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THE JAPANESE BANKING CRISIS AND WORLD FINANCIAL INSTABILITY

The deepening of the Japanese financial crisis has increased the risks to the international financial system, over the last couple of years. The crisis has amplified capital movements, towards the emerging Asian economies (check) where they aggravated the speculative bubbles. Subsequently, such capital movements have been towards the western financial markets, especially America, thus contributing to the rise of stock markets and the probabilities of a brutal turnaround. Until last September, these movements led to the fall of the yen and worsened the risks of a Chinese devaluation or further depreciation in the Asian crisis economies. Since then, the opposite has occurred, though without any profound change having taken place the Japanese outlook. Unless a credible consolidation programme is put into place, nothing can guarantee that the yen will not fall again.

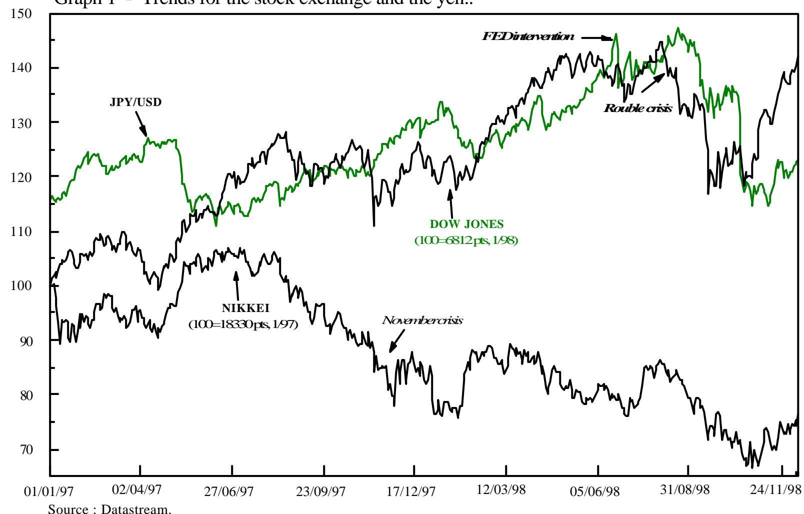
Japanese finance at the heart of Asian instability

As of 1991, Japan has been going through the longest and deepest economic slowdown since the war. The slowdown has been accompanied by a crisis in the banking sector which has worsened steadily throughout the decade. In 1997, the problems of Japan's banking sector took on an international dimension, as activity once again stalled due to tightening fiscal policy.

This renewed fall in growth first interrupted the improvement of the Tokyo stock exchange, then led to stock falls (see Graph 1). The latter has occurred at the same time as stricter solvency norms and supervision have been reinforced, obliging banks to declare and absorb, in record time, losses that had previously been covered up. By generating immediate operating losses and wiping out latent capital gains that were to finance consolidation, the fall in the stock market has led to a direct contraction of banking activity. This credit crunch has strongly affected lending programmes in Asia.

Up to now, Japanese banks have been massively involved in the region. At the beginning of the 1990s, the opening up of the Asian financial systems occurred just at the time when Japanese banks were encouraged to look for higher returns, due to pressures from the latent domestic crisis and cuts in interest rates. The pace of accumulation along with high interest rates in the emerging countries thus strongly attracted the Japanese financial largesse[1]. This aggravated the malfunctioning of local credit markets, and in some case contributed to the creation of financial and property speculative bubbles.

Graph 1 - Trends for the stock exchange and the yen..



Source : Datastream.

1. In the mid-1990s, the Japanese banking system had become the main foreign creditor of the zone, as 39% of international commitments in Asia were held by Japanese banks (source: BIS ***The Maturity, Sectoral and Nationality Distribution of International Bank Lending*** 1998).

During 1997, the instability of international credit to the zone and the worsening outlook for growth led to withdrawals by Japanese banks. This retrenchment provoked, or revealed, the weak solvency of private debt in Asia. Insolvency concentrated progressively in the balance-sheets of local banking systems, which were already fragile and pushed the whole of Asia towards the financial instability that lay at the origins of the crisis[2].

