THE "JUSEN" DEBACLE AND JAPANESE ECONOMY

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(Preliminary)

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Introduction: five specific issues

The basic purpose of my lecture today is to analyze the nature of the current banking problems in the broad context of the Japanese economy. For this purpose, I shall also have to highlight the characteristics of the regulatory framework of the Japanese banking industry. Specific issues that I am going to address will be as follows. First, what is the jusen problem? Contrary to the wide spread perception, the jusen is not a deposit-taking financial institution, but a non-bank. why, then, is the liquidation of the jusen alleged to cause a banking crisis in Japan? Why does the Government propose to inject public money? Is its purpose to bail out whom or what? Interestingly, the jusen problem points out an important origin or cause of the asset price inflation (or the bubble) in the 1980s. Such an origin is distinct from a macro-economic cause of the bubble, i.e., prolonged easy monetary policy. The second issue, therefore, is what caused the bubble in the decade? Was it really the easy monetary policy after the Plaza accord in 1985 which was further protracted because of Black Monday in 1987? Third, why has the resolution of the jusen problem become such a heated issue despite the relatively small amount of injection of taxpayers' money ($6.8 billion) proposed by the Government? This issue reflects the problem of the burden sharing of loan losses among financial institutions which is, in turn, associated with the unique regulatory system of protecting deposits in Japan, labeled "no bank failure policy". Fourth, then, what reforms are necessary for the financial system and regulatory framework as highlighted by the jusen liquidation? Fifth, (lastly) can the Japanese economy really recover from the recession while struggling with the problems of huge non-performing assets? By having addressed these five issues, I will give you my conclusions at the end of this speech.

I. What is the jusen problem?

As of September 1995, all the Japanese depository financial institutions carried non-performing assets (including restructured loans) of about 40-50 trillion yen (or US$400-500 billion at the exchange rate of ¥100/US$), accounting for 6-7 percent of their total loans and above 8-10 percent of GDP. Non-performing assets (or bad assets) are defined as the sum of three asset items: (1) loans to borrowers in legal bankruptcy, (2) past due loans over six months, and (3) restructured loans including lower-than-discount rate interest repayment loans (see notes to Table 1). Not all non-performing assets are necessarily actual losses (no market value) to financial institutions. Loan losses or unrecoverable bad assets probably account for three-fifths of the total non-performing assets.

Jusen is a specialized housing loan company, but not a deposit-taking financial institution. The jusen debacle per se, therefore, does not cause an immediate collapse of the financial system or banking crisis due to withdrawal of deposits simply because jusen is not a bank. Instead, the jusen has borrowed from depository financial institutions in order to extend loans to housing and real estate. And yet, why has the jusen debacle generated so much heated debates that the Japanese economy is perceived to stand at the edge of a financial crisis? And why was the passage of the national budget for the new 1996 fiscal year including the injection of taxpayers' money of mere 0.685 trillion yen (US$6.85 billion) was completely blocked for three weeks due to sitting in the Diet building by the opposition party? Only a week ago (April 10), the Parliament lower house passed the budget, but with the freezing clause of the injection of public money. It is not clear when such clause will be de-frozen.

The jusen problem has been hot because the vast majority of depository financial institutions have large risks exposed to this particular single class of non-banks as a major borrower. The non-performing loans extended to the jusen of 13.2 trillion yen account for about one-fifth to one-quarter of the aforementioned huge total bad assets held by all depository institutions. Out of the bad assets, the immediate losses which are identified at present amount to about 6.5 trillion yen, accounting for about half. Hence, when massive potential losses on the loans extended to the jusen are realized, it should greatly affect the level of damage to individual depository institutions, the overall financial system and ultimately the scale of the burden to be borne by taxpayers.

