreover, this problem has festered and worsened throughout the 1990s. The harsh reality is that every Big Bank and indeed most other deposit-taking institutions have had serious bad loan difficulties. These range from loans to companies that have gone bankrupt; non-performing loans in which interest and principal payments are unpaid and substantially past due; loans which have been restructured at highly preferential, extraordinarily low interest rates; and loans which are currently being serviced but future payments are in doubt. Banks lending in urban areas, particularly Tokyo and Osaka, have been the most hard hit. In contrast regional banks in rural areas to which the real estate speculative mania did not spread have had minor losses, and are now the strongest banks in Japan.

Over time the disclosed amounts of bad loans have increased until recently, even after write-offs. Private estimates of actual bad loans have been substantially greater than the amounts announced by the banks and the Ministry of Finance.[4] In Autumn 1997 the Ministry of Finance shocked the world with its estimate of the bad and troubled loan problem – some ¥76.7 trillion, triple previous estimates, and 12 per cent of total bank loans and credits, 12 per cent of loans of Big Banks, ten per cent of regional banks, and 14 per cent of second-tier banks. However, this reflected the new inclusion in the definition of bad loans a category of loans currently being serviced but in potential future danger. A Bank of Japan study estimated that over a three year period about 84 per cent of such loans continued to be serviced, but of course future estimates depend upon corporate borrower performance, in turn dependent upon the overall performance of the economy.

In practice, the actual amount of bank bad loans has been ambiguous, for a combination of definitional, measurement, and disclosure reasons. Most data are on a parent bank basis, but when their various real estate financing and other non-bank financed institutions are included on a consolidated basis, the estimates are often far different. Only in 1997 did regional banks and credit associations first disclose their bad loans. Over time the definition of bad loans has become more comprehensive and clear, now approaching the US SEC definition. However, each bank estimates its own bad loan situation. The presumption is that

the estimates of stronger banks are closer to reality than those of weaker banks. When weak banks have in fact collapsed, subsequent audits have revealed that the actual bad loan situation was far worse than the banks had announced even a short time earlier.

Three facts are important. First, most loans – good, doubtful, and bad – have some form of collateral backing them, frequently real estate. The key issue is the disposal value of the collateral. The actual losses banks have taken and will take are substantially less than the estimates of bank bad loans bandied about. Second, it has been very difficult for tax and legal reasons for a bank to actually write off a loan as bad. Most of the 'write-offs' are in the form of provisioning – increased allocations of profits and capital to bank loan loss reserves. Third, while small until 1995, over time the cumulative amount of actual write-offs has been huge and impressive. The 21 Big Banks between 1992 and 1998 wrote off ¥42.02 trillion, most (68.5 per cent) in the last three years and ¥12.14 trillion (28.9 per cent) in the last year alone.[5] This was financed from operations profits, realised capital gains on securities holdings, and modest capital account transfers. The immensity of this write-off is apparent in comparison with the amount of capital these banks had at their peak (March 1994) of ¥22.15 trillion.

Bad loans and their write-offs are directly related to a bank's capital. Banks engaging in international operations, with overseas subsidiaries and branches, have been subject to the Bank of International Settlements (BIS) 8 per cent capital adequacy requirement, a serious constraint during much of the 1990s. As capital was used to write off bad loans, banks had to raise more capital (difficult and expensive); reduce total assets; or shift their asset portfolio risk mix away from loans to government bonds. Banks doing only domestic business – credit associations and cooperatives, second-tier regional banks, and some of the first-tier regional banks – are subject to only a 4 per cent capital requirement. In reality, both the 8 per cent and 4 per cent requirements are unusually low in international comparison; bank capital adequacy remains an issue for the future.

Failure to create prudential regulatory system

The first cause of the banking crisis was the fact that deregulation took place without the creation of an effective system of prudential regulation and supervision to replace the postwar system of regulated interest rates, convoys, and constrained competition which provided safety to the system. Deregulation generates competition. Banks lost their guaranteed profits, market niches, and the franchise value of deposit-collecting branches. Banks had to adjust to the challenges as well as opportunities of an increasingly risky environment, yet

their capital bases were small. This created a situation of moral hazard, in which banks took on greater risk in the expectation that if they suffered losses the Ministry of Finance would bail them out. This was particularly true of the Big Banks, assumed to be too large to be allowed to fail.

Since the deregulatory process was gradual, it took a long time for the Ministry of Finance to realise it simply could not, and more importantly, should not guarantee all banks against failure.[6] In the mid-1990s the Ministry of Finance realised that even depositors might no longer feel completely safe. While deposits were insured up to ¥10 million by the Deposit Insurance Corporation (DIC), the insurance fees charged to banks were very low and the DIC reserves minuscule. They could be, and in fact were, soon depleted by several small banking institution failures.

To guarantee basic system safety the Ministry of Finance and government have taken three actions. First, in summer 1995 the Ministry of Finance announced that *all* deposits would be guaranteed until March 31, 2001. However, no specific funds were earmarked to support this pledge. The Ministry of Finance (MoF) believed its announcement effects were sufficient to ensure credibility. Second, deposit insurance fees were sharply increased, up to US levels. This generated new DIC income and reserves, but the amounts were sufficient only to handle two or three small bank failures annually, not more. Third, in February 1998 the government enacted its ¥30 trillion bank bail-out package, of which ¥17 trillion is to cover the guarantee on deposits in excess of ¥10 million until 2001. Thus, a credible safety net for depositors was finally established.