Table - The solvency of the banking system

	On 31/03/98				On 31/09/98	
	Banking system		17 large banks		17 large banks	
	yen billions	*in %**	*yen billions*	*in %**	*yen billions*	*in %**
(a) Estimated bad debts, net[1]	18 850	3,70	13 574	3,90	14 642	n.d.
- declared	9 871	2,00	6 263	1,80	7 331	n.d.
- estimate unidentified out standing debt[2]	8 979	1,70	7 311	2,10	7 311	n.d.
(b) (a)/Gross, basic operating income[3]	4,44 years		4,9 years		n.d.	
(c) Latent capital gains on declared stocks	5 307	-	2 460	-	-2 763	-
(d) Indicator of absolute solvency = equity + (c) – (a)[4]	9 257	1,01	2 363	0,43	-3 586	-0,66

Sources : Zenginkiyo and Financial Supervisory Agency.

* (a) in % of loans; (d) in % of assets.

1. Definition by the Financial Supervisory Agency of bad debts (non-performing loans with arreavs of more theen 3 mouths and restructured loans). Gross out standing debts are deducted from provisions accrued in special accounts.
2. American definition, lowes estimates by author.
3. Gross operating income (1994-1998) based on French norms and excluding stock operations.
4. Excluding the re-evaluation of real estate assets.

In turn, the Asian crisis has spread to Japan via a number of channels. First, it has wiped out the only dynamic component of demand. Asian exports, which formerly accounted for up to 40% of Japanese exports, have fallen strongly since the second half of 1997. Next, the Asian crisis has increased the number of bad debts held by Japanese banks, though only to a limited extent. Above all, it led to a drop in the stock market, in November 1997, which triggered a series of major financial bankruptcies. In particular, the securities house Yamaichi was forced to shut down due to cash-flow insolvency. The fall of this flagship of Japanese finance ended confidence in State support for the financial system as well as solidarity between companies in Japan's commercial groups (the ***Keiretsu***).

From financial crisis to depression

From this moment on, the mechanisms which pushed Japan further into recession, and which continue to bear down on growth today, can be summarised as follows. First, the strong pressures on bank liquidity, which appeared in the wake of the Yamaichi collapse, play an important role given that absolute priority has been assigned to re-building balance sheets, which is worsening the credit crunch. Second, the decline in exports, the strong fall in public sector demand and the expected slowdown in world growth are weighing down on value of industrial stocks. The evaporation of latent capital gains on stocks held by banks has cut back their equity (see Table), as banks are unable to make extraordinary profits by selling stocks and as they cannot count on incorporating the 45% of latent capital gains to increase their Cooke Ratios. Hence, the fall in share prices is accentuating the rationing of credit, via solvency margins. Thirdly, the rise in industrial bankruptcies has swollen the scale of bad debts. Lastly, there has been a flight to quality, as banks are investing all their funds in public debt, which in turn is leading to a fall in long term interest rates and a levelling-off of the yield curve. This flattening-out of the yield curve has led to a further source of fragility as it puts pressure on intermediation margins by reducing the spread between the cost of resources and the returns on assets. As for households, returns to savings which are practically zero and growing risks on deposits are both weighing down on private consumption on the one hand, and on bank liquidity via the shortening of terms of deposit and flight into the post office savings system on the other hand. The rise in the economic risks perceived by all agents is strengthening the mechanisms which are contracting activity and cutting returns.

The incapacity of the political establishment to implement a coherent consolidation programme has played a central role in the unfolding of these events. Faced with this paralysis, the Financial Supervisory Agency and the Bank of Japan have been able merely to maintain liquidity in the system so as to prevent a deepening of the crisis. On the one hand, the supervisory institution has been constrained to suspend the renewed tightening of regulation, in order to head-off an implosion of the banking system under the pressure of the imbalances weighing down on it. On the other hand, the Bank of Japan has ceded considerable quantities of liquidity to the money markets to avoid them drying up[3]. Such intervention has made it possible to limit the degradation of the banking system and its immediate effects on activity. But, once again, true consolidation has been delayed.

