From Cozy Regulation to Competitive Markets:
The Regime Shift of Japan's Financial System

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Abstract

The Japanese banking and financial systems are substantially along the transformation process of shifting from one regime to a new one. The “postwar” financial regime was characterized by extraordinarily high priority placed by the Japanese regulators on financial system safety. To that end they restricted capital market development, and established the conditions in which no bank could fail: deposits and loans to business as the predominant financial instruments; wide interest rate spreads; no entry and no exit mechanisms; close, informal, opaque, administrative guidance by the Ministry of Finance with little disclosure, is what evolved into a cozy, collusive, nontransparent relationship between regulator and those regulated... in other words, the cliché “bank convoy system.” This protected system gradually dissolved once growth in the Japanese economy in the mid 1970s shifted from being supply constrained to inadequate aggregate demand constrained. With credit becoming easily available, deregulation began its very slow, piecemeal, gradual process, evolving to the new financial system regime today based in principle on open, free, competitive financial markets. The transformation was complicated and made much more expensive by the stock and urban real estate bubbles of the late 1980s, the bursting of which destroyed the collateral value of loans, compounded by Japan’s miserable economic performance of the 1990s. Today Japan’s financial system rests on highly competitive capital and loan markets, with Japanese financial institutions weak and engaged in consolidation, and many major foreign financial institutions as active players in many Japanese wholesale financial markets.
“From Cozy Regulation to Competitive Markets: The Regime Shift of Japan’s Financial System”

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“Crisis and Change in the Japanese Financial System” is generally descriptive but a somewhat prosaic phrase. Considering the problems of the past decade and even today, this could be titled “The Japanese Siamese Twins of Professed Economic Optimism and Forbearance”. In a longer-term perspective of the past 25 years, it could be titled “The Paradox of Thrift - Saving rather than Consuming”. And a focus on the 1980s could be described as “indulgent overinvestment without concern for returns”.

The Japanese economy has gone through a miserable decade of very slow growth from the early 1990s to the present, with dramatic and enduring declines in the prices of stock and urban real estate, deflationary pressures, and inadequate aggregate demand. Japan now has an extraordinary monetary and fiscal policy situation: a huge government budget deficit, a huge and growing government debt, and extraordinarily low interest rates. Moreover, virtually all of Japan’s banks, insurance companies, and other financial institutions are weak; some of them are in great difficulty, and a few at least are close to collapse.

Contrast that with the late 1980s. Then Japanese banks, securities companies, and insurance companies, were not only the largest in the world, they had very high credit ratings and

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1 This is a slightly edited and somewhat expanded version of a distinguished lecture titled “Crisis and Change in the Japanese Financial System” presented at Lingnan University, Hong Kong, November 6, 2000.
huge hidden assets in the form of unrealized capital gains on their portfolios of domestic equities purchased far earlier to develop and cement banking and business relationships. In those days the banks were as proud as peacocks and as arrogant as Americans. We did not use the phrase Japan's "21 big banks" then. We distinguished among the 11 or 12 city banks, which were nationwide commercial banks, the three long-term credit banks providing industrial project term lending, and the 7 trust banks engaged in real estate finance and pension and other asset management. All were deemed too big to fail. Even small banking institutions were considered too safe to fail. What was not recognized at the time, however, was that this hugely successful financial system contained the viruses of its own destruction.

The contrast with today is astounding, something that no one predicted 10 years ago or even 5 years ago. I classify Japanese banks and other financial institutions as: weak, weaker and weakest. Three of the 21 big banks have failed, and the rest are coalescing into five or six financial groups – bringing together as partners, such as Sumitomo and Mitsui, that historically have been rivals.

The final part of this paper considers present issues and problems, and speculates briefly about the future. My comparative advantage lies in providing a broad analytical framework and perspective for understanding Japan's financial difficulties, in order to suggest where Japan's financial system will go from here. Accordingly, I provide some historical perspective in order to identify causes, patterns, and the processes of change that have brought the Japanese financial system to where it is today. As fascinating as Japan's banking and financial mess of the 1990s is, I will not focus particularly on that period.²

Thus my central purpose here is to contrast two Japanese financial — and by extension economic — regimes, and to emphasize the importance, nature and process of the shift from the past regime to the present regime that is emerging. A regime shift is more comprehensive than a paradigm shift in that it includes not only changes in ways of thinking and in goals, but in institutions and markets as well. The two regimes are, respectively, what has been termed the postwar financial system emerging in Japan’s economic recovery and era of rapid growth; and the current regime of open, free and fair competitive financial markets, still in the process of being achieved.

The early postwar regime was that of a highly regulated, quite effective economic and especially effective financial system in an era of rapid growth, where one of the main constraints on growth was the inability to finance even more business investment. It was a situation of credit rationing, high rates of return on investment, an inexpensive and relatively highly trained labor force, and opportunities for profitable investment by importing technology from abroad. In this regime the financial system effectively played a central role in collecting the rising amounts of savings from households and corporations and channeling them to directly productive business investment uses.

Over time the postwar regime has evolved into a market based regime of open competitive markets. That process is not yet complete, especially in the services sector or in agriculture. Most progress has been made in the banking and financial system. This regime shift has been a slow, gradual, evolutionary process based primarily upon domestic forces, though responding also to the evolving international financial system. This shift in regimes has not been due to an external crisis, such as World War II, or even to a fundamental domestic crisis, such as occurred in Japan and Western countries in the late 1920s and early 1930s. Indeed I, like many
other foreigners, have been surprised by the lack of sense of crisis among the Japanese public, despite an increasing sense of disquiet and concern, and decline in confidence in the institutions of government, politics, bureaucracy, and business, and their leaders. One of the advantages of being an affluent, homogenous nation is that social cohesion and a sense of personal well-being remain strong.