However, MoF has been much slower in imposing disclosure, capital strengthening, and other prudential regulations. Its supervisory capabilities appeared so weak they were hived off in June 1998 to the newly established Financial Supervisory Agency directly under the Cabinet Secretariat. The reluctance of MoF to move more rapidly in the 1990s to impose a system of prudential regulation was probably because it did not understand fully the implications of deregulation. After all, deregulation undermined the old convoy system, and made traditional MoF modes of action now seem counterproductive. MoF persisted nonetheless in attempting to defend an inefficient, uncompetitive, and outmoded system.

Bursting bubbles and macroeconomic policy mistakes

The second, and indeed most obvious, cause of the banking mess was first the creation in the late 1980s and then the bursting of the stock market and real estate bubbles in the early 1990s.

The basic causes of the bubbles included macro mis-management; widespread belief that, based on the entire postwar experience, land prices would never decline for any sustained period so real estate was excellent collateral; bank and related non-bank financial intermediaries, with ample, even excess, funds rushing into the financing of urban land and real estate projects; and, finally, this process creating a high degree of speculative excess in both real estate and stock markets. Much of this story is familiar, and does not need to be repeated here.[7]

However, macroeconomic policy mismanagement deserves special attention, since Japan's poor economic performance during the 1990s has made the bank bad loan problem worse over time, and has made it more difficult to resolve the ongoing banking and financial mess. Between 1988 and 1998 the Japanese government (i.e. the Ministry of Finance) made five major macroeconomic policy mistakes. While both fiscal and monetary policy instruments were involved, the Bank of Japan was subservient to, rather than autonomous from, the Ministry of Finance.

There were two dimensions to these policy mistakes. One was the size, timing, and degree of commitment when the authorities undertook demand stimulus or restraint. The other was the growing imbalance between the use of fiscal policy and monetary policy. Because the MoF's fiscal policy since 1980 was single-minded pursuit of budget deficit reduction and budget surplus creation, the responsibility for compensatory macro policy fell heavily and excessively on the use of monetary policy instruments.

In 1986 when, following the sharp decline in the price of oil, the yen appreciated more than expected and economic growth slowed more than desired, the sole policy response was monetary stimulus. Interest rates were reduced to postwar lows and money supply was expanded, while the MoF persisted in its efforts to reduce the budget deficits of the 1970s. That policy succeeded in accelerating economic growth. The problem is that the policy was continued for too long, at the least fueling and some would argue creating the stock and real estate bubbles of 1988-90. That was the first macroeconomic mistake. In 1989, the Bank of Japan finally began to raise interest rates sharply in a series of steps, puncturing the bubbles, and leading to eventual economic growth slowdown, and then stagnation.

The second mistake was in not easing monetary policy *and* fiscal policy sooner and more forcefully in the early 1990s, in 1992-93. The authorities saw the downturn as primarily a business cycle. They underestimated both the cumulative effect of structural problems, and the lasting and profound effects of the huge ongoing decline in asset values. The prevailing

perception was that, as in the past, the downturn would be relatively short-lived and economic recovery and growth would occur readily.

The third mistake was to rely excessively on easy monetary policy in the mid-1990s, so that interest rates since 1995 have been at incredibly and undesirably low levels. This extreme imbalance between fiscal and monetary policy has virtually shackled the latter, making it very difficult to stimulate demand. While the extraordinarily low interest rates have helped banks and borrowers, in effect they simply postponed the resolution of the bad loan and corporate bankruptcy problems, but at high economic and political costs. The low interest rate policy has generated an excessively weak yen. Savers have been deeply dissatisfied, and are increasingly seeking higher yields in foreign assets. Returns on pension funds have been seriously inadequate, so that virtually all pension programs are substantially underfunded. And, once interest rates do rise to a more normal level, the prices of government bonds and similar financial assets will drop, imposing huge capital losses on holders. (Government bonds are probably Japan's most risky financial asset in the intermediate term.)

The fourth macro policy mistake has been in the way fiscal stimulus through supplementary budgets in the mid-1990s was applied: too little, too late, and most important, too grudgingly.[8] Policy stimulus is supposed to inspire confidence in business people and consumers. However, each policy package, especially the tax cut component, was presented as temporary, and incorporated offsetting policies which made ambiguous the stimulative signal that was supposedly being sent. Moreover, the credibility of each fiscal stimulus package was undermined both by the exaggerated statements concerning the real amount of stimulus (the real water, to use the Japanese phrase) and by the focus on public works construction that has become increasingly unproductive - roads, railroads, bridges to nowhere. It was not until the supplementary budget in Autumn 1995 that fiscal stimulus finally became effective, generating a good recovery, with 3.4 per cent GDP growth, in fiscal 1996.

The fifth macroeconomic policy mistake was the government decision in late 1996, beguiled by excessively optimistic economic forecasts for 1997 and beyond, to shift its top policy priority 180 degrees from sustaining economy recovery to tackling the long-run, structural problem of budget deficit reduction. While the concern was appropriate, the timing was far too early. The policy error had two major components. The first was to shift the 1997 budget to severe fiscal restraint from 1996 budget ease, reducing demand generation by as much as 2 percentage points of GDP. This was done by increasing the consumption tax from

3 to 5 per cent, ending the ¥2 trillion temporary personal income tax cut, and raising medical care and other user fees. The second error was to enact a fiscal structure reform law which stipulated steady annual decreases in future government budget deficits and in the issuance of deficit financing government bonds.

Rather than continuing the recovery, in 1997 Japan's economy stalled and then went into decline. GDP shrank by 0.7 per cent, and by year end the economy was in recession (defined as two consecutive quarters of negative growth). The fiscal structure reform law shackled Prime Minister Hashimoto's government politically; if he were to admit it was a mistake his own position was at risk. Accordingly, even as economic conditions were obviously worsening at the beginning of 1998, his government had first to pass a restrictive 1998 budget in order to comply with the law before it could – at long last – announce in April 1998 the huge supplementary budget of ¥16.6 trillion (about ¥12 trillion in real demand-generating expenditures and tax cuts), and to pass it in June 1998 in an extended Diet session.

