BUBBLE BURST AND JAPANESE BANKING INDUSTRY (*)

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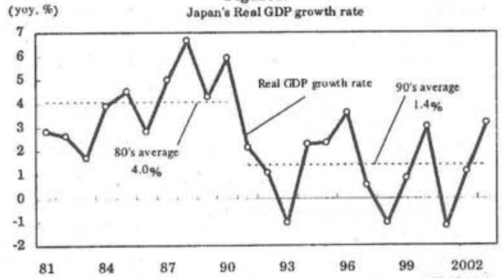
1. The emerge of the bubble and its bursting

The bubble formed gradually in the latter half of the 1980s, and it burst in the early 1990s, and then began the deflationary period now called Japan's "lost decade". In Figure 1, we see that before the bubble period, Japan's real GDP growth was a robust 4% annually. Since the bubble period, that figure has dropped to anemic 1-2%.

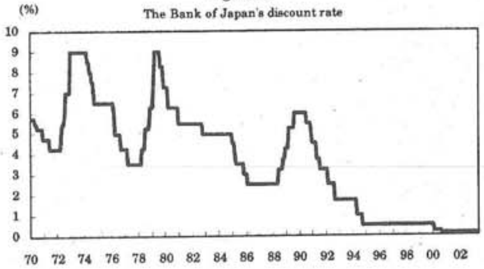
Figure1.
Japan's Real GDP growth rate



Source: Cabinet office

In response to that slow pace of growth, interest rates were reduced sharply. For example, as we see in Figure 2, the Bank of Japan's discount rate was 6.0% in the early 1990s, but it fell to virtually zero.

Figure2.
The Bank of Japan's discount rate

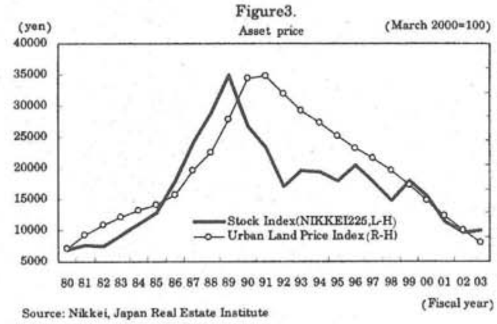


Note: Figures are end-of-the-month
Source: Bank of Japan

Figure 3 indicates the volatile ups and downs in asset prices, in this case as shown by stocks and land. Starting in December 1990 for stocks, and a year later for land, asset prices began a steep descent that threatened to erase the bubble gains completely. The amount of national wealth lost in these two markets is estimated at 2.5 times Japan's GDP.

At that time, asset inflation had made itself strongly fall

Figure3.
Asset price



Source: Nikkei, Japan Real Estate Institute

not just in Japan, but also in other countries such as the U.S., Britain, Sweden, Norway and Finland. There were three reasons for this phenomenon seen in each of these countries: (1) the interest rate reductions that these countries had agreed to in the Plaza Accord, (2) falling oil prices, and (3) a flourishing of money games.

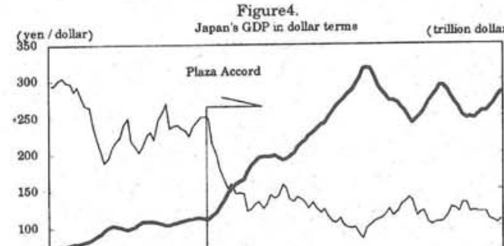
What were conditions in Japan at that time?

In my view, Japan's economic bubble had its origins in yen strength that started with the September 1985 Plaza Accord.

The strong yen had many different effects on Japan, but as shown in the familiar phrase "Japan as No.1", the strong yen boosted Japan's international status, and caused a mood of optimism and bullishness about the future to spread throughout Japan.

Japanese saw their salaries and Japan's GDP, as expressed in dollars, climb to unimaginable levels, before their very eyes. Figure 4 shows Japan's GDP in dollar terms, and how it began to show very rapid growth in the mid-1980s.

Figure4.
Japan's GDP in dollar terms



Source: Bank of Japan, Cabinet Office

Under these conditions, Japan's monetary policy course led to historic lows in interest rates and unprecedented highs for money supply. Financial liberalization also proceeded at a rapid pace, all of which led to an unusually high level of activity in Japan's financial market.

I believe the key to understanding Japan's "lost decade" lies in this synchronicity of events.

