

# Briefing Paper

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## *Asia's Financial Crisis and Japan*

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Capital flight, currency depreciation, banking failure, and threatened national default first in Indonesia and Thailand then spreading to Hong Kong, South Korea, and Japan have exposed the archaic financial and regulatory systems of Asia. That South Korea and Japan are the world's eleventh and second largest economies further exacerbates the expanding crisis. The problems in Japan and Korea are not new. They have festered in Japan since 1991 and in Korea since the early 1980s. What is new is how they may affect both regional stability and the world economy.

Too-cozy ties between Asian governments and their private sectors undermine the competitive forces that allocate capital and rationalize markets. Asia's politicians have reacted by calling for curbs on market forces such as imposing taxes on short-term currency movements or slowing the pace of the internationalization of domestic financial systems, as voiced at APEC's November meeting. Some have placed the blame for the current financial problems in Asia on market failure or mercenary foreign speculators.

Those who seek to contain the power of the market have the situation confused. ***Market forces are only responding to government failure to modernize their economies, especially the financial sector.***

Administrative controls over financial systems support favored sectors. Both government and market participants are resisting the structural changes needed to render domestic financial systems compatible with an increasingly integrated world trading and financial system where market forces play the key role in allocating funds and resources.

With international economic stability at stake, the IMF, as the world's effective lender of last resort, has provided \$10 billion to Indonesia, \$3.9 billion to Thailand, and \$57 billion to South Korea. The conditions imposed by these IMF bailouts promise politically challenging austerity in these formerly high growth countries. More important, the structural changes demanded now raise questions about the once admired "Japan model" of government-led economic development.

Indeed, nowhere is Asia's financial crisis more acute than in Japan. Inefficiencies in the Japanese economy were exposed beginning in 1990. Financial problems have escalated in the past six months as the economy turned toward recession following the failure of Sanyo Securities Company and Hokkaido Takushoku bank, financial and corporate scandals involving organized crime, and most recently, the failure of Yamaichi Securities Company, Japan's fourth largest security company. It remains to be seen if Tokyo has the political will to push financial deregulation and enforce the structural changes needed to energize and modernize Japan's markets.

### **There are four points worth emphasizing about Asia's financial crisis:**

1. The situation is serious and has the potential to generate contagion as one country's problems spill over to the next. For example, the non-performing loans in Indonesia, Thailand, and South Korea further weaken the Japanese financial system since Japan has been a major lender in the region, and Japan's problems in turn can spill over to Europe and the U.S. Thus, the world has a strong stake in seeing these financial problems dealt with in a timely manner.
2. The financial problems in Asia are not new and have long been recognized, especially in South Korea and Japan. Starting in 1992, my research warned that both countries faced serious financial problems, especially if they did not address the extensive system of government deposit guarantees. In the case of Japan, reform of the massive Postal Savings System would be essential.
3. Asia's currency crisis and capital flight do not reflect market failure and the need to constrain market forces. This crisis reveals, and is a response to, government regulatory failure in these countries that has persisted for decades. This is most evident in Japan.
4. Do not count Asia out. The crisis may prove to be a tonic for the region by rationalizing markets and reducing government intervention.

### **The Japan Model**

#### **Postwar Japan's Economic and Financial Development**

Japan's postwar economic and financial development has gone through five distinct phases. They are: (i) 1945-1950: postwar adjustment, foundation for rapid growth provided by the Dodge Plan, and stimulus from the Korean War; (ii) 1950-1970: the High Growth Period where real GDP grew at an average of 10 percent per year in the context of moderate inflation of about 5 percent per year; (iii) 1971-1975: a short but turbulent period of "wild inflation," yen appreciation, and the collapse of fixed exchange rates; (iv) 1976-1985: period of impressive macroeconomic performance with economic growth in the range of 3 to 5 percent, price stability, minor business fluctuations, internationalization, and emergence as the world's second largest economy and largest creditor nation; and, (v) 1986 to the present: asset price inflation or the "bubble economy," asset deflation or the "burst of the bubble economy" after 1989, recession and economic growth less than one percent per year, fundamental weaknesses in the financial system, and a regulatory/political infrastructure unwilling and/or incapable of dealing with the problems.

The last three periods are the most interesting for understanding the current financial crisis in Japan. During the 1950-1975 period Japan's financial system was the most rigidly regulated, administratively controlled, and internationally isolated among the industrial countries. Interest rates were subject to administrative control with only two exceptions, financial institutions were segmented, and money and capital markets played a minimal role in the flow of funds from the household to the corporate sector. The financial system was designed to support export-led economic growth, international isolation, high household saving, and low household spending. This financial infrastructure served Japan well and deserves considerable credit for Japan's impressive economic performance from the ashes of war to the mid-1970s.