The Japanese economy has been the victim of these macroeconomic policy errors throughout the 1990s. On the one hand the MoF (Banking Bureau) depended upon the restoration of economic growth to halt and reverse the continuing declines in urban real estate prices, to convert marginal bank loans into good rather than bad, and otherwise to ease the handling of the persistent, immense bad loan problem. On the other hand the MoF (Budget and Tax Bureau) persistently pursued budget deficit reducing measures which thwarted economic recovery.

Effects of globalisation

The third cause of the ongoing banking mess is what is vaguely denoted by the word 'globalisation'. This refers to changes both in the world political and economic environment and in Japan's now major position in the world economy. From the perspective of Japan's financial system several elements are particularly important.

First, since Japan is now a large country – in the terminology of economists – its economic and financial policies are subject to reactive foreign pressures from the United States, the European Community, the G-7, and others. Second, Japan has become the world's largest creditor nation as its persistent current account surpluses has had to be invested abroad. Japanese banks, insurance companies, and other financial institutions actively engaged in foreign lending and portfolio investment, thereby exposing themselves to major foreign exchange risks. As the yen appreciated, the cumulative losses were huge, almost on

the same order of magnitude as the financial system's domestic bad loan losses. Third, the flourishing of a free global capital market – the Euro-market – provided Japanese large creditworthy companies with inexpensive bond and equity alternatives to loans from Japanese banks. The MoF could not stop that offshore financing process. Fourth, continuing deregulation, particularly the Big Bang, has made it attractive for foreign banks, investment banks, securities companies, mutual funds, insurance companies and asset management companies to compete in the Japanese home market, on Japan's hitherto restricted, sacrosanct turf.

Financial technology innovation

The fourth cause of the current financial mess is the high rate of innovation in finance. This now includes a wide range of sophisticated high tech derivatives, complex trading technologies, and changes in scale and organisation for the efficient management of financial services. This wave of innovation has been accomplished mainly by US banks, investment banks and other financial institutions, with some significant European players as well. While highly sophisticated financial products are primarily for very large financial and industrial corporations, new technologies are important in retail financial services markets as well, such as ATMs and the development and marketing of investment trusts (mutual funds).

Japanese banks have been organisationally and institutionally unable to learn, absorb and implement many of these new technologies sufficiently rapidly to be able to compete in such markets with foreign institutions. These technologies require specialists, not generalists, so the traditional Japanese management system of job rotation and seniority-based wages undermine the development and retention of specialists. The productivity and profitability of transactions-based wholesale financial markets are directly and quickly measurable, and excellent specialists are paid extraordinarily well. The most capable Japanese are frequently hired away by foreign firms applying their systems of performance-based huge bonuses but without job security.

A few major financial institutions have adjusted to these market realities, at least in foreign operations, but not most. For example, Nomura Securities Company's New York operations were highly profitable in 1996, and its London operations in 1997. Both were run by non-Japanese, and the top bonuses of the highest performing specialists were more than US$20 million.

Concluding comments

The discussion in the previous section suggests basic reasons why Japan's severe banking problems have persisted so long. Here I recapitulate.

First was the mistaken belief in the early-mid 1990s that the economy would rebound quickly from what was perceived to be little more than a cyclical downturn, and again the mistaken belief in late 1996 that recovery was so firmly entrenched that the fiscal priority could immediately return to budget deficit reduction. If the economy and especially real estate prices had indeed turned up, then adjustment would have been easier and perhaps less costly, so a policy of waiting it out was attractive, but turned out to be mistaken. Not surprisingly this led to a series of macroeconomic policy mistakes: too little stimulus, too great a reliance on monetary relative to fiscal stimulus.

Second, as a consequence, MoF initially decided and the banks readily agreed to simply wait out the bad loan problems until economic growth was restored. It was not until 1995 that banks seriously started disclosing and writing off bad loans. And it was not until recently that they reduced dividend rates, halted annual increases in wages and bonus, or began to reduce the number of employees significantly despite earlier attrition opportunities. In a remarkable statement in 1995, *Nikkeiren* (The Federation of Employers Associations) acidly noted that bank manager salaries were 24 per cent higher than those in comparable positions in industry, and urged that banks reduce the disparity before taxpayers monies (government funds) be used to bail them out of their difficulties. The widespread sense among the public that banks were not making any significant sacrifices has made it difficult for the political leadership to commit government funds to handle what came to be an increasingly obvious need to bail out the banks if the system were not to fall into chaos.

Third, the economy continued to grow only very slowly, averaging about 1 per cent annually since 1991; more ordinary loans became doubtful, and more doubtful loans became bad. Businesses could not generate cash flows for interest payments much less loan repayments. Moreover, urban commercial real estate prices continued to decline, are now some 70 per cent or so below their peak, and may only in mid-1998 be reaching the bottom. Office space, very tight in 1990, became super abundant by 1995, as projects were completed. Rents declined precipitously, exacerbated by the custom that most leases are for a maximum of only two years. Many speculative projects, such as golf courses, have been only partially constructed and may never be completed. Nonetheless, banks and other holders of real estate,

directly or as collateral, have refrained from selling, apparently in hopes the market would bottom out soon as well as the fear that if they sell real estate prices will fall even further.

This series of mis-estimations of Japanese economic performance, which delayed and thereby worsened Japan's financial crisis, have created the current crisis in Japanese financial institutions and markets. Only since early 1998 has the government begun to seriously address these needs for financial reform and begun to provide the public funding that is essential.

Notes

1 Standard references on the postwar period include Suzuki (1985 and 1987), Feldman (1986), Cargill and Royama (1988), Rosenbluth (1989), FAIR (1991), and Cargill, Hutchison and Ito (1997).