The speculative bubble was not a Japanese invention. Its origins can be traced back to the Tulip Craze in the Netherlands in the 17th century. At that time, tulip prices rose steeply, encouraging speculation that pushed prices still higher, which encouraged further speculation. Ultimately, prices collapsed. Since that time, whenever we witness a euphoric rise in asset prices to historic highs, in retrospect we can only call it a form of rapture. The speculators in every economic bubble believe their actions to be perfectly reasonable. They have confidence, and no reason for doubt.

As someone who was working on the front lines of finance at the time, I think the bubble that occurred in Japan was exactly like that. As long as the speculative run continues successfully, speculators make money.

Above mentioned are a few things about what caused the bubble in Japan, but now I would like to go into a little more detail or "Zaitech" and land speculation.

"Zaitech" is a term that was used to mean a financial management technique where managers would borrow funds at low interest rates, not to invest in meaningful ways, but simply to invest in other financial products such as the newly introduced large-scale time deposits and "tokkin/fund trusts," just to earn the difference in the interest rates. During the bubble, interest rate spreads widened to as much as 600 basic points.

In land speculation, we witnessed a situation where major corporations moved to distance themselves from banks; as a result, financial institutions, forced to look for new borrowers, began lending to small-and medium-size companies and to the real estate industry. Some of this money ended up in property flipping, price ratcheting, golf courses and resort condominiums. These two trends served to accelerate the rise in asset prices in the stock and real estate markets.

Eventually, Japan learned the lesson that "the higher the mountain, the deeper the valley," as asset prices plunged. As had been the case in past bubbles, many speculators ended up bankrupt.

Many companies suffered severe damage to their balance sheets. This is the situation that gave rise to the many non-performing loans that Japanese banks held on their books.

The bursting of the bubble had many negative consequences for Japan, politically, economically and socially. Of these, the widening gap between haves and have-nots, the decline in what economists term the relative value of labor, and the destabilization of the financial system are deserving of particular mention.

2. Japanese banks' behavior when the bubble burst

As we have seen, the bursting of the bubble plunged Japan's economy into a prolonged slump. Let us see how Japan responded to the bursting of the bubble.

As I mentioned earlier, the bursting of the bubble, resulted in the generation of a large volume of non-performing loans banks saddled with non-payment loans have to deal with them somehow, usually through write-offs. Truth to be told, Japanese banks were slow to take this step.

Some critics charge that Japanese banks' reluctance to deal with their non-performing loans exacerbated the financial problems. That may certainly be true to some extent. It is certainly not appropriate, however, to say that the banks deliberately tried to disguise their non-performing loans and delay the write-offs, or to contend that the responsibility lay with the banks alone.

There were many reasons behind the delay in dealing with non-performing loans. One was that the banks themselves did not anticipate that the economic slump would go on for such a long time.

The economy is ruled by cycles. An economy may contract, but no one expects contraction to go on forever. Monetary policy and fiscal policy are used to stimulate the economy. As time passes, excess inventory and surplus production facilities are eliminated, and eventually the economy gets back on track. Once the economy is growing again, corporate earnings recover, and in many cases, loans that had fallen to a non-performing status can themselves return to normal.

In Japan in the 1990s, however, things often seemed to be heading for recovery, but they never quite seemed to get there. As a result, banks were hoping their non-performing loans would go away if they could just be patient, but these hopes were thwarted.

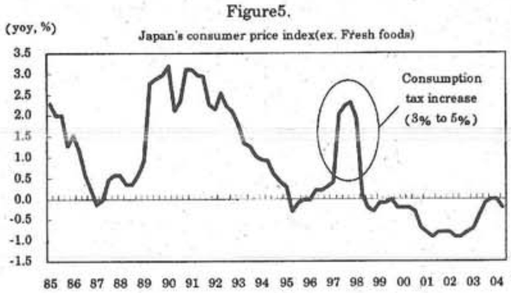
Another reason was that asset prices were falling, and consumer prices were falling. After the bubble burst, prices of stocks, real estate and other assets plummeted, and this skewed corporate balance sheets. Corporations that had borrowed funds during the bubble period and invested in stocks and land found that they could no longer afford to repay their loans, which resulted in greater non-performing loans for the banks.

If the deadline in asset prices ended, that would mean the end of the increase in non-performing loans, but asset prices kept falling. For land, prices are still falling even now. As a result, each passing year would see more new non-performing loans; banks could take write-offs, but before long they would have to take still more write-offs.

As the prices of goods and services continued to fall, the prevailing currents of deflation also caused increases in non-performing loans. Figure 5 shows trends in consumer prices in Japan. A strong increase was seen in 1997 when the consumption tax was increased, but after that consumer prices resume their decline.