This paper is organized as follows. The next section identifies the basic characteristics of the postwar controlled financial system. In the following section I consider the main forces which eroded and eventually brought down that financial regime. I particularly stress the changes in the underlying macroeconomic savings and investment relationship whereby credit tightness gave way to credit ease, and the implications for deregulation and the deregulation process. I touch only briefly upon the twin stock price and urban real estate bubbles of the late 1980s, since a great deal has been written already. Without going into detail, I do stress some basic points about the miserable 1990s, since they are the sources of the Japanese financial crisis of 1997-98. Finally, I consider the current situation of banks and other financial institutions, in particular their dramatic, ongoing processes of consolidation. While overall this is a rather pessimistic story, nonetheless I conclude on a moderately optimistic note.

The Postwar Financial System

Following the devastation and disruption of WWII, the Japanese monetary and financial authorities had as their highest priority the establishment of a very safe financial system which could effectively transfer the savings of Japanese, held primarily in short term deposits, to corporate business, both operating loans and longer term funds to finance new factories, equipment, and other investment. Financial system safety was a preeminent concern of the
regulatory authorities, in response not only to the early postwar devastation and inflation but in remembrance of the great financial crisis of 1927, when a number of banks failed. After that crisis the regulatory authority attitudes shifted toward regulation and safety rather than toward maintenance of a competitive financial system. To that had been added the control mechanisms of the wartime period. Banking system safety meant the safety of every bank, indeed every financial institution. It was not simply the assumption of too big to fail. It was the assumption that no live bank should die. The postwar financial system had eight major characteristics.

1. Japan had a bank based financial system, in which capital markets played a very limited role, being heavily regulated and restricted by the regulatory authorities. Securities companies and insurance companies developed, but they were less important than banks, and subject to the same formal and informal constraints as the banks.

2. Bank loan markets were highly segmented. Large corporate borrowers were the clients of the 11 or 12 city banks doing commercial and some longer term lending, the three long-term credit banks, and the trust banks. Local lending in various parts of the country was done by regional banks, one or two in each prefecture. For even smaller businesses there were a myriad of financial institutions, including mutual savings banks (which evolved into second tier regional banks), credit cooperatives, credit associations, and agricultural credit cooperatives, among others. Each financial institution category had its own market niche and focus, with little competition across markets. The smaller, local financial institutions were surplus collectors of deposits, which they made available to the city banks and other large financial institutions through the call market.

3. Interest rates on both deposits and loans were controlled, the spreads were wide, and profit margins high. Since the demand for credit in the rapidly growing economy was
particularly strong, the effective loan rate was even higher, especially for small businesses. Bank safety was assured by this virtual inevitability of good profits.

4. Entry was not allowed into the banking system; new bank licenses were not issued. At the same time, there was no exit mechanism (a problem which came to bedevil the system in the 1990s). When small, weak financial institutions were in danger of failure, they were smoothly merged into larger banks. This happened infrequently, given the profitability of collecting deposits in branch offices. Where mergers did occur, potential losses of the acquirer were offset by the franchise value of branch offices.

5. There was an excess demand for credit because business investment opportunities were so great, especially given the backlog of very profitable foreign technology that could be licensed and learned, credit rationing and allocated lending became the main revenue source for banks.

6. The relationships between large banks and their larger corporate clients became intensified, ever closer, and more formalized, in what came to be called the main bank system. The main bank directly obtained special access to information about its corporate clients in an environment in which availability of information was poor. The main bank took on the monitoring function of its client performance, new project investment proposals, and behavior. It organized informal syndicates to fund the companies, held a 10% (later 5%) maximum equity stake in the company, and was its lender of last as well as first resort. The main bank was rewarded for maintaining the relationship not so much through higher interest rates on its loans as by preferential access to a wide range of client fee business.

7. The corporate governance system for both financial institutions and industrial companies rested primarily upon the norms of good behavior of entrenched top management
themselves, especially since external corporate governance mechanisms were weak. A majority of a company's shares were placed with other friendly companies, especially among banks, related insurance companies and their corporate clients in an extensive system of cross-shareholding. Outside hostile take-over efforts were not possible and stockholder representation was very weak. Stock price movements were not deemed an important signal, though generally it was a happy situation since stock prices rose dramatically throughout the postwar period until 1990, when they plummeted dramatically and remained far below the peak even today. Credit rating agencies did not exist. The main bank was considered to be the primary instrument of external governance over management performance and behavior. Corporate governance was also shaped by the close, informal, strong, and mutually beneficial regulatory arrangements between the Ministry of Finance and the banks, securities companies and insurance companies.

8. This banking system has come to be characterized as the convoy banking system, a cliché which contains considerable truth. In the convoy banking system the regulatory authorities assured that all banks would grow at about the same rate, and the weaker institutions would be protected from failure by a variety of preferential arrangements. Dividend rates were kept fixed and low. The convoy system meant the safety of every bank. And in fact it was not until the 1990s that failures actually occurred, and then belatedly and modestly relative to the degree of insolvency that existed.