2 There were 11 city banks, three long-term credit banks, and seven trust banks, a total of 21 Big Banks. With the merger of Bank of Tokyo and Mitsubishi Bank and the failure of Hokkaido Takushoku Bank the city banks were reduced to nine. The *de facto* absorption of Nippon Trust Bank by Mitsubishi Bank means that the Big Banks as of Summer 1998 are counted as 18 or 19.

3 For a description and analysis of the main bank system, particularly in the high growth era, see Aoki and Patrick (1994).

4 The literature estimates of the evolving amounts of bad loans is substantial; see, for example, Ohara (1996), Marsh and Paul (1996), and Waterhouse (1997–98).

5 See Waterhouse (1998a).

6 Stephen Vogel (1996) has well analysed the slow, near-haphazard process of MoF policymaking.

7 See Cargill, Hutchison and Ito (1997), Hartcher (1997) and Wood (1992)

8 See the careful, thorough, econometric analysis of McKibbin (1996).

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2

Japan's Financial Crisis: Resemblances with East Asia

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Japan's Financial Crisis: Resemblances with East Asia

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The problem

The non-performing loan problem has plagued the Japanese economy for several years, and it is a major reason for the very slow growth of the Japanese economy (the average growth rate being about one per cent per annum for the last seven years). Non-performing loans are largely a result of the burst bubble (a sharp decline in real estate prices). Financial institutions that had lent to real estate companies and developers became beset with loans that were not repaid, or ended up seizing collateral whose market values were far below the book value.

The problem was complicated by the stock price decline, since Japanese banks traditionally hold a large amount of securities. The accounting rule dictated (until March 1998) that bank balance sheets show the lower of the book value or the market value of securities. The difference between the market and book values (which was considerable during the bubble years of the late 1980s) was latent capital gain (*fukumi*), which was counted as a part of bank tier II capital in the Bank of International Settlements (BIS) risk-based capital standard. Banks had held securities for a long time, and stock prices had gone up tremendously in the 1960s and 1970s.

The problem was not addressed early or decisively. Minor financial crises had occurred in the previous four years, however, government policy during this period has been reactive, rather than proactive action aimed at preventing a crisis. Decisive action on the non-performing loans problem is needed now to prevent a further shrinkage of Japanese financial institutions and markets.

Mistakes dealing with the problem

A first wave of crises occurred in 1995, when the problem that Japan had created became so apparent. Although small financial institutions had been merged with help of the Deposit Insurance Corporation (DIC) since 1991, it was not until August 1995 that for the first time a bank listed in the stock exchange was closed. The problem of housing-loan financial institutions (*jusen*) was also dealt with in 1995, in favour of agricultural cooperatives which had lent to *jusen*, and with a loss of credibility on the part of the bank regulators. Also in 1995 a trader in the New York branch of Daiwa Bank was found to have hidden a huge loss. The delayed reporting of this to US regulators cost the bank an operating license in the United States, and the credibility in bank supervision by the Ministry of Finance was further damaged.

The yen appreciated to 80 yen per US dollar in April 1995, and affected export industries. A pessimistic view on the economy prevailed. The stock price index declined below the 15,000 mark. Banks' *fukumi* declined and affected their balance sheets. Bank lending declined, and further affected the real economy. The official discount rate was cut from 1.75 per cent at the beginning of the year to 0.5 per cent in June. A fiscal stimulus package was also introduced.

With these ample signs of financial distress in 1995, policy responses were less than adequate. First, the regulators believed that by solving the *jusen* problem with burdens on banks, a major part of the non-performing loans problem had been solved. The monetary authorities proclaimed that none of the 21 largest banks would be allowed to fail. However, the authorities would not be able to maintain the 'too-big-to-fail' policy. Moreover, moral hazard among bank executives became prevalent after the too-big-to-fail policy was announced. Second, by denying the seriousness of the problem, the authorities could not prepare a scheme that would inject fiscal funds to solve the problem, or to inject enough funds to the deposit insurance corporation. This made it impossible to act decisively, such as by closing

down insolvent or near-insolvent banks and selling off assets with losses. Third, the monetary authorities failed to enforce accurate accounting rules. Moreover, the authorities changed accounting rules to hide non-performing loans.

These mistakes prolonged the non-performing loans problem, and finally erupted into a full-blown crisis in November 1997.

Magnitude of the problem

At the end of September 1995, the volume of non-performing loans amounted to 10 per cent of Japan's GDP and 6 per cent of all the loans held by Japan's depository institutions. It was estimated that the total amount of non-performing loans made by Japanese banks amounted to ¥27 trillion. These estimates might have been too low, however. Published estimates of non-performing loans from private sources typically ranged between ¥50 trillion to ¥60 trillion, or about twice the official estimate. These higher estimates of non-performing loans often included loans overdue between 60 and 180 days (beyond 180 days they are counted in the Ministry of Finance's definition of non-performing loans), restructured above the official discount rate (the official definition of non-performing loans counts only those that are restructured with the interest rate below the ODR, and somehow estimated an amount of cumulative loans toward interest payments (*oigashi*)

In November 1997, the government announced new criteria for non-performing loans, and a new definition of the problem according to the new criteria. The first category in the new criteria included normal, performing loans; the second category included performing loans with some concerns for the future; the third and fourth categories corresponded to non-performing loans. The sum of the second, third, and fourth categories amounted to 79 trillion yen. From 1994 to 1997, banks used various resources to write off non-performing loans. Japanese banks realised latent capital gains (*fukumi*) to write off non-performing loans, in addition to using current profits. Banks also realised some of the gains from the falling stock prices of the 1990s to help write off non-performing loan losses.