Figure5.

Japan's consumer price index(ex. Fresh foods)



Source: Ministry of Internal Affairs and Communications

In a deflationary environment, corporations suffer declining sales in value terms, even if their sales volume increases, and the result is lower revenues. This makes it harder for corporations to pay interest and repay principal on debt. A fall in prices does not mean a reduction in the debt incurred in the past. This is the mechanism by which deflation increases the burden of debt.

The third reason was that banks themselves lacked sufficient grasp of the principles of risk management with regard to lending. Until the bubble, banks had little or no experience of facing large amounts of non-performing loans, so in many cases they did not even keep accurate records of the exact amount of non-performing loans on their books, or the risk of losses. The banks only began external disclosure regarding their non-performing loans in the mid-1990s. Unless one has an accurate grasp of the magnitude of the risk of loss, it is inevitable that write-offs will be delayed.

Lastly, tax issues are also important. In Japan, the losses that a bank records in writing off non-performing loans are now recognized as costs, and easily expansible for tax purposes. In the 1990s, however, things were not that simple.

Broadly speaking, there are two ways to deal with non-performing loans. The first is to take a write-off of the losses a bank actually incurs once the borrowing company.has actually gone bankrupt. The other is to add to reserves in advance, against future losses that may be incurred with regard to borrowers for which there exists a rising probability of failure. This second method of adding to reserves is important if a bank is to avoid putting off dealing with its non-performing loans.

In this case, however, because the borrowing company had not declared bankruptcy, the tax authorities would often stubbornly refuse to recognize the funds added to loan-loss reserves as losses. In this situation, banks would lose all incentive to deal with their non-performing loans on a timely basis. In Europe, and especially in the U.S., allowance for possible loan losses is recognized as costs; this is one major point of difference in the Japanese system.

These are the reasons that prevented a forthright solution to the problem of writing off non-performing loans. If Japan's banks had followed this course in the first half of the 1990s, when they still had sufficient health and vigor, this might have prevented some of the disruptions to the financial system that occurred in the second half of the 1990s. Still, for some time after the bursting of the bubble, there was neither the environment nor the atmosphere for such decisive action.

3. The wave of financial liberalization, and the emergence of financial system instability

In the mid-1990s, there was a pause in the confusion that immediately followed the bursting of the bubble, and the economy improved a bit. At one point in 1995, the yen clambered to a rate of ¥80 yen to the dollar, but through major fiscal policy efforts, Japan managed to avoid any crippling impact this might have had.

Amid these circumstances, lack of liberation of Japan's financial markets surfaced as a major issue. While Japan's banks were dawdling about dealing with their post-bubble problems, regulations in other countries were steadily being done away with. Japan had also taken steps to liberalize deposit interest rates and expand the fields in which financial institutions could operate, but market outside Japan were deregulating faster.

For this reason, Japan's banks fell behind in terms of global standards. The development of the financial centers in Hong Kong and Singapore also shook the position of the Tokyo market as the traditional center of the financial markets of Asia.

To redress in one fell swoop these delays in the liberalization of Japan's financial markets, Japan hammered out its "Big Bang" financial forms in November 1996. The concept was to deregulate Japan's financial markets by 2001 to the point where Tokyo would once again stand on equal footing with New York and London as a center of international finance. Until that point, Japan's financial system, including the banks, had been firmly protected by regulations and by the financial authorities; it was decided that these protections would be eliminated, and supplanted by market principles.

This Japan-style Big Bang was a policy of high ideals, and one that would have to be implemented at some point. At this specific point in time, however, and particularly since it all came at once; it was a severe test for Japan's banks.

As liberalization progressed, competition among financial institutions themselves grew harsher. The aftershocks of the bursting of the bubble had not yet subsided, and now the addition of these severe competitions came as a heavy burden for financial institutions whose strength had already been sapped.

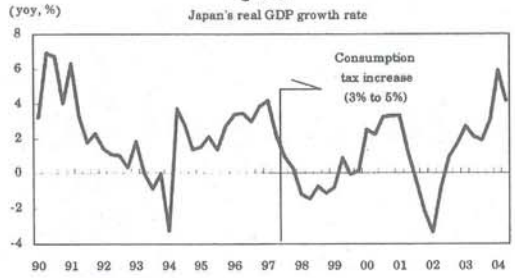
In April 1997, to restore Japan's weakened government finances, the consumption tax was raised to 5% from 3%. Due in part to this tax increase, economic growth faltered. Figure 6 shows Japan's GDP growth, by quarters, showing clearly that momentum was lost starting in the April-June quarter of 1997.