The fall of the yen and the risks for the IMS

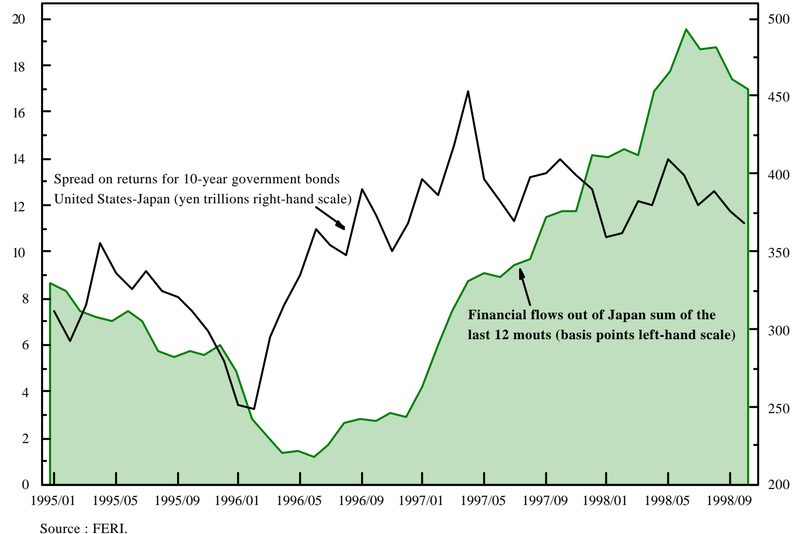
As long as the financial crisis has not been resolved, the price of Japanese assets will likely be over-valued with respect to the revenue flows that can be expected. The weight of Japanese assets in the world portfolio must therefore fall. This can take place either through an adjustment of the internal value of asset prices, or via an adjustment in the value of the yen. The perceived ability of

2. See Rémy Contamin and Cyrille Lacu, "Origines et dynamique de la crise asiatique", in the collective book ***L'année de la régulation***, vol 2, La Découverte, Paris, 1998.
3. The liabilities of the Central Bank grew by 66.5% between 1997-1998 (source: Bank of Japan, Annual Report, 1998).

the political system to bring about a restructuring of financial institutions' balance-sheets will be of fundamental importance in this. If such perceptions are negative, then a rapid contraction of the internal value of assets is not to be expected. Adjustment will then have to occur through the yen, which is in fact what was observed between early 1997 and the summer of 1998.

The contrast between a buoyant American business cycle and the Japanese recession is not sufficient to explain the scale of this adjustment (Graph 1). Instead, it stems from a profound wariness on behalf of market agents with respect to Japan. They became convinced that Japanese investment returns would pick up, as soon as they no longer expected the implementation of reforms necessary to combat the worsening financial situation. This drain has been all the more destabilising as it has led to an acceleration of activity in American bond markets and the American stock market bubble, while the Tokyo market was falling. This divergence in stock market trends validated expectations of a depreciation in the yen, and aggravated the fall of the Japanese currency. Furthermore, the spread between the American and Japanese reference rates has remained high (Graph 2), despite major capital outflows from Japan. This spread is due to the strength of American growth and especially to the low level of the Japanese reference rate, linked to the flight into public sector bonds[4].

Graph 2 - The worsening of Japanese Financial accounts



Source : FERI.

The worsening financial situation in Japan and the fall of the yen are alarming from an international point of view, given the context of the Asian crisis. By provoking speculative attacks on the Hong Kong currency peg, and hence on the Chinese yuan, the fall of the yen has exacerbated pressures on equilibrium exchange rates in Asia. Yet, the Japanese Central Bank does not have the capacity to defend its currency. As has been shown above, its monetary policy is constrained by the banking crisis. It must maintain very low interest rates for banks' difficulties not to be compounded. Under these circumstances, any support for the yen must be sterilised by an injection of liquidity into the money markets. But, such liquidity is invested in public sector bonds - leading to a fall in long term rates - or recycled on the forex markets. It was only the intervention of the American Federal Reserve, on the 17 June 1998 to prevent regional contagion, which blocked the further fall of the yen[5]. Shortly thereafter, external pressure was put on Japanese parliamentary representatives to work out an emergency stabilisation plan, just as Japan's eleventh largest bank (the LTCB) appeared to be falling into bankruptcy.

At that point, the prospects of restructuring led financial markets to hope that assets prices would find their real levels through a fall in domestic values. This phenomenon helped the exchange rate to stabilise during the summer of 1998. It even permitted a rebound in the yen during the autumn, as the financial crisis was worsening throughout the rest of the world.

A renewed rise of the yen, but an uncertain end to the crisis

The renewed rise of the yen which began in September 1998 is first and foremost linked to growing risks in other markets, following the collapse of the rouble and Wall Street on the 17th August. Subsequently, the record US current account deficit and the worsening outlook for growth have confirmed these trends.