Japan's banks, once regarded as among the most financially secure in the world, have been continually downgraded by credit rating agencies. In August 1995 Moody's Investor Service released a new rating system for the major Japanese banks that did not incorporate the government support they enjoyed. The new rating system was designed to rate banks on a 'stand alone' basis, without government support, and is a 'measure of the likelihood that a

bank will require assistance from third parties such as its owners, its industry group, or official institutions'. According to the new Moody's rating system, no Japanese bank received a rating of A (exceptional intrinsic financial strength) or B (intrinsic financial strength), and the top 50 Japanese banks received an average rating of D (adequate financial strength limited by a variety of factors). In January 1996, Moody's cut its debt ratings of three Japanese banks and that of the Yamaiachi Securities Company.

The problem of jusen *companies*

The *jusen* companies were created in the mid-1970s as subsidiaries of banks, securities firms, and life insurance companies. The *jusen* companies initially expanded to provide consumer credit. Much like consumer finance companies in the United States, they borrowed from other institutions as they were not permitted to accept deposits. As the corporate sector reduced its dependence on bank credit after 1975, however, banks began to turn to consumer finance, and in the 1980s, they became aggressive lenders to individuals. In response to the aggressive bank competition for individual loans, *jusen* companies turned to real estate lending in the second half of the 1980s to substitute for the lost consumer lending business.

In April 1990 the Ministry of Finance introduced guidelines to banks to limit total lending to the real estate sector; however, lending by *jusen* companies were exempted. During 1990 and 1991, *jusen* lending increased rapidly as a result of funds provided by agricultural cooperatives and their prefecture federations. Concerns over the quality of assets held by *jusen* companies were raised as early as 1992, and a 10-year rehabilitation plan was arranged for the seven *jusen* companies in the Spring of 1993.

The problem of the *jusen* companies became the focus of an intense political debate in 1995 and even overshadowed the problem of banks' non-performing loans. In August 1995, the Ministry of Finance conducted a special examination of the *jusen* problem. Of the total ¥13 trillion of *jusen* assets, non-performing loans were estimated at ¥9.6 trillion, of which ¥6.4 trillion was considered unrecoverable and ¥1.2 trillion was considered a possible loss. This is more than one-fourth of all losses incurred by financial institutions to date.

The Ministry of Finance and the suppliers of funds to *jusen* companies agreed to dissolve the seven housing-loan companies, and in July 1996 the *Jusen* Resolution Corporation, now known as the Housing Loan Administration Corporation, assumed the ¥6.4 trillion of unrecoverable loans extended to failed *jusen* companies.

The majority of the funding of *jusen* companies came from the 21 major banks and agricultural credit cooperatives, each providing about the same levels of funding (¥5 trillion for the 21 banks and ¥5.5 trillion for the cooperatives). Other funding sources were regional banks (¥1.1 trillion), life insurance companies (¥0.8 trillion), and others (¥0.6 trillion). Agricultural cooperatives' being the largest supplier of funds posed a major policy issue. If the potential loss of ¥7.6 trillion is divided in proportion to the outstanding loans to the *jusen* companies, the agricultural cooperatives would have to write off more than ¥3 trillion in losses. This was not possible, however, since these cooperatives operated with a small capital base.

Politicians and Ministry of Finance officials suggested that banks should shoulder a more than pro rata share of the *jusen* losses. The precedent for this approach had already been set when banks were required to provide a more than pro rata share in schemes for dealing with failing institutions in July and August 1995 (the Cosmo Credit Cooperatives, the Kizu Credit Cooperatives and the Hyogo Bank). Banks not related to these institutions were asked to contribute to the loss-sharing scheme by contributing capital or by making below-market-rate loans to banks that assumed the assets of the insolvent institutions. The argument made to justify these requests was based on the public-good characteristic of the financial system and on the need to maintain stability, and to request responsibility beyond the legal framework. The policy of requiring unrelated banks to contribute directly to bailout schemes was referred to as the 'all-Japan' rescue scheme.

In December 1995, the government proposed a resolution plan for the seven insolvent *jusen* companies. The plan has two shortcomings. First, the sharing of the burden was not equitable. Rather, it reflected the political strength of the agricultural sector. The Banking Bureau Director General of the Ministry of Finance had secretly signed a memorandum of understanding with his counterpart at the Ministry of Agriculture during the debate over cost sharing of the financial crisis. The heavier burden on banks also reflected the public perception that 'founder banks' (banks that had set up *jusen* companies as subsidiaries) were providing personnel to manage operations and were referring potential borrowers (who turned out to be high-risk customers) to *jusen* companies. Second, the political opposition to using tax funds was strong.

The perception of increased risk in Japan's banks at large resulted in a 'Japan premium' in the Eurodollar market – a premium over the London interbank interest rate required of Japan's banks. The premium increased further when Daiwa Bank was discovered to have

covered up derivative losses, amounting to at least US$1 billion, resulting from a 'rogue' trader in New York.

The *jusen* problem also reflects the problems of smaller institutions in Japan, such as agricultural credit cooperatives. These are:

- Credit cooperative have diversified significantly away from their traditional specialisation on loans to farmers related to agricultural operations;
- Some cred in July and August 1995it cooperatives have strong ties to the local community and to local politicians;
- Credit cooperatives hold significant amounts of real estate related loans; and
- They are not regulated and supervised by the Ministry of Finance or by the Bank of Japan, and local regulation and supervision is uneven in extent and sophistication.

Significant risk resides in these small institutions because of the substantial uncertainty as to where they stand in Japan's deposit-guarantee system.

Thus, by the end of 1995 the *jusen* problem, the problem of non-performing bank loans and the risk exposure of large numbers of small financial institutions were seen as major and unprecedented policy issues. The financial debacle in Japan is at least as great as the collapse of the savings-and-loan industry and the related banking problems in the United States.