In the mid-1970s, Japan's financial structure became increasingly incompatible with economic fundamentals and the emergence of a new economic and technological environment. Financial liberalization was initiated and up to the mid-1980s, proceeded at a slow, steady pace with few disruptions to the real or financial sectors as witnessed in the United States. Bank of Japan monetary policy deserves considerable credit for providing a favorable environment for the liberalization process in the form of price stability. In fact, some observers regarded the Bank of Japan as a "model" central bank for its policy outcomes during the 1975-1985 period.

## **The Bubble Economy**

What started as a smooth transition, however, changed dramatically after 1985 with the run-up of land and equity prices, and booming economic and monetary growth characterized as the bubble economy. The change in the nature of the transition was caused by three factors: (i) Bank of Japan policy became increasingly concerned after 1987 with limiting the appreciation of the yen resulting in rapid accumulation of international reserves and the money supply. (ii) The liquidity created by the central bank found its way into equity and real estate markets given the close interaction between banks, agricultural credit cooperatives, household loan companies, and equity markets as banks sought increased market share that had been lost as a result of liberalization and lower corporate demand for credit. (iii) The financial and regulatory structure was poorly designed for liberalization. The regulatory structure was incapable of monitoring risk-taking in the emerging liberalized environment in which no meaningful financial disclosure framework existed, and there was a regulatory attitude of "no failures of financial institutions or markets," and a failure to appreciate the policy errors and moral hazard of government deposit guarantees manifested by the collapse of the S&L industry and deterioration of the banking system in the U.S.

These features summarized in Table 1 contributed to the bubble economy. Like all bubbles, this one came to an abrupt end when the Bank of Japan, out of concern for the asset inflation, raised the discount rate in May 1989 from 2.5 to 3.25 percent and to 6.0 percent August 1990. Asset prices fell sharply, causing Japan's most serious recession since 1950 and weakening the balance sheets of all financial institutions, especially those heavily involved in the real estate market.

## **The Bubble Bursts**

### **Government Failure, Regulatory Inertia, Forgiveness, and Forbearance**

The Japanese bureaucracy's response exacerbated the problem. It was one of denial, and once denial was no longer credible, the response was one of delay, forbearance, and forgiveness. After the initial sharp decline in equity and land prices, the Ministry of Finance allowed banks to hold non-performing loans without special

write-offs and made little effort to close insolvent institutions.

The Ministry's response to the *jusen* problem is especially noteworthy. The *jusen* companies were created in the mid-1970s as subsidiaries of banks, securities firms, and life insurance companies that initially provided consumer credit but moved more heavily into real estate lending in the second half of the 1980s. *Jusen* were dependent on funds from banks, credit cooperatives, and other institutions since they had no deposit base. In 1991-92, the Ministry was aware of a serious non-performing loan problem in the *jusen* industry but failed to move to close down what was obvious to many observers was an insolvent industry. Indecision by the Ministry of Finance is primarily responsible for the delayed response, especially during 1992 and 1993, since by that time the *jusen* problem had been evident for several years both to the Ministry and market insiders before becoming public knowledge. Documents submitted to the Diet in February 1996 show that the Ministry of Finance made the first on-site examinations of *jusen* in 1991-1992. Those examinations revealed that 67 percent of loans made to the largest 50 borrowers were already non-performing. *Jusen* companies, however, were allowed to operate predicated on the assumption land prices would rise in the near future. Instead of an increase in land prices, land prices continued to decline and the *jusen* problem increased in magnitude. Non-performing loans in the *jusen* industries increased by 75 percent in the following four years.

A number of factors are contributing to the delay in regulatory response: lack of political leadership; agency problems in administering deposit guarantees; political power of the agricultural sector; existence of three separate and in some cases competing regulatory authorities (Ministry of Finance, Ministry of Agriculture, Forestry, and Fisheries, and the Ministry of Posts and Telecommunications); and a general unwillingness to recognize that Japan and Japanese financial institutions are susceptible to moral hazard problems.

A "ten year rehabilitation" plan was introduced in 1992. It was to provide temporary liquidity based on the belief that real estate prices would recover. The plan was bankrupt. The *jusen* non-performing loans increased rapidly in the face of continued declines in real estate prices. In August 1995, the Ministry conducted a special audit of the *jusen* and found that 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. There followed a protracted political debate over how to close the *jusen* using an "all Japan" or "convoy system" solution of burden-sharing among institutions that often had only a weak relationship to who had provided funds to the *jusen*. In particular, the credit cooperatives were essentially absolved of financial responsibility even though they had been significant providers of funds to *jusen*.

The same type of approach—one of forgiveness and forbearance—is also evident in how the Ministry dealt with 11 insolvent banks and cooperatives from 1991 to 1995. The response was delayed and when no other solution but closure was possible, the Ministry provided complete deposit guarantees. In many cases, it imposed few penalties on shareholders.