It is important to remember that until the 1970s global capital markets and opportunities for foreign finance were very limited. Moreover, the strong domestic demand for funds meant that Japanese institutions had little incentive to go abroad, and anyway regulations restricted that. Under these circumstances the Japanese banking system was both quite insulated and quite effective. It successfully transferred the rapidly growing savings of households to finance
productive business investment; households had no significant other financial assets to choose from. Credit was on the whole allocated by quite rational criteria; the issues were access to information about the creditworthiness of business projects and borrowers. Political connections, nepotism, or cronyism, pervasive in other Asian banking systems, did not play a significant role in Japan. Even so, there were significant costs built into the system. The various market niches which generated rents were themselves inefficient. Savers received a low return on their savings deposits, especially relative to lending rates.

As the postwar financial system developed, the relationships between the banks and those regulating them became increasingly cozy. An alliance deepened among the Liberal Democratic Party politicians who remained in sole control of the government from 1955-1993; the elite bureaucrats in the economic ministries, notably the Ministry of Finance, who were perceived to be the “best and the brightest” Japanese university graduates; and the senior management of the large banks, and indeed of large corporations more broadly. Smaller financial institutions developed strong alliances with their local politicians. A mind set developed among the major players - bankers, government officials, and politicians alike – that the financial convoy system worked well, and its oversight and management were best done by the Ministry of Finance’s informal, opaque administrative guidance measures, quietly and without disclosure, in what became an increasingly cozy, even collusive relationship.

However, the very success of economic growth and financial deepening created the forces which undermined this postwar system of financial and economic control. Trade and foreign investment were being deregulated, and industrial companies were becoming large and more independent of government authority. Over time the overwhelmingly bank-based, highly regulated financial system became increasingly costly, for borrowers and savers alike. Pressures
developed within Japan to pursue financial deregulation and liberalization.

The question then, is how did that deregulatory process get started, why, and how did it evolve. After all, the deregulation process undermined the fundamental basis of the existing banking and financial system. Perhaps the most difficult problem of all has been the slowness with which the mind set of the regulatory authorities, particularly at the Ministry of Finance, adjusted from their perception of the virtues of their informal, administrative guidance system to the concept of the virtues of an open, competitive financial marketplace. I am not convinced that change in mind set or paradigm has yet been fully accepted and absorbed by the Japanese bureaucracy or the politicians, or indeed many bankers.

Nonetheless, I stress that today the basic characteristics of the postwar financial system are virtually extinct, or at least seriously weakened. Interest rates are now determined in the financial marketplace. Japan has an active capital market. Segmented markets and institutional segmentation have essentially disappeared. Entry is possible and exit is occurring – though certainly not rapidly enough. Excess demand for credit has given way to excess supply, at least for creditworthy customers. The role of the main bank has declined and changed. The convoy system is dead, despite sporadic resuscitation efforts by regulatory authorities. Corporate governance is now an important issue, at least in rhetoric. The previously stable structure of the system of financial institutions is being dramatically transformed. Japan's financial markets today are much more competitive and efficient than they have ever been in the postwar period.

The details of this process are rich, variegated, nuanced and complex. The unraveling of the postwar financial system was driven by three major forces: the ending of the superfast, high growth era in the mid-1970s; a profound macroeconomic shift from investment demand outstripping saving to a private sector persistent saving surplus; and increasingly strong
domestic, as well as foreign, pressures for Japan to deregulate and liberalize its bank-based financial system.

The Unraveling of the Postwar Financial System

The transition from the postwar controlled financial regime to a market-based competitive financial regime in Japan has been a very gradual, evolutionary process. The 1970s represent, symbolically and in reality, the substantial beginning of the transformation process. The oil crisis of 1973-74 was the trigger and a partial cause of the transformation. By then Japan had also become a large economy, with relatively advanced status, and hence the object of increasing foreign pressures to reduce its restrictions and barriers on international economic transactions in trade, foreign direct investment, and financial capital flows.

Of course, the 1970s were a turbulent period not just for Japan but globally. The ending of the Bretton Woods fixed exchange rate system, replaced by a floating, flexible exchange rate, has resulted in a highly volatile yen-dollar exchange rate over the past quarter century. The oil crisis was a major shock to previously benign and rather na"ive Japanese perceptions, assumptions, and expectations about the nature of the international economic system, and induced substantially more caution in projecting both GDP and individual corporation growth.

Japan's economic growth rate, averaging some 9% until the mid-1970's, dropped in half, to about 4 ½%, though still faster than other OECD economies. The business investment rate slowed more rapidly than household and corporate private saving. Japan shifted from being a traditional neoclassical economy, in which the main constraint on growth was supply capacity limitations, to a typical Keynesian economy in which the deficiency of demand has been the major cause of slower growth. A major consequence was the dramatic easing of credit, and a
new set of pressures to deregulate the Japanese financial system.

A number of forces worked at the same time to slow the Japanese growth process. While the oil crisis was a trigger, the rise in the price of oil alone is not sufficient to explain why the growth rate slowed so dramatically. One basic cause was the substantially slower growth rate of business investment. Part was because Japanese companies had already imported and absorbed the most highly profitable foreign technologies. As the technology gap narrowed remaining foreign technology was more expensive, less available, and relatively less productive and profitable. The catch-up benefits of being a follower country were coming to an end. As Japanese at the time liked to point out, Japan had caught up with the West.

A very successful country cannot be a technology follower forever. Japanese R&D expenditures and activities expanded. While they were on the whole profitable, they were relatively less so than the cream of foreign technology. Japanese firms had approached the global technology frontier in many civilian goods industries. Relatedly, Japanese businessmen lost their naive belief that superfast growth would continue forever, though belief that growth would persist above average for an advanced industrial country tended to reassert itself in the economic boom of the late 1980s.