Regulatory response to the problem of non-performing loans

On 18 August, 1992, the government announced a temporary rule change that allowed corporations to defer reporting stock-portfolio losses until the end of the fiscal year (March 1993), permitted other accounting innovations that delayed or concealed the impact of stock price and land price declines on reported assets, allowed banks (in special cases where a loan default would have adverse social effects) not to report interest concessions as taxable income, directed the Postal Life Insurance System to support the stock market via funds provided to trust banks, postponed sales of government-held shares of Nippon Telegraph and Telephone and Japan National Railways, used administrative guidance to encourage institutional purchases of equities and discourage institutional sales of equities, and provided less-than-candid estimates of the magnitude of the problem of non-performing loans.

The Cooperative Credit Purchasing Company (CCPC) was the first visible effort to deal with the problem of non-performing loans. The CCPC now appears to have been set up

primarily to provide accelerated tax benefits to the large banks without requiring the banks to directly write off loses and acknowledge the losses in their public reports. Banks were required to lend to the CCPC the amount equivalent to the value of assets, so if the assets were finally sold to the market from the CCPC with losses, banks would still be held responsible for the losses.

Banks' response

Japan's banks have been increasingly setting aside funds in special accounts to eventually write off loses. Special provisioning by 21 banks increased from ¥1.9 trillion in March 1993 to ¥3.0 trillion in March 1994, and to ¥4.3 trillion in March 1995. Sumitomo Bank took a more drastic step, charging losses of ¥826 billion to write off bad loans and showed losses in its annual report for the period ending March 1995. But despite varying degrees of problems with non-performing loans, Japan's banks continue to pay dividends. Dividends per earnings actually increased when the decline in earnings was taken into account.

The banks could pursue more aggressive remedies. More aggressive organisational restructuring, such as selling assets and subsidiaries (branches or foreign operations) or cutting personnel costs, could reduce operational costs.

Assisted mergers and the deposit insurance corporation

In 1991, the regulatory authorities, for the first time in the postwar period, officially assisted mergers of insolvent depository institutions with stronger institutions, using the resources of the Deposit Insurance Corporation (DIC), the larger of Japan's two deposit-insurance agencies. Since 1991, however, the DIC has publicly assisted a small number of problem institutions, and the two more recently assisted institutions have exhausted the DIC's reserves. The details of the assisted mergers reveal a disturbing pattern about the ability of Japan's regulatory authorities to effectively administer deposit guarantees and limit 'moral hazard':

- Toyo Shinkin Bank in Osaka failed as a result of issuing fraudulent certificates of deposits. In October 1992, the DIC provided a cash payment of ¥20 billion to Sanwa Bank, a large city bank, to help it acquire Toyo Shinkin Bank. Shareholders of the

failed institution retained ownership rights. One and a half shares of Toyo equity were exchanged for one share of Sanwa equity.

- The failures of two credit cooperatives, Toyo Kyowa and Anzen, were handled by establishing a new bank, Tokyo Kyodo Bank in March 1995. The new bank received an infusion of capital from the Bank of Japan. This rescue plan was heavily criticized for two reasons. The top management of the two failed institutions had engaged in fraudulent behaviour by lending to themselves through their own real estate companies. The use of government funds to rescue an institution that had failed because of fraud was questioned, even though management was purged and prosecuted.
- The Cosmo Credit Corporation collapsed in August 1995 in the wake of a classic run on deposits, after which the Ministry of Finance moved to place restrictions on fund withdrawals. Several weeks after the collapse of Cosmo, the Ministry of Finance decided to close down Hyogo Bank and Kizu Credit, both experiencing deposit withdrawals. In November 1996, the Ministry of Finance moved to liquidate Hanwa Bank. The government made an explicit statement that the government would guarantee all of Hanwa's deposits. This reaffirmed a 1995 announcement that all deposits at failed institutions would be guaranteed until the year 2000.

The banking crisis of November 1997

In November 1997, the Hokkaido Takushoku Bank, one of the 19 largest banks, and Yamaichi Securities, one of the Big Four securities companies, failed. The immediate cause was that these institutions could not get funding for overnight loans in the call market (interbank market), because the market regarded these institutions as too risky to lend to. Although both institutions were known to be weak, the failure was a surprise. The government had announced in 1995 that the largest banks would survive, and all deposits would be safe. Despite its promise, deposits to the Hokkaido Takushoku Bank continued to be withdrawn in 1997.

The market interpreted the failures of the two large financial institutions as a sign that the government had lost its grip on the financial market. The stock prices of other weak financial institutions plummeted in Tokyo and the 'Japan premium' soared to 100 basis points in the international market. It was feared that other collapses of financial institutions in Tokyo would disrupt functions of the world financial markets.

The government belatedly promised to strengthen the deposit insurance corporation by issuing 30 trillion yen government bonds for protecting deposits from failed institutions and for injecting capital to banks. The government belatedly realised that only fiscal authorities can help the financial system.

The government also allowed banks to adopt an accounting method which could hide unrealised capital losses from securities holdings. This was designed to clear the capital adequacy requirement at the end of March 1998, as average stock prices slumped at around 16,000 yen. This was another cosmetic measure.

How to use 30 trillion yen effectively

A plan to appropriate 30 trillion yen was a response to the panic that followed the failure of the Hokkaido Takushoku Bank and Yamaichi Securities. Of 30 trillion, 13 trillion was to be used to inject capital to solvent, but thinly capitalised, banks, while 17 trillion was to be used to protect depositors in insolvent, failing institutions. In March 1998 the first wave of capital injection, amounting to less than 2 trillion yen, was carried out to 21 banks (18 large banks plus 3 regional banks). However, due diligence, which was supposed to be a pre-condition, was less than adequate. The inadequacy became apparent when the Long Term Credit Bank, which received capital injection, became attacked in the market in June, and was forced to seek a rescue merger.

