Financial Reform in Japan and Global Economic Stability

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The subject of financial reform in Japan and its impact on the global economy is one that intrigues not only the Japenese but foreign observers as well. What has happened to the financial presence of Japan, which loomed so large worldwide in the latter half of the 1980's? More specifically, one may find it difficult to get answers to such questions as why the "bubble" in asset prices in Japan emerged and collapsed, what relation it had with financial reform in Japan, and what implications it has today for global economic stability.

The Bursting of the Bubble: A Result of International Policy Coordination

The emergence and bursting of the bubble in the Japanese asset market was neither a result of financial reform nor of financial deregulation. It was the international policy coordination carried out in the latter half of the 1980s that led to these events. Because of coordinated cuts in interest rates decided upon in the Louvre Accord of February 1987, Japan's ODR was cut to 2.5 percent, an historical low. To be sure, there was no conflict between international policy coordination and domestic stabilization policy at the time of the Accord, since Japan was suffering from a recession brought about by the high yen. In the course of 1987 however the Japanese economy began to recover. At that point in time the optimum policy mix to achieve the twin policy goals of sustained growth with price stability as well as a reduction in the current account surplus would have been a combination of expansionary fiscal policy and neutral monetary policy. This, of course, would have been against the Louvre Agreement because the resulting

Cato Journal, Vol. 13, No. 3 (Winter 1994).
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higher interest rates in Japan would have depressed the value of the dollar. (In fact, when Japanese and German interest rates rose slightly in the autumn of 1987, the New York stock market crashed in October, causing the dollar to plummet.) Therefore, in compliance with the Louvre Accord, Japan was obliged to continue its easy monetary policy, keeping its interest rates at the lowest level ever through May 1989. As a result a mistaken notion spread in the Japanese market between 1988 and 1989 that Japan would not be able to raise interest rates lest she create a dollar crisis. This assumption of permanent low interest rates was responsible for the bullish sentiment that caused asset prices to surge beyond the level justified by economic fundamentals, thereby creating the bubble.

However, although Japan is the world's largest surplus and net creditor nation, the yen will begin to fall when overshooting occurs. This, then, is a phase in which a rise in Japanese interest rates will not cause the dollar to collapse. We have been in such a phase since May 1989. Japan's ODR was raised three times in 1989 and twice in 1990, causing the bubble to burst.

The bursting of the bubble has had a broad impact on the Japanese economy. Personal consumption has been sluggish because of the negative wealth effect. Corporate investment has declined for two reasons: first, the deterioration of corporate profits due to investment losses, and second, a decline in the availability of funds resulting from difficulties in equity financing, as well as in borrowing from banks using land as collateral. The negative effects of the bursting of the bubble on consumption and investment are one of the major causes of the present recession.

Banks are beset by a drop in latent profits on the stocks they hold, and by the emergence of bad loans to the real estate sector. As a result, despite six cuts in the ODR by the Bank of Japan since July 1991, the year-on-year growth rate of Japan's broadly-defined money supply continued to decline and was negative between September 1992 and January 1993. Securities companies are chalking up deficits because of drops in commission income caused by a sharp decline in the stock trading volume.

The spill-over effect of the bursting of the bubble on the international front includes the expansion of Japan's current account surplus to 110 billion dollars, equivalent to 3 percent of GNP, caused by an increase in the excess of domestic savings over investments due to the business slump. Moreover, the portion of the surplus that is recycled overseas through direct investments has decreased in recent times. An increasing portion of the surplus is being recycled overseas in the form of repayments of short-term bank debts.

Toward Autonomy of Economic Policy

Japan has learned at least two valuable lessons from her experiences between the latter half of the 1980s and the early 1990s. The first one concerns her contribution to global economic stability. Japan has experienced the emergence and bursting of the bubble because it defined its contribution to global economic stability in terms of the maintenance of the value of the dollar through a sustained low interest rate policy and the contraction of its current account surplus. As a result, bubbles have formed and burst, the economy has fallen into recession, and the current account surplus has expanded contrary to Japan's aim of contributing to global economic stability and development.