Japan’s shift from being a savings-short economy to one in which desired private saving has consistently and structurally exceeded private investment demand has been absolutely fundamental, and cannot be overstressed. Without adequate demand an economy cannot grow at its full potential. That is the paradox of thrift. when individuals save more, and consume less, then aggregate demand does not increase and the economy does not grow.

How can an economy adjust when it has a surplus of domestic saving over domestic
investment? Earlier textbook analysis saw this primarily as a business cycle problem. The answer was straightforward: implement domestic macroeconomic demand stimulus policies, including increasing government budget deficits by combining rises in public works and tax cuts, and an easy monetary policy and low interest rates to make business and housing investment more attractive. That indeed is what Japan did between 1975-1980. And it is what Japanese policymakers have been doing in an extreme way for the past five years.

But suppose the saving surplus is long-term: people and companies want to save more than they want to use for real investment at home. One approach would be to reduce saving by taxing it and encouraging consumption. The Japanese government rejected such an approach. Since 1980 the Japanese policy goal has been to tax consumption, arguing that in the very long run accumulated savings will be required to fund the commitments to an aged society.

The simplest solution to a surplus of saving over domestic investment is that a country — its people, financial institutions, and industrial corporations — lend or invest those savings abroad. As free market economists strongly argue, this is the efficient solution in a global economic system.

But the world is not ruled by economists. What is the problem? After all Taiwan and Singapore lent some 10-15% of their GDP to the rest of the world for many years. The problem lies in the difference between being a small economy, as they are, and being a big economy, as Japan is.

How does a country export capital on a net basis to the rest of the world? It has to export more goods and services than it imports; in other words it has to achieve a current account surplus in its balance of payments. To do that its currency has to be weaker than it would be otherwise, in order to make export prices attractive. In theory and in practice Japan exports more
than it imports, so conversely the rest of the world has to import more than it exports. In contrast, the United States saves less than it invests domestically and for the past two decades has had a foreign trade deficit; and about one-third has been with Japan.

Japan's competitive export growth in the early 1980s put tremendous pressure on major American industries, particularly automobiles, steel, and machine tools; and the protectionist response was strong, as it had been earlier in Europe. Japan's exports were and are simply too large to be readily absorbed by other markets. When Japan's current account surplus hit 4.3% of its GDP in 1986, US policymakers made clear that was intolerable, and that Japan had to reduce it to a more reasonable level, say 1 1/2 -2%. Japan's current account surplus then did decline quickly from that peak but it has remained positive, and in Japan's recent recession rose to 3.2% in 1998. Yet this foreign trade demand stimulus has not been sufficient to overcome the overall demand deficiency, the major immediate cause of Japan's mediocre growth performance ever since 1992.

The bottom line is that ever since the mid-1970s Japan's structural saving-investment gap has been far too large to be absorbed by an export surplus because the United States and Europe will not tolerate the massive readjustments forced onto their economies. Japan has been such a large and visible member of the global economy that it has been internationally constrained not to generate as immense an export surplus as would have been required to solve its domestic saving-investment gap. To rephrase, Japan politically has not been able to export its way out of its domestic demand deficiency, especially in the 1990s; the domestic saving-investment gap has been much too large.

How have the economy and policymakers dealt with the structural deficiency in private domestic demand, which I have here identified as one of the defining characteristics of the past
quarter century? In the first place, few policymakers or analysts recognized that deficient private
demand was a persistent structural problem rather than a series of temporary cyclical problems.
Indeed many still have not realized this fundamental fact.

The policies undertaken have embodied virtually all the alternative ways to absorb excess private saving. From 1975 to 1980 the Japanese government sector maintained an expansive fiscal policy and rising budget deficit. That was halted in 1980, and a strong policy of fiscal restriction was implemented which persisted through 1992, with a government budget surplus achieved from 1987. In the first half of the 1980s this was fortuitously offset by US Reagan macroeconomic policies which engendered a high value for the dollar and a wonderful market for many exporting countries, of which Japan took full advantage. Japan's global current account surplus went from minus 0.9% in 1980 to its peak of 4.3% in 1986, a huge demand stimulus for the Japanese economy. Since, as noted, that was intolerable for the United States, Japanese policymakers took actions to reduce the current account surplus.

From 1986, Japanese policymakers replaced foreign demand stimulus with domestic stimulus. They adopted a low interest rate policy that was extraordinarily effective in generating a new domestic demand led-boom founded on rising business investment rates, which persisted into 1991.

The late 1980s boom had some fantastic manifestations. One was Japanese pride and then hubris: the Japanese economic system was the world's best, and Japanese growth would continue forever.

The boom and its low interest rate policies also created the dramatic, exciting increases in stock and urban real estate prices. The policies and the economic growth were not indefinitely sustainable, the high asset prices became bubbles, and in 1990 and 1991 the bubbles burst. It
turned out they were far bigger than anyone had believed, and their bursting far more injurious than anyone anticipated. I will return to this theme shortly.

Slower growth and a net domestic saving surplus have had profound implications for Japan's financial system. Japan's banks and other financial institutions became awash with money. While many corporations continued to borrow, some corporations found themselves also holding surplus funds, earning only very low regulated interest rates. The pressures by major financial institutions and large corporations to deregulate financial markets and institutions increased dramatically over time. At the same time, of course, those financial institutions benefiting from special protected market niches as a result of the regulated and segmented system resisted deregulation in their own areas, while seeking deregulation in other attractive parts of the financial system. It was financial market and financial institution pressures, rather than the vision of the regulatory authorities, that drove the deregulation of Japanese financial markets and institutions.