The abruptness of the adjustment may be explained by several factors of a financial nature. First, the bankruptcy of the American hedge fund (LTCM) led to an awareness of the systemic risks arising from such institutions, and provoked strong pressures on liquidity in the American bond markets, thus accentuating the fall of the dollar. Next, since 1996, arbitrage funds have abundantly relied on yen carry trade to finance highly-leveraged operations[6]. Under these circumstances, the rebound of the yen triggered the unwinding of highly unstable chains of financial contracts. Lastly, the sharpness of the adjustment can be explained by moral hazard affecting bank behaviour. Though banks were

4. See above. The yield on 10-year State bonds fell from 2.4% to 1.7% in the financial year of 1997/98, and then fell further to 0.7% in September 1998, prior to the turnaround in the yen.
5. The Japanese currency stood at nearly 150 yen to the dollar at that point, and option prices indicated expectations of further falls (see. BIS, 68th ***Annual Report***, Basel, 1998).
6. In its simplist form, this strategy consists of buying American Treasury bonds with short- to medium-term, floating-rate loans taken out in yen. See IMF, ***World Economic Outlook***, May, 1998.

generally suffering from poor liquidity and insolvency [7], the supply of central bank money, which was non-discriminatory and inexpensive, encouraged them to try to improve their situation by expanding their international portfolios (mainly in dollars), up until the summer of 1998. Once the yen began to move up, they abruptly reversed their positions by selling dollars massively, in order to avoid risks of capital losses and hence default. The turnaround in the yen does not therefore stem from any real improvement in the Japanese outlook. To be sure, a stabilisation plan for the banking system was voted last September, and the yen rose on the back of the ensuing optimism. The plan sets out an overall budget of Yen 60000 billion (12% of GDP), along with the liquidation of LTCB. Yet, the plan risks being effective, notably because the application of new accounting norms and prudential management are still wanting.

To begin with, the measures relating to bankruptcy include a twofold snag. Gaps in the regulation make it impossible to detect systematically insolvent banks, but only extreme situations. Next, the measure on recapitalisation is based on voluntary adherence by the banks. With no revision of the regulation, banks are not forced to revealing their financial situation and gauging their needs objectively. The only solution that was retained, to make them subscribe to the programme, has been the loosening of conditions for access to public funds. At present, the major banks have requested modest amounts, which are quite similar from one bank to another, despite the fact that their needs are very different[8]. The process selected therefore delays consolidation, and, ultimately maintains the weak operating conditions.

If, however, it is held that the aim of the plan is merely to diminish credit rationing in the short term, and not to consolidate the banks thoroughly, then the diagnosis is not much more favourable. The recapitalisation measures adopted in March 1998 have not produced the expected results in terms of credit: there are indeed many other factors than capital constraints that are susceptible to bearing down on credit (the flight of deposits out of the banking system, banks' preference for safe sovereign bonds, or the wish to increase profitability by selecting borrowers more carefully).

Two points reinforce such negative criticisms of the plan. First, the consolidation programme is financed by money supply and not via public bonds. Even if this is a temporary solution, it will exacerbate the problems arising from Japan's excessive savings, by further flattening the yield curve and putting pressure on the exchange rate. Next, the fiscal expansion plan of Yen 24000 billion promised by the government has not yet been completed, and real additional spending is far less. The generation of solvent demand that could assure a healthy upturn in credit is therefore not certain. At the same time, the supply of public bonds remains insufficient to mop up overly-abundant savings and correct the yield curve.

Thus, at the beginning of 1999, the Japanese economy is thus more or less where it has been, and remains a major source of instability in the international monetary system. The present strength of the yen in no way reflects a positive outlook for the economy, and may only be temporary. The only means for containing the risks of destabilisation of the international financial system by Japan lie in the implementation of coherent consolidation linked to a strengthening of the prudential framework and bank restructuring, all within a programme financed by public borrowing and associated with a real expansion in public sector demand. Such a programme, however, requires political will and power, which are presently cruelly lacking.

Cyrille Lacu

7. See Table: the index of absolute solvency for the 17 largest banks, which measures their net value at market prices, fell from +0.43% of total assets in March 1998 to -0.66% by September.
8. Less than Yen 6000 billion have been taken up (1.2% of assets) of the total Yen 25000 billion that have been made available.

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