The knockout punch for Japan's economy was the development that you might be most familiar with: the Asian currency crisis that began in the summer of 1997. Japan's economic relationships with the various countries of Asia are deep and complex, and the impact of this new development was huge.

When the economy turns downward, corporate bankruptcies increase. An increase in corporate bankruptcies

Figure6.

Japan's real GDP growth rate



Source: Cabinet Office

causes harm to banks' loan portfolios. Normal loans become non-performing loans, and loans that should already have been written off only grow worse.

In these circumstances, market participants began to speculate that the total volume of banks' non-performing loans was even greater that was being publicly reported. This skeptical view carried over to market valuations, causing banks' stock prices to fall, which made it harder for banks to raise fresh funds. On top of that, some depositors began to withdraw their funds from banks.

Japan's financial system suffered heightened instability on two occasions: in the fall of 1997, and again in mid-1998. The first time was when one major bank and one of Japan's four biggest brokerages went bankrupt; the second time, two banks failed.

When the financial system suffers instability, particularly involving the operations of a bank, with its payment and settlement functions, the paralyzing effect on economic activity can become a real possibility. All funds transfers between corporations pass through banks. If a bank fails in its role in the payments and settlements system, large piles of cash need to be moved to fulfill simple purchases of goods. The inefficiency of this kind of system can bring economic activity to its knees.

When one single bank fails, its payments and settlements no longer function, and this has an impact on funding at other banks, generating fears of systemic risk and potentially leading to a domino effect where one bank failure leads to another.

Faced with shocks to the financial system, each individual bank fears for its own ability to raise funds, and so lending also shuts down. In fact, we experienced a situation where some banks severely curtailed their lending to corporate borrowers. This kind of situation also leads to a worsening of corporate sentiment.

Amid this kind of financial system instability, economic growth is too much to hope for. Now, the financial system is a necessity for society as a whole. To restore the financial system to stability, it was necessary to attack the root cause of the problem: it became widely and immediately apparent that it was necessary to find a decisive solution to the problem of non-performing loans.

4. Japan's problem of non-performing loans and banks' response

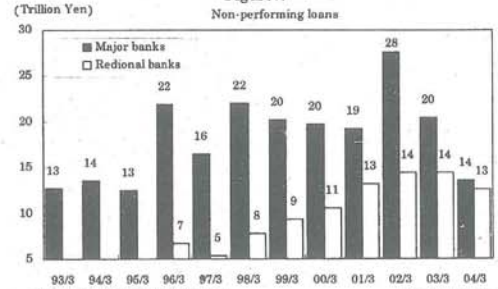
Let us look more closely into the real extent of Japan's problem of non-performing loans, and what was done about it. The non-performing loan problem can be looked at in two ways: the perspective of the banks, as principal players, and the perspective of the financial authorities, as regulators. Let us consider first how the banks have dealt with the problem of non-performing loans.

After the bubble burst Japan's banks first had to come to grips with the problem of non-performing loans, which did not become a really major problem until after the mid-1990s when a few smaller financial institutions went bankrupt. Let us look at some specific figures.

Figure 7 shows trends in banks' holdings of non-performing loans, for major banks beginning in March 1993, and for regional banks beginning in March 1996. The reason for these starting dates is that before these dates, Japan's banks were not obligated to publicly disclose anything about their non-performing loans, and so no figures were made public. Even when figures began to be announced, standards regarding non-performing loans were not very clear. This delay in disclosure invited speculation in the market that the amount of non-performing loans might be greater than the banks were admitting to.

Figure7.

Non-performing loans



Source: Financial Services Agency (The end of FY)

To dispel these doubts, the banks had to reduce their non-performing loans through write-offs; Figure 8 shows the cumulative total of losses banks had taken by writing off their non-performing loans. Since March 1993, Japan's banks have lost about ¥94 trillion. Japan's GDP is about ¥500 trillion, so these losses represent about one-quarter of a year's GDP.

So where did Japan's banks get the money to dispose of their non-performing loans? First, from their yearly profits. Incidentally, even if the banks took write-offs, new non-performing loans kept popping up, so profit alone was not enough to recoup the disposals. Banks used whatever was remaining of the unrealized gains on stock holdings after the bubble burst. In addition, the banks sold land, buildings and other assets ■

(To be continued)

(*) Lecture delivered at the workshop held in November 2004 to commemorate the 10th anniversary of the Scholarship Program between UFJ Foundation with HCMC University of Economics