The Ministry of Finance and other regulatory authorities behaved in a reactive, ad hoc way to these various pressures. Accordingly the deregulation process was piecemeal and extraordinarily slow, taking more than 20 years. This was not surprising; after all, the Ministry of Finance was trying to maintain its control over the financial system. It had two policy process objectives. One was to offset the benefits of deregulation one set of financial institutions received by providing some other benefits to those whose profitable market niches were being eroded. The other objective was to prevent the banks from overwhelming the securities companies, so they were not allowed to take on major investment banking activities until 1994.

The Ministry of Finance was a captive of its own system of regulatory administration, and was slow to develop a new, market-based vision. Officials, engaged in an incremental
deregulatory process, were unable to understand fully its broader implications for the safety and oversight of a new financial system. Prudential regulation was not put into place quickly enough. A new regulatory vision, at least for capital markets, finally came into being with the Big Bang deregulation program beginning in April 1998, in principle to be completed by the end of March 2001.

The deregulation process began in the late 1970s when the controlled interest rate system became undermined by market forces. The Ministry of Finance found that when it began to substantially increase new government bond issues from the mid 1970s, it could no longer prevent the development of a secondary bond market. As yields in that market were greater than the new issue yields, price-setting control over the underwriting syndicate collapsed. At the short end of the interest rate structure, companies and other institutions with surplus funds, unhappy with the very low yields on deposits in financial institutions, entered an informal short-term repurchase agreement market (the gensaki market) developed to handle what were considered to be these minor, exceptional cases. Market based interest rates at both the long end and the short end created arbitrage opportunities between free and regulated interest rate financial instruments. This put incredible pressure to deregulate interest rates first in the wholesale market, for deposits and similar instruments, and then very gradually in the retail market. The ending of controls over interest rates, and the new competitive market forces they unleashed, put pressures on all the other elements of the postwar financial system.

One of the most important consequences was the development of an effective stock and bond market, which was a cheaper source of funds for large Japanese creditworthy institutions. Corporations switched from bank loans to capital market finance. A second major change was the gradual ending of market segmentations, between the various categories of banks, and
between banks and securities companies, in what has been a long, complex and not yet fully completed process.

What were the large banks to do with their surplus funds in the 1980s? Their deposits were rising continuously, and traditional loan demand had slowed significantly due both to slower growth and the shift of their best clients to the capital markets. As the decade progressed, banks looked for various ways to adjust. A cautious strategy to constrain internal growth to clearly defined good business opportunities was antithetical to bank growth ideology. Moreover, the buoyant economy, especially in the late 1980s, seemed to offer many profitable opportunities.

All banks looked for new customers, and they increasingly entered each other’s traditional market territories. Very large banks expanded their foreign financing activities. Nonetheless, the main expansion was into domestic lending to new customers. Large banks moved into the mid market and started lending increasingly to small and medium sized enterprises. As the boom developed in the late 1980s, they also increased their proportion of lending to the real estate and construction sectors. In the competition to increase loans, banks casd credit terms, lending up to 90% of the value of appreciating real estate collateral rather than the standard 60%, foregoing independent internal credit analysis, and placing more emphasis on collateral than on cash flow. From such behavior are bubbles born. And, subsequently, when real estate prices drop 50% or more, so are bad loans created.

Deregulation and the strengthening of financial market competition create new opportunities, make credit allocation more efficient, and generate substantial financial innovation. It also creates new risks – creditworthiness evaluation risks, interest rate fluctuation risks, foreign exchange risks, and the risks of being left behind by more effective competitors.
Some blame the nature and process of Japanese deregulation for forcing imprudent, risk-taking behavior by banks and other financial institutions. That is not the correct interpretation. Deregulation created the opportunities; banks made their choices how to respond. In the free-wheeling, exuberantly optimistic atmosphere of the late 1980s, it is not surprising they took on new lending risks so readily.

In doing so, banks had four fundamentally wrong perceptions about their risk exposure. First, they believed the growth boom of the late 1980s would continue indefinitely; Japan had a new economy. Second, the unrealized capital gains in bank cross-shareholding portfolios would increase in value forever, even though there might be occasional, temporary stock market downturns. Two other assumptions were even more important. One was that the Ministry of Finance would never allow any reasonably behaved bank — that is, one that behaved just like its peers — to fail. The other assumption was by far the most serious of all.

Every society from time to time makes certain basic assumptions that are so strongly and widely held that they are not even very conscious, and certainly not subject to careful critical analysis. The widespread assumption in Japan in the late 1980s, based on the obvious experience of the past forty years, was that real estate was the safest asset and best form of collateral. Its price had virtually never declined, and when it did so it was only in a small amount and for a short period of time. This belief was extraordinarily widespread — bankers, company managers, households, and the regulatory authorities all believed it. This was a once-in-a-hundred years disastrously mistaken assumption. It made the bubble huge, more so than in any other country. Once Japan’s linked bubbles of stock prices and land prices burst, the decline has been devastating, both in the depth of decline and the duration of low prices — right until the present. No real estate collateral-based banking system could have absorbed a shock of this size.
The Bubble, Its Bursting, and the Miserable 1990s

There is now an extensive literature analyzing the causes of the bubble and the effects of its bursting. The story incorporates the role of low interest policies pursued correctly and effectively from 1986 but then incorrectly continuing far too long; the particular pattern of financial deregulation which encouraged capital market development but restricted effective bank participation in it; and misguided lending policies by banks. Policy mistakes by the monetary and regulatory authorities are part of the story. So too are the bad decisions made by businessmen and bankers alike. And to that are added, perhaps inevitably, the elements of speculative, fraudulent, and even gangster behavior.