Capital-adequacy requirements

One issue that complicated resolution of Japan's banking problems concerned stock price fluctuations and the application of capital-adequacy requirements. Japan's banks commonly hold stocks of their large corporate customers with which they have long-term cross-shareholding relationships in the same enterprise groups. Since these stocks have typically been held for some time, they contain unrealised capital gains that are not reported on balance sheets. The latent capital gains (*fukumi*) have been a huge buffer in the capital position among the Japanese banks that had been relatively undercapitalised.

In 1988, at the time of the adoption of the Basle capital-adequacy requirements, the Japanese monetary authority negotiated successfully for latent capital gains to be counted as a part of near-capital (Tier II capital). This was expected to make it easier for Japanese banks to meet the Basle requirements and looked reasonable in 1988 and early 1989, before the

bubble burst. As stock prices plummeted, banks suddenly faced a shortage of capital because latent capital-gains fell significantly.

Whenever the stock prices declined sharply, banks became squeezed. This stock-market induced credit crunch happened in 1992, 1995 and 1997. Although the decline in stock prices in 1992 was largely offset by issuing subordinated debts (*retsugo sai*), bank lending was cut after 1995.

Deposit guarantees

Before the start of liberalisation in the mid 1970s, Japan's deposit guarantees were supported by an extensive set of constraints on portfolio decisions. From the 1950s to the early 1970s, Japan's financial system was one of the most regulated and administratively controlled in the world. These controls limited the ability of financial institutions to assume and manage risk; at the same time, they left the deposit-guarantee system untested.

Japan has relied upon administrative guidance by the Bank of Japan and the Ministry of Finance to monitor institutions, impose regulatory discipline, intervene in financial markets and force mergers. This is an activist approach in implementing deposit-guarantee, and the degree to which Japanese regulatory authorities are willing to regulate financial institutions is far greater than in most countries despite almost two decades of liberalisation. Japanese financial regulation has historically been predicated on a 'no-failure' policy and has not relied on a deposit-insurance framework that explicitly recognises the possibility of failure. As a part of the 'no-failure' policy, deposit guarantees are interpreted broadly. It is illustrative that Sumitomo Bank's announcement in January 1995 that it expected to become the first major Japanese bank to report an annual loss in the postwar period was regarded as a major attitudinal change on the part of private banks and the Ministry of Finance.

Until recently, Japan's deposit-guarantee system has not been tested for a variety of reasons. Its macroeconomic environment has been conducive to a smooth and gradual evolution toward open and competitive markets. Price stability generated only a small gap between regulated and unregulated interest rates and thus provided few incentives to innovate. The absence of open money markets limited the means to innovate; and regulation and administrative guidance have been quite binding.

The major part of Japan's deposit-guarantees is that offered by the Deposit Insurance Corporation for banks and other deposit-taking financial institutions other than credit

cooperatives, which protects up to 10 million yen per person per bank. However, an explicit commitment by the government to protect all deposits until 2001 was added to calm the market in 1995. It included another deposit insurance for specialised depository institutions, mostly credit cooperatives and an explicit deposit-guarantee commitment to the Postal Savings System.

The Deposit Insurance Corporation and the much smaller Savings Insurance Corporation have counterparts in many countries. However, the Postal Savings System – the largest financial institution in the world – is a less understood financial intermediary. The system, established in 1874, has come to play a major role in Japan's public sector activities, especially in the postwar period. It is regulated by the Ministry of Posts and Telecommunications, placing the ministry among the three major financial agencies in Japan (after the Ministry of Finance and the Bank of Japan). In 1992, the Postal Savings System even began to publicise the fact that postal deposits were more secure than bank deposits.

The Postal Savings System has been a focal point of discussion during the past two decades. Two issues seem particularly important in the context of the deterioration of the financial system in the 1990s. First, a significant part of the flow of funds is likely to be allocated on the basis of strong political connections rather than on the basis of economic criteria. Postal savings funds are easily accessible to the Ministry of Finance to bail out troubled financial institutions, especially the housing-loan companies. The Ministry of Finance in 1992 even directed the Ministry of Posts and Telecommunications to use funds from postal life insurance to support equity prices in the Tokyo stock exchange.

Second, the existence of the Postal Savings System in essence allows a dual system of complete deposit guarantees and ensures that Japan will not easily be able to solve the conflict between liberalisation on the one hand and deposit guarantees that encourage risk taking on the other. The Postal Savings System thus stands at one end of the deposit-guarantee system. At the other end are large city and regional banks that for all practical purposes are regarded as too big to fail.

At some point Japan will need to deal explicitly with the Postal Savings System because of its size and its potentially destabilising role in the deposit-guarantee system. Privatisation, apparently the most efficient long-term solution, is bound to run into stiff political opposition.

Lessons from the non-performing loans and *jusen* problems

In the context of growing public awareness of the non-performing loans and *jusen* problems, as well as intense international pressure, in December 1995 the Japanese government initiated a series of reforms. Six legislative bills were introduced and passed by the Diet. Unfortunately, reform of the supervisary framework was omitted from this round of reforms. Some observers question the effectiveness of any reform as long as the Ministry of Finance – whose indecision is primarily responsible for delayed response to the *jusen* problem – remains the primary financial regulatory authority. Documents show that the Ministry of Finance made the first on-site examinations of *jusen* companies in 1991–92 and found that 67 per cent of loans made to the largest 50 borrowers were already non-performing. *Jusen* companies were, however, allowed to operate, because it was assumed that land prices would rise in the near future. As land prices continued to decline, non-performing loans held by the *jusen* companies increased by 75 per cent in the next four years.