Back in the 1970s when the household demand for housing loans became increasingly strong, eight jusens were established to meet such demand, but banks perceived this new business of 20-30 year maturity housing loans too risky. Out of eight jusens, seven were founded by 21 major banks (city, long-term credit, and trust), through pooling capital by different founding groups comprising several major banks for each jusen. Remaining one was founded by agricultural finance cooperatives which are also depository institutions. In the latter half of the 1970s, mortgage lending by the jusen increased five-hold. By the early 1980s, the jusen were doing business so well that their founder banks wanted increasing part of their business. The jusen business was squeezed by their own founder banks.

However, there were more fundamental reasons why the founder banks searched new areas of the loan extension. In the first half of the 1980s the Japanese financial markets began to be liberalized and internationalized. This caused previous large borrowers to move away from banks and turn to the liberalized bond markets at home and euro-yen capital markets abroad. Furthermore, major borrowers enjoyed increasingly greater self-financing of their own business investment through their own retained corporate incomes. The result was that good and large customers relied increasingly less on bank lending. Major banks were forced to search new customers, one of which was found the jusen's housing loan business. In turn, the squeezed jusen were also forced to look for new business, which happened to be the extension of loans to the real estate sector. Who accommodated the jusen for financing such loan extension to real estate in the 1980s? They were again founder banks of the jusen.

Therefore, in addition to the aforementioned sheer scale of loan losses to be borne by depository institutions due to the jusen liquidation, this history of the establishment and development of the jusen has raised the following two important questions. One is what was the origin of the bubble in the 1980s? The jusen history points out the importance of the sectoral allocation of bank loans. The other is what responsibility should be assumed by founder banks for the liquidation of the jusen and how much losses should be borne by them? This issue has become even more complex due to the proposed injection of public money by the Government, since the purpose of such injection is "distorted" as to be explained below. Let us, first, turn to the issue of the origin of the bubble and the associated sectoral allocation of bank lending.

II. What caused the bubble - easy monetary policy or sectorial concentration of bank lending?

Triggered by the strong demand for office space by foreign financial companies due to the internationalization of the Tokyo financial market in the first half of the 1980s, prices of commercial land started to rise in Tokyo already in 1983-84, well before the Plaza accord of September 1985. For the jusen, and later for depository institutions, too, this new rising trend of land prices offered a perfect opportunity of venturing out of core business into the much riskier business of financing property speculation. In fact, loans extended by all banks (i.e., 21 major banks, first and second tier regional banks) to real estate, construction and non-banks increased by 15-20 percent per year in 1983-85, as compared with very stable annual growth of total bank loans at 10 percent or so during the whole decade of the 1980s (Chart 1). This fact clearly indicates that the monetary aggregate alone, whether it is money supply or total bank credit, was not responsible for the asset price inflation in the 1980s but that the sectoral concentration of bank lending was more essential for such property speculation. This raises the most important question of the conduct of the monetary aggregate policy in the midst of the asset price inflation caused essentially by the sectoral concentration of bank lending. At the same time, this raises the most crucial and analytical question of how and why land prices doubled and stock price tripled in the 1980s when monetary aggregates grew rather steadily and also when price inflation in the goods and service market remained extremely modest at just above 1 percent per annum during the speculative period.

During the last boom period, nominal GNP was growing at 6.2 percent per annum with the real GNP growth at just above 5 percent, and GDP deflator inflation just above 1 percent. The underlying demand for money was about 8 percent per year, given the declining trend of the velocity of money. The supply of M_2 + CD grew by 10.8 percent per year (Table 2). Hence, the excess of the money supply over the underlying demand for money was 2-3 percent of GDP per year. This magnitude of the excess of the money supply was too small to account for doubling land prices and tripling stock prices in the second half of the 1980s. A more important question is why such excess of money supply was not transformed into higher inflation rates in the goods and service market but transformed into the asset markets. This question can not be answered without taking into account the sectoral distribution of bank credit. The bubble can not be attributed just to the easy monetary policy, introduced after the Plaza accord in September 1985

and protracted after Black Monday in October 1987.