Consider, however, what should the monetary authorities—the central bank and the Ministry of Finance—do when an economy is growing unusually rapidly due to high business investment, productivity is increasing, the inflation rate is very low, and stock and urban real estate prices are rising rapidly? On the face of it, that is a happy world. Has the economy moved onto a new, higher, sustainable growth path? Or is it in a bubble based on excessively optimistic projections and expectations, doomed to collapse? This is the problem Japan faced in the late 1980s, and indeed the United States faces today. No politicians want the monetary authorities to stop glorious growth, of course, so it takes considerable political will as well as acumen to decide to tighten monetary policy, slow growth, and halt incipient inflationary pressures. It is always easier to analyze and criticize in hindsight than to determine the correct policies at the time.

Without considering the 1990s in detail, I simply remind you of a few major facts before making some broader comments.

First, Japan's economic performance has been mediocre at best-- the slowest growth of any of the OECD countries, culminating in the 1997-98 recession.
Second, asset prices have not recovered. The stock market Nikkei index has bounced between 14,000 and 20,000. More importantly, urban land prices, especially commercial real estate, have continued to decline year after year. Much of the value of collateral for bank loans has evaporated.

Third, stimulative macroeconomic policies—ever lower interest rates and ever-increasing government budget deficits—have been inadequate to generate sufficient demand in a persistent savings surplus economy. The paradox of thrift was never more at work than in the 1990s—and today.

Fourth, in retrospect the Japanese government made its worst macroeconomic policy mistake in fifty years when it decided in early 1997 to give top priority to budget deficit reduction and shifted from an expansionary fiscal policy to a strongly restrictive fiscal policy, a swing of 2 percentage points of GDP. I must confess that even among the pessimists no one at the time thought it would result in an actual recession; at worst we thought it would substantially slow growth from the 1996 pace, making recovery less rapid and longer, and the ongoing structural adjustment processes more difficult.

Fifth, the 1995 failure of the seven housing loan corporations, (jusen), as well as several small credit associations and banks, exposed both the seriousness of the financial difficulties of banks and other financial institutions and the ineptness and lack of understanding of the Ministry of Finance and the Government about to how to deal effectively with these difficulties. Mishandling the jusen problem created public distrust of the authorities; taxpayer monies were perceived as being used to bail out rich bankers and mismanaged but politically protected agricultural credit cooperatives.

Sixth, the worsening financial conditions of banks and other financial institutions came to
a head in November 1997 when institutions still considered too big to fail actually failed—the tenth largest city bank, and one of the Big Four securities companies; and a mid-sized securities company defaulted in the hitherto sacrosanct overnight call market. The impending systemic crisis set in motion government policies, over the course of the next year, to force banks to disclose the extent of their bad loan problems and write them off, to recapitalize the major banks with injections of Government funds, to declare insolvent and nationalize two of the three long-term credit banks, to establish a bridge bank mechanism to deal with smaller insolvent banks and to fund the underfunded Deposit Insurance Corporation. The government made available an unprecedented 60 trillion yen (about $550 billion U.S.) to finance this bailout of the banking system.

Many OECD countries, much less Asian and other developing economies, have gone through banking and financial crises over the course of the past two decades. Japan is not exceptional. What is exceptional in the Japanese case is that its financial mess has persisted so long, and became worse and worse until the incipient crisis of late 1997 finally forced the authorities to take remedial action.

There are many reasons for this slowness to respond. I stress three: excessive optimism about the prospects for quick economic recovery and renewed growth; the delay in implementing sensible business rules and regulatory requirements, and tackling problems--forbearance-- by the bankers and the regulators alike; and inept fiscal policy budget, culminating in the disastrous shift to a restrictive fiscal policy in the fiscal 1997 budget, as already stressed.

One notable feature of Japanese postwar economic history is that earlier economic downturns were shallow and short-lived. Even the oil shock-induced crisis of 1973-74 was fairly readily and quickly overcome, at least in retrospect. So too was the dramatic collapse of the
stock market in the mid-1960s, when it declined by one-third. Thus, it was not unreasonable that
Japanese bankers, businessmen and government policy makers saw the 1992-93 downturn as
little more than a short-term business cycle adjustment following what had been Japan’s longest
postwar boom. That assumption of reasonably quick economic recovery proved to be
completely wrong, for a variety of reasons: persistent deficient demand; business overcapacity
and low returns on assets and equity; underlying structural adjustment pressures in land and labor
as well as capital markets; restructuring, especially of labor-intensive industries which had lost
their competitive advantage; and the deepening bank bad loan difficulties, among other factors.

At any rate, until the past few years bankers, businessmen, and government officials all
based their policies on the assumption that the economy would soon vigorously recover. The
implication both for banks and corporate borrowers was that rather than immediately and
urgently addressing serious structural difficulties—bad loans, non-performing assets, excess
capacity, redundant employees—they should just wait until the costs of adjustment were reduced
by renewed economic growth.

This misguided optimism about imminent economic recovery led not only to policies of
inertia and delay, they created an atmosphere of forbearance. Forbearance means the refraining
from enforcing rules and obligations internal to the firm, in the financial system and by the
regulatory authorities.

