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Challenges for the Japanese Financial System

AKINARI HORII*

It is not necessarily pleasant to talk about the Japanese financial system these days. Before I begin, therefore, allow me to remind you of the usual disclaimer for a central bank official's remarks—i.e., the views expressed here are my own and do not necessarily represent those of the Bank of Japan. This is a kind of magic spell that makes me feel less constraint and therefore less uneasy.

Economic growth performance in Japan has been disappointing during most of the past eight years. During the recent twelve months, it has become worse than a disappointment. Japan's economy is facing a threat of deflation for the first time since the 1930s, when deflation was real in the United States, Japan, and other industrial countries. Outputs declined for five consecutive quarters at an annual rate of three percent. Not only has the unemployment rate been renewing the record high, but also employment has been decreasing. On top of that, both prices and wages are declining. Against this background, the Japanese government has prepared an emergency economic policy package amounting to over 20 trillion yen or \$200 billion, whose effects on economic growth will appear and continue in the first three quarters of 1999.

A few caveats, however, should be in place against optimism about Japan's economic outlook. First, Japan's private demand has declined by three percent during the past several quarters. Therefore, I am not sure if these fiscal stimuli will prove to be sufficient to turn the current trend in the economy upwards, although they may be able to hold the decline in check for some time. Second, because of the prolonged recession as well as repetitive fiscal expenditures during the past eight years, the budgets of both the central and local governments are deep in deficit, which makes any fiscal stimulus less feasible in the future. Third, this most recent emergency package is in fact the eighth fiscal package during the past six years. The first one was the package of August 1992, amounting to 11 trillion yen, followed by seven more fiscal policy packages. On nearly every occasion when the fiscal stimuli were given to the economy, they had some positive influences on economic growth. After their direct impetus phased away, however, Japan's economy fell into recession again.

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Thus far, monetary policy has also failed to achieve a strong economic recovery in Japan. It was about eight years ago that the Bank of Japan cut the discount rate, beginning its easy monetary policy only a few months after the peak of the earlier economic boom. After a series of interest rate reductions, the Bank of Japan cut the discount rate yet again in September 1995 to one-half percent, making this the lowest discount rate in the 300-year history of central banking in the world. Even during the times of the Great Depression in the United States, the discount rate stood at one percent, with the exception of extraordinary lending for war chest. Six weeks ago, the Bank of Japan decided on another unprecedented policy, i.e., aiming money market rates as low as possible or as close to zero as possible. Interest rates are not standing in Japan but lying on a rock bottom. The monetary aggregates, however, have been increasing by a modest rate of four percent per annum. Obviously, the money multiplier fails to function properly. In addition, the nominal GDP has been showing negative growth. In other words, the velocity of money has been falling dramatically.

As such, repetitive fiscal stimuli as well as unprecedented monetary ease have failed to bring with them sustained economic growth. As you may be aware, Japan's economic problem is more structural than cyclical. At the core of the weak growth performance lies the malfunctioning of its financial system. You are perhaps familiar with how the Japanese banking system has been left with a huge volume of nonperforming assets after the speculative bubbles burst in the early 1990s. In those days, Japan was not the only country that experienced the bubble: the United Kingdom, Australia, Sweden, Finland, and the United States, to name but a few, also felt its impact. Among these and others, the Japanese bubbles were the largest in terms of change in asset prices and the size of the impact that their burst exerted on the economy. The upshot was accumulation of nonperforming assets in the banking sector. Similar episodes were witnessed in other countries. The United States had the saving and loan crisis. In addition, a number of American money-center banks were also in trouble in the late 1980s and early 1990s. In this period, U.S. economic growth was weak with, as Federal Reserve Chairman Greenspan termed it, a "50-miles-per-hour-headwind." In Sweden, the bubble burst in 1990, and the unemployment rate shot up from below two percent to eight percent within three years. This occurred in a country where the unemployment rate had rarely gone above three and one-half percent during most of the post-World War II period. A similar development has more recently been witnessed in Eastern Asia. In Korea, Thailand, and Indonesia, unemployment rates have risen to well above historical highs. This is also the case in Japan.

The post-bubble episodes in industrial countries in the 1990s, as well as in the 1930s, tell us that without addressing the banking problem, an autonomous economic growth is extremely hard to come by. In addition, those episodes show us a set of policies or procedures that is about right. First, have banks identify the magnitude of nonperforming assets by realistic accounting standards. Second, eliminate the nonperforming assets from banks' balance sheets. Third, create a market for distressed loans and/or collateralized real estate. Fourth, restore capital, the scope of which depends upon banks' decisiveness with respect to restructuring. And finally, engineer orderly exit of unsound banks whose restructuring is not promising. It is extremely important to do all of this quickly and during the period of implementation. Confidence in the stability of the financial system must be preserved by all means.