Such macro-economic monetary policy is, therefore, simply a necessary, but not sufficient conditions for the generation of the bubble. Sufficient conditions can be met only by the sectoral concentration of bank lending into the real estate sector in the 1980s, as well as probably the markets' strong confidence in the excellence of industrial performance of Japan manufacturing industries based on then-going innovations and technology fusion. Such sectoral concentration of bank loans into high-risk and high-return areas was probably be associated with emerging new financial circumstances in the early 1980s. First, capital markets were extensively liberalized, to which major clients of banks, namely, large-scale companies turned for rasing external funds. Second, at the same time, major customers became able to finance increasingly portion of their own physical business investment out of their own retained incomes. A result was that large banks were forced to reach new outlets for lending where they had not experienced sufficient monitoring. Furthermore, the liberalization of interest rates particularly on deposits substantially reduced interest margins. Banks searched high-return, high risk projects. All these new financial circumstances induced major banks for the extreme sectoral concentration of bank lending in the real estate and commercial building construction sectors. At the same time, the banks heavily relied on land as collateral to secure their little-monitored loans to the new sectors.

III. Why has the resolution of the jusen problem became such a heated issue? - (a) the lack of principle and (b) no-bank failure policy -

(a) The lack of principles about the burden sharing of loan losses

Reflecting the history of the jusen and the sheer scale of the loan losses, a key question of how to share the burden of the losses among individual depository institutions has become extremely hot issue. This issue goes to the heart of the regulatory framework of the banking industry in Japan in post-World War II.

At first sight, the burden sharing scheme appears simple to design. A simple pro-rata scheme, namely, the burden sharing in proportion to the lending share to the jusen can be adopted. Two issued have arisen. One is whether founder banks should bear more burden than proportionately and if so, how much more. The other issue is what should be done if a particular burden sharing scheme causes some depository institutions to become insolvent.

For the first issue, it has been agreed that founder banks should forgive all of the loans extended to the jusen and that non-founder, regular banks should bear the remaining burden in proportion to their lending to the jusen. There has been strong political pressure that big banks should bear even more burden than the founder based sharing. Such pressure comes not only from the coalition government parties comprising three ideologically different parties, namely, LDP (Liberal Democratic Party), Socialist, and Harbinger, but also from opposition parties, the New Frontier party led by Mr. Ozawa (who is famous for advocating Japan should make military contributions through the United Nations) as well as Communist party. But, major banks have

claimed that their own shareholders would not permit the bank management to agree at sharing more burden than the allocation of jusen losses on a founder-basis.

This resolution of the jusen problem on a founder-basis increases the burden sharing of 21 major banks by one trillion yen ($10 billion) up to near 60 percent of total losses from less than 40 percent if a pro-rata basis were adopted. This founder-based burden sharing, in turn, reduces the losses to be borne by agricultural financial cooperatives by above one trillion yen, down to less than 20 percent of the jusen-associated losses from 45 percent on a pro-rata basis. Yet, it is strongly claimed politically that the absolute amount of the loss-sharing burden of 1.5 trillion yen ($15 billion) is still too heavy for agricultural finance cooperatives, though it is substantially reduced from the case where the burden would be 2.6 trillion yen ($26 billion) on a pro-rata basis.

This leads us to the other issue of the resolution of the jusen problem, namely, what should be done if particular depository institutions become insolvent due to the resolution of the jusen problem. In principle, insolvent institutions have to be closed down. Executives of such institutions and their shareholders should assume responsibility, respectively. Then, the deposits of insolvent institutions should be protected, if necessary by the injection of taxpayers' money. Some of their assets and deposits will be purchased and assumed by other financial institutions through the resolution scheme which would have to be newly established in Japan like in the case of RTC (Resolution Trust Company) for the insolvent S&L liquidation in the United States.