The essence of financial forbearance involved collusion between the banks and the
Ministry of Finance to hide the seriousness of the banking difficulties, and to delay in dealing
with them. Apparently the regulators feared that any signs of bank distress might lead to panic
and systemic crisis. Everyone pretended the problems were not so serious, and decided to
disclose as little as possible. Thus banks continued to pay regular dividends until 1997, even
though they reported losses from 1995 on; potential losses from non-performing loans were rolled over, and only slowly and grudgingly disclosed; staff hiring and wage increases continued; branches were not closed; lax bad loan classifications were tolerated; substantial restructuring was not attempted. Bad loans were transferred to related non-bank financial institutions in order to remove them from the bank balance sheets. To bank management credit, bad loan provisioning did increase greatly from 1995 on, but assets taken over on defaulted loans were not sold off. Yet conditions were clearly worsening. The housing loan corporation (jusen) collapses of 1995 were a major signal, which triggered the Ministry of Finance guarantee of all bank deposits, though how that would be financed was not dealt with until after the late 1997 crisis.

The economic recovery beginning in late 1995, achieved finally by adequate fiscal stimulus, generated rapid growth in 1996. If that growth had persisted, Japan’s financial and corporate adjustment process would have been less costly and substantially easier, and the economy would be in much better shape today. However, by 1997 resumed economic growth alone would not have been sufficient to solve the financial system’s structural weaknesses, especially the huge overhang of actual and potential bad loans. The fall 1997 financial crisis made clear that the postwar financial system—convoys and all that—was dead, and transition to a new, competitive, efficient, profitable financial system had to be accelerated. And, over the course of the past two years, that has been taking place.

The Current State of Japan’s Financial System

What is the current status of Japan’s financial system? There is good news and bad news. The good news is that the old, postwar, convoy-style, highly regulated system with all its inefficiencies no longer really exists. Deregulation, the Big Bang package of capital market reforms, and real competition in financial markets have gone a long way to the creation of a free,
open, market-based financial system in which capital markets are playing an increasing role. A systemic banking crisis has been averted, a reform program is in place, and a new financial crisis seems unlikely. Eventually an efficient financial system will become a central ingredient in creating a new, competitive Japanese economy. The process is far along, but by no means complete, and it will still take considerable time.

The organization and structure of Japan's financial system is now completely different from even a decade ago. Institutional segmentation is giving way to financial conglomerations—universal banking Japanese style—combined with specialization in certain market areas. For some years major foreign financial institutions have been storming the castle of Japanese financial markets. Now they are inside the castle, thanks both to deregulation and to the opportunities created by Japanese financial institution weaknesses. Once inside, the nature of the game has changed. Japanese financial institutions have numerous, excellent client relationships and financial instrument distribution capabilities; and foreign financial institutions have new financial technologies, new financial products, and better ways of organizing and doing business.

The bad news is that only a few Japanese financial institutions of consequence are in reasonably good shape; most have persisting serious difficulties. The life insurance industry is in a throes of a major shake-out, a consequence of the negative yield spreads that have emerged after they sold huge amounts of high yielding products a decade ago, at a time when maturity matching long-term bond assets did not exist. The securities industry is consolidating.

Consolidation among small banks, credit associations and credit cooperatives is slowly proceeding. Many hidden problems persist nonetheless. That is why the termination of the government's 1995 unlimited guarantee of bank deposits and return to a more reasonable system of limited deposit insurance, originally due April 1, 2001, has been postponed for one year. The
general problem is that Japan is over-banked and the banking system overcapitalized, with very low profits, while ironically each bank is undercapitalized relative to its needs in the new competitive financial environment.

Japan's remaining big banks face a common set of daunting problems.

First, the overhang of non-performing loans persist. Perhaps most have been provisioned against by bad loans loss reserves, but no outsider really knows. And the bad loan overhang has two additional dimensions. First, the underlying real estate and other assets taken over by banks from defaulted loans have not been sold off. Second, each bank continues to have relationship entanglements with some very large, very weak corporate clients. The Sogo Department Store, Hazama Construction, and other recent insolvency cases are only the visible tip of what may be a very large iceberg. How to take care of, and restructure, these ailing companies is an ongoing drain on bank managerial and financial resources.

Second, bank profitability is extraordinarily low. Bank lending is no longer adequately profitable and is not likely to become so in the foreseeable future, as more and more Japanese companies utilize the capital markets. And eventually depositors will find other, more attractive financial assets. Like the major global players, Japanese bank profitability will have to be built upon various forms of fee business: organizing syndicated loans, bond and stock underwriting, mergers and acquisitions business, distribution of mutual fund and insurance products and the like.

Third, Japanese banks and other financial institutions lag far behind their global competitors in financial technology and information technology, which have become major competitive tools. Both technologies are based on highly specialized human skills; and information technology also requires immense investments, billions of US dollars, in
infrastructure. Information technology has become a major strategic tool, in finance as in many other industries.

These challenges are driving the quite dramatic process of merger and consolidation among major Japanese banks and insurance companies today. They seek economics of scale and scope in order to become more competitive and more profitable. Probably the most important scale economies lie in the investment requirements for new information systems. Economies of scope lie in the potential synergies in providing corporate clients a wider range of financial services, and depositors a wider range of financial assets. Most of the remaining big banks are consolidating into five groups, some through merger, others by setting up a financial services holding company that will bring together city banks, trust banks, securities companies, asset management companies, and eventually some insurance companies under one umbrella.