The United States and Japan are economic superpowers to which the "small nation hypothesis" of economic theory does not apply. The stability of the global economy requires that their economies be able to sustain growth without inflation or bubbles, a fact which to me seems to imply that both countries should have autonomy in their economic policies. If one of the superpowers sacrifices its domestic stabilization policy for the benefit of the other superpower, the resultant domestic destabilization will eventually cause serious harm to global stability. The right policy for Japan between 1988 and 1989 would have been a mix of neutral monetary policy and expansionary fiscal policy to achieve sustained growth without the bubble, and to reduce its current account surplus. This policy mix would have raised Japan's interest rates and would have further pushed down the value of the dollar. Surely the two nations could have tolerated this.

The Environment for Financial Deregulation in Japan

The other important lesson for Japan is that we must make haste in implementing financial reform. This is because the formation and bursting of the bubble occurred not as a result of financial deregulation, but because deregulation was delayed. Deposit interest rates will be deregulated completely between 1993 and 1994. Stock brokerage commissions on large transactions will also be deregulated, and the deregulation is expected to be expanded gradually to smaller transactions.

There will also be change in the scope of financial business. Banks will enter the field of corporate bond underwriting, while securities companies will move into trust banking, both using subsidiaries. Initially, the operations of the subsidiaries will be limited, but they will be increased gradually and in stages, with careful monitoring of the functioning of fire walls and the degree and form of competition.

However, Japan is not aiming ultimately at forming a universal banking system. Japan takes the view that a complete universal banking system may promote oligopolic power of city banks, conflicts of interest, insider information, and the spreading of risk to the payment system, and that contrary to belief it may harm fairness and efficiency. In order to achieve economy of scope, the authorities will seek scope deregulations within necessary limits.

Japanese banks and securities houses have been hard hit by the bursting of the bubble. Will they still have the capacity to take advantage of this scope deregulation in the financial sector?

As the land-price bubble formed and collapsed mainly in large cities, the deterioration of asset portfolios was confined mainly to large powerful banks in major metropolitan areas, such as city banks. This is a lucky condition in an otherwise bleak environment.

Combined statistics for Japanese city banks, long-term credit banks and trust banks show that at the end of September 1992 loans on which interest had not been paid for six months or more stood at 12 trillion yen, most of which were made through their subsidiary non-banks to the real estate sector. The Ministry of Finance announced that 4 trillion yen of this figure was unrecoverable and needed to be written off. Such loans must be increasing now. However on the same date, these banks had latent gains of 15 trillion yen and bad loan reserves of 3 trillion yen, while net operating profits stood at 3.5 trillion yen per annum. This suggests that Japanese large banks have ample ability to correct the deterioration of their asset portfolios due to the bursting of the bubble. By taking advantage of the lessons they have learned, banks are now striving to practice risk management based on prudence and to enhance their net worth.

As regional cities did not experience a land-price bubble, regional banks and credit association banks whose asset portfolios have deteriorated are the exception rather than the rule. The Ministry of Finance and the Bank of Japan are closely monitoring the small number of such exceptions. Large creditor banks have lowered their lending rates to these exceptional small banks or non-banks in order to restore their solvency. If solvency cannot be restored in this way, as in last year's Toyo Shinkin case, these institutions will be split up and the deteriorated parts will be merged with large creditor banks, while the sound parts will be merged with shinkin (credit association) banks in the same region so that depositors will not be hurt. This will diversify the burden on large creditor banks.

In Japan the deposit insurance system has not been mobilized so far. However, the split-up and merger of struggling banks under the guidance of the Ministry of Finance and the Bank of Japan is more severe than the mobilization of the deposit insurance system and may effectively prevent moral hazard. The approach to ailing banks in Japan, which is different from the U.S. approach, is partly based on the fact that the number of commercial banks in Japan is only 150, with average assets per bank as high as 38 billion dollars. In the United States the number of insured commercial banks is 12,000, which is eight times as much as in Japan, while average assets per bank amount to only 3 billion dollars, or less than one-tenth of the Japanese average.

Japan has learned many valuable lessons from its recent predicaments. These lessons will enable her to implement financial reform more rapidly and execute the right policy mix to achieve sustained growth without inflation and bubbles, and to reduce its current account surplus thereby contributing to global economic stability.