Moral hazard

Moral hazard – incentives to assume more risk because deposit guarantees remove depositor discipline as a constraint on risk taking by depository institutions – is a serious problem despite a general unwillingness by Japanese regulatory authorities to recognize that fact. Two credit cooperatives suffered from a classic case of moral hazard in their last two years. Deposits at both institutions increased from ¥139 billion in March 1992 to ¥244 billion in November 1994 (an annual rate of 32 per cent), while lending increased from ¥137 billion to ¥225 billion (an annual rate of 22 per cent). The majority of the new loans made during the period were ultimately classified as non-performing. The total non-performing loans of the two credit cooperatives increased from ¥250 billion (out of total loans of ¥1,371 billion) in March 1992 to ¥1,769 billion (out of a total loan of ¥1,990 billion) in March 1994. Moreover, unrecoverable losses increased from ¥65 billion in March 1992 to ¥1,118 billion in March 1994. Not only did the two credit unions aggressively expand deposits to make new, higher-risk loans during their decline into solvency, total non-performing loans increased sevenfold and unrecoverable losses increased sixteenfold between March 1992 and March 1994. In addition, rapid increases in deposits were made possible by offering above-market deposit rates.

Another moral hazard was apparent after 1995. Efforts by large banks to write off non-performing loans were not enough. Dividends were still paid out, and management stayed. No major consolidation and restructuring took place until the crisis of November 1997.

The big bang

The aftermath of asset inflation has revealed serious problems in Japan's financial system and structure of regulation. In many ways, Japan's regulatory authorities appear to be committing the same policy errors that US policymakers did several years earlier. Japan's deposit guarantee system remains bimodal, makes little effort to impose discipline on depositors or shareholders, and relies on a passive regulatory attitude. The Japanese government announced that a new regulatory regime would emerge by March 2001, when the blanket guarantee for deposits will end. A new financial supervisory authority, spun off from the Ministry of Finance, will be created.

The big bang policy, a comprehensive deregulation of financial markets, was announced in November 1996. The first step was taken in April 1998 by deregulating the Foreign Exchange Law and regulation. As a result, anyone can trade and transact foreign exchanges, without being brokered by authorised banks. With deregulation, Japanese residents can open accounts in foreign institutions abroad directly. With competition from abroad, financial institutions (Japanese and foreign) in Japan also became aggressive in pursuing the ¥1200 trillion of household savings. Money management funds (MMF) and foreign bonds, which offer higher yields than yen deposits, became popular. The exodus of saving is believed to be partly responsible for the yen depreciation after April 1998.

The current deterioration of the financial system may force the Bank of Japan to give increasing consideration to prudential objectives in formulating policy – and those objectives may conflict with domestic price stability. The newly created Financial Supervision Agency has a difficult task in implementing a stringent standard, and forcing banks to take actions. Concerns with prudential policy are always present. However, the willingness to directly subsidise the banking sector on the basis of vague arguments of systemic risk has imposed serious costs on the economy at large. With the failures of the Hokkaido Takushoku Bank and Yamaichi Securities, no banks or securities firms feel safe under market pressure. Combined with a new regime of financial supervision, the Japanese financial system is undergoing significant changes.

Without a strengthened supervisory regime, the big bang will result in a big failure.

Parallels with other countries

It has been shown that a currency crisis and a banking crisis occur simultaneously in a mutually reinforcing manner. A country with a banking crisis often develops a currency crisis, either by capital flight or being attacked by speculators. A currency devaluation often puts banks with foreign-currency denominated liabilities into serious trouble. East Asian countries are no exception. Thailand had problems with the finance company industry (a form of non-bank). Finance companies were identical to *jusen* in Japan, in terms of their funding, investment and how they got into trouble. The Bangkok bubble (stock prices and real estates) burst in 1995–96. By the end of 1996, several finance companies were beset with non-performing loans problems, and short in liquidity. The Bank of Thailand supported them with emergency loans through the deposit insurance fund. However, eventually 16 finance companies were suspended in late June (just before the devaluation of 2 July 1997), and 42 more suspended in early August 1997 (just before the IMF support package). Those which lent to finance companies were affected by their failures. This is also similar to the Japanese banks that lent to *jusen*.

In Korea, banks were extending loans to *chaebol* group firms. As *chaebols* expanded into industries which were not previously covered by their operations, banks were forced to lend money to them. When the 'diversification strategy' failed, banks were left with non-performing loans. Another route of problems was through merchant banks (non-banks). They escaped banking regulation, appropriately stringent, and lent to real estate sectors.

In summary, the banking problem in Asia is either a trigger or a complicating factor of the currency crisis. It is easy to say that over-development of the banking sector increased the vulnerability to a crisis, and that the equity and bond markets were underdeveloped. However, for developing countries, human capital in the financial sectors is limited, and it is a difficult choice whether banking or securities industries should develop first. The Asian experience poses this question.

In the case of Japan, it is more inexcusable. As the economy was integrated into a global system, a better policy should have been devised earlier. On the one hand, regulation was too much. Segmentation into banks, long-term credit banks, trust banks, smaller financial institutions, securities firms, life-insurance companies and non-life insurance companies

should have been ended earlier. Basically, the 'Big Bang' should have taken place ten years earlier. 'Gradualism' allowed rent-seeking financial institutions to make crucial mistakes during the bubble years. On the other hand, there was too little regulation. Financial deregulation should have been accompanied by strengthened supervision and a legal framework. For example, Japan should have had a framework to fail banks. That is, the total plan is ten years late with the benefit of hindsight, or at least five years late without the benefit of hindsight.

Maybe, 'Look East' will have a new meaning – do not repeat the mistake of Japan.

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