The key to success in such consolidations is first to develop a vision of what the new institution will become, based on the respective core competencies and synergistic complementarities of its members. To implement the vision requires a clear strategy, embodied in a good, strong business plan. Assessing the relative strengths and weaknesses of the partners is relatively straightforward, though in the Japanese case it is complicated by the degree of embeddedness of bank-client relationships, commitments to major keiretsu partners, and the true state of non-performing or poorly performing loans each has. Each partner has to make explicit what have been implicit or tacit rules, procedures, and commitments. I am impressed that banks and other financial institutions have judged it necessary and been willing to join together, especially from different major business groups (horizontal keiretsu). Necessity creates surprising bedfellows.

The most difficult problem in any consolidation is the assignment of the top management
positions among the senior managers from the banks and other financial institutions coming together. Most important is leadership. Who will be the CEO, and who will be on his top management team? How will the inevitable personnel redundancies be dealt with? These fundamental issues are the Achilles heel of the current Japanese financial consolidation process.

Time is of the essence. The longer the consolidation process takes, the more difficult and more expensive it becomes. It is impressive that in the few weeks in August 2000, between when Chase Manhattan Bank and J.P. Morgan Bank agreed to merge and it was publicly announced, they had already decided who would hold the top fifty positions. Within another six weeks the next 250 positions had been decided. As one participant noted to me, “this is a sort of rough justice; about 80% of the decisions are correct, and the other 20% will be cleaned up later on.” I cannot imagine any Japanese financial institution merger moving so quickly and effectively.

It remains to be seen how successful this consolidation process will proceed in Japan. My guess is that mergers will be more efficient and effective than the creation of financial services holding companies, where power will be less well defined and the autonomy of individual companies within the holding company umbrella will be greater.

Mergers among equals are very difficult to implement. Merger in the form of acquisition of one by the other, however implicit that may be, is substantially less difficult. Someone has to be in charge, to make all the difficult decisions required to define core strategies, create synergies, define and implement the integration process, and especially to eliminate redundancies.

Mergers between two large weak banks create one huge weak bank. If the strategy is to
create a bank the regulatory authorities once again will consider too big too fail, that would be a
dangerous step backward. Yet a strong strategy and effective implementation can indeed create
one strong bank out of two weak ones: witness the merger in the early 1990s of Chemical Bank
and Manufacturers Hanover Bank in New York.

The actual definition of success may converge somewhat among countries but significant
differences will probably persist. The American financial and business mantra is rising profits,
high return on equity, and rising prices of bank and company share prices. The earlier Japanese
mantra was acceptable profits, high rank and hence status by asset size and market share, and the
protection of the implicit permanent employment rights of regular employees. The Japanese
mantra is changing, though how much in practice rather than just rhetoric is still unclear. Given
their dismal profit performance over the past decade Japanese banks are leading the new
emphasis on profitability, announcing new, high ROE targets. But I have not heard any Japanese
institution state that profit maximization and shareholder value is its sole or dominant purpose.
Taking care of their employees continues to be a central objective. How this is done, and how
extensively so-called permanent employment will be maintained is unclear. I think firms will
define at each level a rather large cadre of employees they want to keep and will devise
mechanisms to do so. Employee loyalty and reputation as a good employer are important
corporate assets, but they also generate high costs of lack of flexibility, inability to make good
decisions in response to rapidly changing conditions, and perpetuate a bureaucratic environment.
One solution will continue to be early retirement, bronze parachutes if you will, rather than direct
lay-offs. One danger is that the most able young managers, in their thirties or so, will leave and
join foreign financial institutions, as indeed a number have already done.
Concluding Comments

Inevitably I have not addressed a number of important financial system issues, and others I have touched on only briefly. The nationalization and then reprivitization of two of Japan’s three long-term credit banks, at great cost to Japan’s taxpayers, is fascinating. So too is the incipient entry of new banks specializing in certain transactions activities—Ito Yokado, internet banking, Sony and so on. The creation in 1998 of the Financial Supervisory Agency (the FSA), now expanded into the Financial Services Agency, and the creation of the Financial Reconstruction Commission (FRC) have been important in enhancing regulatory oversight and governance of banks and other financial institutions. How to deal with the immense postal savings system, the government financial institutions, and the still murky valuations of the assets of many government special accounts warrant studies of their own.

What about the future of Japan’s economy, in the near term and the longer run? I am concerned that the current economic recovery is so slow and patchy. There are unrealized opportunities for substantial growth: the gap between actual and potential output; the extraordinary wide productivity gap between Japan’s manufacturing and service sectors; the regulatory and other obstacles slowing structural reform and enhanced competition; newly developing technologies.

The banking system has escaped a financial crisis, but individual banks still have many problems to overcome. It will take some time, but in the longer run Japan’s financial system will sort itself out, and become increasingly competitive. Probably only one or two Japanese financial conglomerates will once again be true global players, while several others will be major players in Asian markets.

I am more optimistic about Japan in the longer run. The Japanese will prevail.
country's fundamentals are strong; a well-educated, smart, hard-working labor force; good business people, with a new group of entrepreneurs eager to succeed; a high technological level and R&D capability; and a society that holds together well. The slowdown in the household saving rate will continue and the paradox of thrift will wane away.

My greatest optimism is founded on the benefits of generational change. The current generation in power- politicians, bankers, businessmen, bureaucrats- grew up in a period when the losses and devastation of World War II made them place great emphasis on stability, job security, and safety. Today's young Japanese have grown up in a relatively affluent society. They are better educated and more internationalist in outlook and experience. They are in a much better position to take risks, and they are doing so. Like every country, the hope of Japan's future lies in the qualities and ambitions of its young men and women.