Contrary to this principle, however, the bill presented by the government intends to reduce the losses to be borne by agricultural finance cooperative only to 0.53 trillion yen ($5.3 billion). Since nobody else would bear additional burden any more, the bill proposes to use the national budget of 0.685 trillion yen ($6.85 billion) in order to compensate for the thus reduced losses for agricultural finance cooperatives. Another complication has arisen. Since the government wants to minimize the losses to be born by taxpayers, the presented bill attempts to reduce the total immediate losses by more than 1 trillion yen, by artificially transferring that amount of losses to the newly proposed Jusen Resolution Corporation (JRC), a jusen loan collecting organization.

Since these calculations are not all disclosed by the government which has not numerically justified the aforementioned public money, the jusen debacle has generated all kinds of confusions. First of all, many people still believe that the public money will be utilized to bail-out the jusens, although even the government has clearly announced the liquidation of all seven jusens.

Second, once the injection of the public money is discussed, taxpayers have started to claim that big banks should bear more burden, which has, in turn, been echoed by politicians including the ruling cabinet members. The public money has become a dirty word to politicians. This is particularly so because of the underlying fragility of the coalition government, but also because of possible general parliamentary election of the lower house on unpredictable date in the near future based on the new electoral system of single seat for each election zone. Under these political circumstances, the outcomes of general election will be extremely uncertain so that

politicians would not want to commit to any unpopular actions, including the injection of taxpayers' money into the resolution of the jusen problem.

Third, the injection of taxpayers' money is definitely needed in order to bail out depositors of insolvent depository institutions, but not insolvent institutions themselves. However, the issue of the public fund is confused with the issue of who should assume responsibility for the bubble (i.e. the asset price inflation), its bursting, forbearance, and the resultant large losses. Furthermore, there are different kinds of responsibilities: legal, political, administrative, social, and even moral responsibilities.

Thus, such confusions are ascribed to the lack of the principles in the presented bill as to the following three basic issues: first, whether the jusen liquidation should be legally handled in the court so as to identify the legally justifiable burden sharing (i.e., legal responsibility), second, which institutions should go bankrupt and insolvent under what criteria (i.e., closure rule) and the associated lack of transparencies of the calculations of the burden sharing of the jusen losses (i.e., transparencies).

More fundamentally, however, these confusions reflect a history of the development of the Japanese financial system after World War II. Let me confine my remarks to the following two main issues: one is the so-called "no bank failure" policy, while the other is the structure of corporate governance in Japan.

(b) "no bank failure" policy and the structure of corporate governance

During the inter-war period, many countries suffered from extremely high social costs of banking panic. Therefore, the United States, for example, established the Federal Deposit Insurance Corporation in 1933 in order to prevent systemic bank runs like in the Great Depression. In Japan, the Ministry of Finance until very recently conducted "no banks failure policy" which did not allow any single bank to fail.

How was this policy implemented in Japan? Larger financial institutions bailed out smaller institutions under latent insolvency by absorbing their assets and deposits, often guided administratively by the MOF. Such policy was made possible since large financial institutions were in a position to earn extra-profits, i.e., rents, under the limited entry to the banking industry and the convoy policy of assisting the marginal suppliers of bank loans, i.e., smaller institutions regulated lower-than-markets interest rates on deposits. This policy proved, in addition to effective in protecting deposits, since any depository institutions were hardly exposed to bank runs owing to the purchase of assets (P) and the assumption of deposits (A) of insolvent smaller financial institutions by larger banks. This P & A policy effectively made deposit insurance scheme unimportant and almost unnecessary in Japan after World War II. It is true that such scheme has existed in Japan since the 1970s, but it has remained "nominal" as shown by the fact that the number of professional staff was less than ten and that the head of the deposit insurance scheme is deputy-Governor of the Bank of Japan and that the office of the scheme is physically

located within the BOJ building. This arrangement did not undergo any serious change even in the 1980s when interest rates were liberalized and greater competition of non-banks in the financial markets were intensified and banks engaged in riskier lending due to squeezed interest margins.