The regulatory authorities as well as politicians minimized the problems and passed up opportunities to deal with them, such as in 1992 when the Financial Systems Reform Law permitted banks and securities companies to enter each other's markets. Despite the weak foundation of Japanese finance, as evidenced by the collapse of asset prices and non-performing loans, the 1992 law all but ignored the conflicts between increasingly liberalized financial systems and pervasive government deposit guarantees.

## A Turning Point in 1995

The non-performing loan problem grew, and by March 1995 was officially reported at about \$500 billion, with private estimates being offered at twice that amount. A turning point was reached in 1995-96 when more decisive action was taken. Japanese authorities departed from the official "no failure of financial institutions" policy and committed limited public funds to problem institutions. Two deposit insurance agencies were restructured and the Diet passed legislation dealing with the special problems of the *jusen* and credit cooperatives.

In November 1996, Prime Minister Ryutaro Hashimoto announced an extensive deregulation of Japan's financial system by the year 2001. He represented a reorganized Liberal Democratic Party (LDP) and had been elected in October on a platform of broad-based reform. His proposal, referred to as the "Big Bang" approach to financial deregulation, was designed to make Tokyo a global financial center to rival New York and London. It had three basic principles of reform: "market mechanism," "global nature," and "transparency."

Acting on Hashimoto's initiative, the Diet passed legislation in June 1997 establishing a new Financial Supervisory Agency (FSA) that would report directly to the Prime Minister. The FSA would assume many of the regulatory responsibilities of the Ministry of Finance in monitoring and supervising the financial system. The foreign exchange market would be further deregulated while the independence of the Bank of Japan from the Ministry of Finance would be enhanced. The law also further deregulates the securities markets and permits the establishment of holding companies.

Although the Big Bang and legislative initiatives would move Japan's financial system in the desired direction of a more open market economy, they did little to confront the problems of Summer 1997. A review of the regulatory response to troubled institutions reveals an unwillingness both to depart from the traditional approach of non-transparency in dealing with troubled institutions and to depart from an extensive system of deposit guarantees. Most important, confronted with a more activist public, the Hashimoto government displayed an unwillingness and/or inability to make a case to the Japanese people that public funds will be needed to deal with the problem.

As of December 1997, this attitude appears to be changing. After much indecision, Hashimoto has begun to make a case to Japanese people that public bailout funds will be necessary and needed soon. The willingness of Tokyo to permit Yamaichi Securities to fail may be a watershed event. It should be remembered that Yamaichi had received a bailout in 1965 under the "no failures of financial institutions or markets" policy.

There is also hope for a new bank regulatory agency. The international financial community has exerted considerable pressure on Tokyo to adopt a more transparent approach to dealing with troubled institutions. The new agency would impose penalties on large depositors, shareholders, and managers with the belief that "pain" will occur in closing down insolvent institutions. Most important, there would be a "prompt corrective action" attitude in dealing with troubled institutions. Unfortunately, this new agency is not expected to begin its work until July 1998.

### **Japan's Postal Savings System: Godzilla of Japan's Financial System**

A significant omission of the 1996-1997 initiatives was the failure to include Japan's Postal Savings System in

the reform package. Japan's Postal Savings System is the largest financial institution in the world with over \$2 trillion in deposits, or over 30 percent of household savings in Japan. *The Postal Savings System has the potential to be a major destabilizing element in Japan's economy.* Few outside of Japan are aware of the importance of the Postal Savings System, but as reforms in Japan move forward, the system will be at the center of debate. Regulation provides the Postal Savings System a number of comparative advantages in attracting deposits, including complete government deposit guarantees. The system is incompatible with a competitive financial system, but has strong political support because it is popular with Japanese citizens and provides about 20 percent of the funding of the Ministry of Finance's Fiscal Investment and Loan Program (FILP). These funds are distributed to a number of public financial institutions which in turn provide subsidized loans to politically favored sectors of the economy.

In late 1992, the Ministry of Posts and Telecommunications and the Ministry of Finance agreed to reduce the competitive advantage of postal deposits relative to private bank deposits. The final agreement, however, leaves considerable room for the Postal Savings System to retain its competitive advantage for household deposits. The Postal Savings System has not been a passive actor in this regard and has shown considerable resistance over the past decade to policies that would erode its regulatory advantages despite the transition of finance toward more open and competitive structures. In 1992, the Postal Savings System even began to publicize the fact that postal deposits were more secure than bank deposits, in an effort to attract funds, by referring to the non-performing loan problem of private banks. The practice was officially criticized even by top Ministry of Posts and Telecommunications officials. Yet it is unlikely that individual post offices would pass up a chance to inform customers of the complete government guarantee of postal deposits and at least implicitly refer to the non-performing loan problems of banks and other depository institutions.