Now let me be more specific about what has been done and what remains to be done in Japan. During the past twelve months, there have been a few remarkable developments in

the legislation and banking fields. The law has been legislated to make it possible to nationalize, or establish bridge banks for, failing banks. In fact, two large commercial banks, LTCB and NCB, were nationalized in the autumn of 1998. Public funds of as much as 60 trillion yen, or twelve percent of GDP, are pledged by the government to maintain the stability of the financial system. On the banking side, a huge amount of provisioning has been made against bad assets. Banks have begun some restructuring, like scaling down overseas operations and cutting remuneration for its executives and employees. Quite a few banks are seeking alliance with partners not only in Japan but also in other countries. There are examples of banking consolidation as well. By strong suggestion of Bank of Japan Governor Hayami, nearly all money-center banks in Japan have applied for capital injection by the government, totaling seven trillion yen. In my opinion, all of these are the right steps toward redressing the banking problem in Japan.

Of course, no one should be complacent, for a number of steps still remain to be taken. First, a bulk of nonperforming assets remain on the balance sheets of banks. Therefore, not only do bank cash flows remain weak, but there also remains a significant degree of uncertainty about banks' future losses should such nonperforming assets grow even worse and asset prices decline. In order to regain certainty and improve cash flow, banks must sell off their nonperforming assets. Second, in order to facilitate such charge-offs, markets for distressed loans and collateralized real estate must be jump-started. In my opinion, the two nationalized banks, as well as the newly created Resolution and Collection Corporation (RCC), could contribute to this by beginning aggressive sales of their distressed loans. Third, banks must restructure their business from a standpoint of strategic efficiency. Without a decisive restructuring plan, no new capital would be made from the market. Finally, those banks whose balance sheets have been so severely damaged that any restructuring might seem infeasible must either be closed or merged into another bank.

All of this must be done fairly soon. Japan's economic growth performance is likely to stop worsening soon, owing to massive fiscal and monetary policy stimuli. But if and when all the stimuli fade away, it may resume its downward trend. In other words, if banks miss this window of opportunity, they will be forced to wait until the next time, if it ever comes. Let me also remind you of another deadline for financial reform, i.e., the end of March 2001, when all the temporary safety nets will be gone, including capital injection, since the law is written that way.

I have already discussed Japan's economy and finance at length. Now I would like to discuss Japan's financial "Big Bang." In Japan, the deregulation program termed Big Bang is in place, which covers a wide range of financial services. I know that there is much skepticism in this country toward Japan's financial Big Bang, but as far as this is concerned, I am rather optimistic. First of all, the legislation of Japan's Big Bang has already been made—in other words, Big Bang is a *fait accompli de jure*. In fact, American and European financial services companies have already begun to take full advantage of this Big Bang by offering a variety of products for Japanese investors. Some of these firms have acquired Japanese financial service firms and others have set up joint ventures with Japanese firms. At the same time, Japanese nonfinancial businesses are also active in seeking a wider avenue of funding as well as investment. As Big Bang brings with it material effects on the avenues for private-sector borrowing and investment, that will help restore functioning of the financial intermediation.

The Big Bang also has a significant implication for the global market, particularly for Asian financial markets. In theory, Japan's Big Bang will offer global borrowers and investors

a wider use of the yen and/or an active intermediation in the Tokyo market. For a wider use of a currency by nonresidents, a safe and efficient payment system is essential, and the banking system plays a pivotal role in it. I know of no currency whose main payment function is borne outside the banking system. The dollar, the euro, and the yen are no exception. Therefore, in my opinion, without a strong banking system, a wide international use of the yen might prove to be a pipe dream.

On the other hand, financial intermediation for foreign borrowers and investors in Tokyo could, in theory, be achieved without a strong commercial banking industry. As is often pointed out, there is a huge pool of savings in the Japanese private sector, which is a great attraction to international borrowers. Investment banks and other securities companies could promote intermediation of these financial resources for nonresident borrowers. One of the most important features of Japan's Big Bang is, in fact, the massive deregulation of securities licensing and pricing and, therefore, Big Bang may indeed prove to be successful in expanding intermediation in the Tokyo market.

In this regard, I also consider the use of the yen to be essential. Otherwise, why would borrowers in other countries be attracted to the Tokyo market when they can opt for New York, London, or Zurich? The rich pool of savings can flow out of Japan easily for investment in New York, London, and other financial centers, where active intermediation of the financial resources of the world takes place.

In sum, without a strong and active banking sector, Big Bang may end up being nothing but a parochial development. Conversely, if Big Bang succeeds in bringing with it the attractive yen supported by an efficient and sound banking system, it will facilitate efficient intermediation not just in Japan but in the rest of the world at large.

As I have already stated, eight years have passed since the speculative bubbles burst in Japan and yet we see its adjustment is incomplete. It is indeed frustrating to face this fact. But it is perhaps fair to say that in recent months, the financial-systems policy in Japan has geared in the right direction and in the banking sector there are some encouraging developments. Some of you may be tempted to underscore the situation in recent months, but better late than never.