Under the umbrella of the no bank failure policy, major banks conducted corporate governance over productive enterprises as follows. The order of priority in which the stakeholders in a Japanese company have been placed starts with employees, followed by a main-bank, then by the company's managers, and finally by stockholders. This priority order is exactly the opposite to that in the U.S. i.e., first, stockholders, followed by managers, and then by banks and (finally) by employees.

It has been the main bank system that governs the Japanese firm which would otherwise have suffered from soft budget discipline and managerial inefficiency due to its strong employee-orientation. The main bank (1) monitors the performance of Japanese borrowing firms as the delegated monitor, (2) finance risky and bold Shumpetarian innovation based on such monitoring, and (3) engages in rescue operation of troubled borrowers through restructuring their management, sending directors to their board, and providing financial assistance. The main bank system has been a solution to the agency problems and associated costs under the separation between ownerships and management of a modern company. Agency problems tend to arise from conflicts between management (agents) who may not maximize stockholders' profits, on the one hand and short-sighted stockholders (principals) who may not sufficiently evaluate long-term business strategy of management, on the other. In Japan, this solution has been strengthened by intercorporate cross shareholdings in a business group in which a main bank plays a key role not only as a largest (not necessarily predominant) lender to member company but also as its large shareholder.

Main banks were guaranteed rents until interest rates were liberalized on loans and deposits, which could be utilized for compensating for the costs associated with the above-mentioned rescue operation as well as delegated monitoring. The rigid control over new entry to city bank status and bank branch licenses generated such rents. Under this corporate governance structure, the banks were managerially almost autonomous. Who, then, has monitored such monitors (i.e., the main banks?). The Banking Bureau of the Ministry of Finance (MOF) and the Credit and Management Department and Supervision Department of the Bank of Japan (BOJ) have been in charge of detecting violations of the Banking Law and the Securities and Exchange Law, by inspecting the books of banks and conducting on-site examinations. If a bank needs drastic restructuring in its organization and balance sheets, the MOF has usually sent a retired high-ranking MOF bureaucrat as a director or even as the president. This is very much like the main banks' rescue operation of a troubled firm which has to accept bank-dispatched managers. The regulatory authorities have kept strong leverage over the banks with the help of, say, the aforementioned bank license permits by the MOF and the extension of emergency loans by the BOJ.

The bursting of the bubble in the 1990s has considerably impaired capital of banks, unabling them to rescue troubled borrowers and smaller insolvent financial institutions. In the past, the latter operation was conducted through P and A, administered by the regulatory authorities, as mentioned earlier. Now that the capital-impaired-large banks are hardly in such a position, the policy of "no failure of any bank" has collapsed in the 1990s, indicating the emergence of a great stress on the relationships between regulatory authorities and the depository banking industry.

Under this regulatory framework and corporate governance structure in Japan, the role of major banks was, therefore, extremely important. This is the fundamental reason why the founder basis is adopted for the resolution of the jusen problem and why claims are very strong for greater burden sharing by large banks. Simultaneously, bureaucrats of the MOF can not be immune from responsibility under this kind of financial regime. For instance, in March 1990 the MOF introduced restrictive financial control on the sectoral concentration of the bank lending to real estate, construction and non-banks in the midst of the land price speculation. The MOF did so only to depository institutions under their own supervisory power and hence excluded agricultural finance cooperatives from this control. Since then, agricultural finance cooperatives accelerated the extension of loans to the jusen under the explicit and implicit guidance given by founder banks. Land prices began to plunge after autumn of 1990, nearly one year later after the peak of the stock market. Land prices fell rather gradually in 1990-92 when the Nikkei index declined more than 60 percent from the peak. The jusen, however, immediately fell in trouble and became unable to repay principals of debt nor to pay interest, triggering financial difficulties of agricultural financial cooperatives. In March 1993, director-general of the Banking Bureau of the MOF and director general of the Economy Bureau of the Ministry of Agriculture exchanged a memorandum which is alleged to suggest that loans to the jusen extended by agricultural finance cooperatives be guaranteed by founder banks. At the same time, agricultural finance cooperatives were promised to receive 4.5 percent interest payments from the jusen, whereas founder banks to receive no interest at all and other depository institutions to receive only 2.5 percent interest, that is, de-facto subsidies to agricultural finance cooperatives by major banks. This is now called forbearance policy, which postponed the liquidation of the jusen by expecting the recovery of land prices. It was indeed difficult to calculate the present value of lands and hence net worth of the jusen. Since then, however, land prices plunged much more sharply, generating much larger jusen losses. Furthermore, the jusen is supposed to be carefully monitored by the MOF, particularly because the MOF had sent a dozen of ex-officials to the positions of presidents and executive directors of the jusen in the past.