## **Current Financial Crisis and Outlook for Reform**

Despite the clear evidence of government failure in Japan, major changes in the structure of Japanese finance have taken place during the past two decades. Even though these changes fall short of achieving a stable financial environment, they are significant and have created both losers and winners. More needs to be done, however.

The changes enacted and those proposed for future legislation, even were they to greatly benefit the Japanese economy as a whole, will create more losers than winners. The potential losers, long protected by regulation from market competition in Japan's compartmentalized financial services industry, are likely to vigorously oppose further change. Financial deregulation in Japan has been on the agenda for many years, proceeding very gradually, and some skeptics argue that a sense of *déjà vu* surrounds the present push for deregulation. One only has to recall the 1986 Maekawa report which also called for major structural changes in Japan.

Japan's financial system, however, is now at a juncture that is not comparable to any other episode during the past 45 years. Stress in the Japanese financial system, especially failure to quickly resolve the non-performing loan problem, continues to hold back the economy and has stagnated a large part of the real estate market. The shortcomings of the existing regulatory and supervisory structure, especially in the context of the large changes in financial institutions and markets during the past 15 years, is readily apparent. Market forces and competition among financial institutions make the existing financial structure incompatible with Japan's regulatory and supervisory structure.

Recent legislation creating the Financial Supervisory Agency recognizes and attempts to address this problem. Moreover, economic and political pressure for fundamental reform will likely continue even if the present wave of popular opinion against Japan's financial institutions and regulators, especially the Ministry of Finance, wanes. Japan simply has no choice but to make the politically difficult changes. The current crisis may well offer the needed catalyst to convince Japanese regulators and politicians that change is needed.

## Repercussions for Asia & the World

The Japanese crisis is seconded only by South Korea's. Although financial problems in the smaller Asian economies are of serious concern to those countries, they lack the potential for adverse affects on the rest of the world. Japan and Korea are different because of their size and, in the case of Japan, because of its position as the world's largest creditor nation.

The real danger does not lie in short-term financial instability or collapse. The international community has learned to work together to maintain financial stability. The real danger is longer term and more general. Japan, Korea, and much of Asia have achieved economic growth based on the export-led Japanese developmental model. Their solution to the crisis may be that they will try to export their way out of the problem and resist making the structural changes that are being demanded. The recent depreciation of these currencies will increase the U.S. trade deficit. "Globalphobia" and protectionism are alive and well in the U.S., and are showing a resurgence recently. The European Community is in the process of forming a trading bloc. Thus, the real danger is longer term and involves far more than financial issues. It is nothing less than a trade war.

The world has a high stake in seeing Japan and Korea and the other Asian economies succeed in the required structural changes in their economies and financial systems. They have the resources, the human capital, the infrastructure, and the knowledge of what needs to be done. Only the political will is lacking. Hopefully, the recent crisis will provide the necessary political courage.

**Table 1**

**Special Features of the Bubble and Burst of the Bubble  
Economy Contributing to the Non-performing Loan Problem**

Factor	Outcome
Financial liberalization starting in mid-1970s and continuing to the present.	Increased asset diversification powers for bank and non-bank depositories. Increased ability to manage and assume risk unequaled in postwar period.

Downward shift in potential GDP growth path after 1973 oil price shock reduced corporate dependence on banking system as rate of investment fell from rates during the high growth period.	Banks sought out new markets to re-establish and enhance market share. Specifically, banks aggressively moved into real estate lending and competed with <i>jusen</i> in 1980s.
The decline of the main bank system and the overall reduced role of banks in enterprise groups.	Reduced the ability of banks to monitor risk.
Japanese banks were permitted to hold equities in non-financial businesses as part of the enterprise group framework. Banks could apply 45 percent of the appreciation of equity holdings to capital referred to as "hidden or latent" capital.	Capital position of banks was dependent on the equity market so that during equity price increases banks would expand loans and investments, and during equity price declines banks would contract loans and investments.
Reliance by the regulatory authorities on "administrative guidance" to monitor bank and non-bank depository institutions.	Regulatory authorities were less able to monitor risk as bank and non-bank depository institutions engaged in greater asset diversification than in the past. Bank and non-bank depository institutions had few incentives to limit risk.
Pervasive system of government deposit guarantees.	Reduced oversight and enhanced asset diversification powers became more sensitive to the risk incentives embedded in the deposit guarantee system.
Monetary ease in 1987 and 1988 as Bank of Japan placed greater emphasis on exchange rate objectives than domestic considerations.	Bank of Japan provided liquidity that supported the asset inflation.
Incentives for regulatory authorities to adopt forbearance and forgiveness in dealing with troubled institutions.	Incentives to assume risk.

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- [Publications of Dr. Cargill](#)

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Back to [Previous Page](#)

Back to [Home](#)

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