IV. What reforms are necessary for the financial system and regulatory framework?

The jusen problem, therefore, strongly suggests that the whole relationships between the regulatory framework and the banking industry ought to change, including the resolution of the jusen problem, the establishment of the explicit deposit insurance scheme by replacing the no bank failure policy and the use of taxpayers' money. These tasks form a series of linked equations that must be solved simultaneously and systematically. In fact, in addition to the establishment of the

JRC for which the public funds of 0.685 trillion yen ($6.85 billion) will be earmarked for covering the balance of immediate losses, three bills of financial reforms have been presented to the current Diet session for the simultaneous solution of these linked equations. The key policy measure is to transform the no bank failure policy to the more direct protection of deposits through substantially strengthening the operations of the Deposit Insurance Corporation. Regular insurance premium will be quadrupled from the mere 1.2 basis points to 4.8 basis points. Special premium will be added by another 2.4 basis points for the forthcoming five years in order to be prepared for securing possibly not only larger pay-offs but also large deposits in the forthcoming resolution processes of insolvent institutions. With the help of the provision of capital by the strengthened Deposit Insurance Corporation, the Resolution and Collection Bank will be newly established to resolve bankrupt credit unions. In 1995, four credit unions became insolvent and shut down. In view of the possibility that more credit unions will be insolvent in the future, this Resolution and Collection Bank will liquidate business and assets of such credit unions. The liabilities of the Bank will be guaranteed and the losses will be compensated for by the Deposit Insurance Corporation which can perform the function of conservator, and if necessary, by the injection of public funds.

Three special accounts will be established within the Deposit Insurance Corporation: Special Accounts for Credit Unions, General Financial Institutions and the jusen, respectively. Through each Special Account, the Deposit Insurance Corporation will assist the resolution of respective class of financial institutions with the help of the Bank of Japan and private financial institutions and, if necessary, the injection of public money by the Government. Furthermore, in order to avoid the moral hazard and forbearance problems in the future, the early correction measures or Prompt Corrective Action (PCA) will be introduced through utilizing capital ratios of depository financial institutions and also through examining CAMEL (Capital, Asset Quality, Management, Earnings and Liquidity). At the same time, the regulatory authorities will be given a new power to force insolvent institutions to obey legal company bankruptcy and restructuring laws in the court so as to liquidate insolvent institutions more legally and resolve the problems in a more timely manner than today.

V. Can the Japanese economy recover from the recession while struggling with the banking "crisis"?

Having discussed the nature of the jusen debacle, let us have broader overall perspective by addressing the following two issues. First, how easy monetary policy has contributed to mitigating the banking problem and how quickly will the whole banking problem be solved? Second, what is the relationship between the current banking problem and the Japanese economy as a whole?

(a) Effects of easy monetary policy

Helped by the easy monetary policy and associated low short-term money market rates of around only 0.5 percent since July 1995, the banking industry has been earning handsome

operating profits. Most of such profits, however, has been utilized for writing-off non-performing assets, directly and indirectly (i.e., in the form of loan loss reserve accumulation). Although the magnitude of non-performing loans is huge as mentioned earlier, the overall magnitude of non-performing assets will hardly tell us the required amount of public money to be injected to bail out depositors of insolvent institutions. This is because the distribution of non-performing loans and the financial capacity to write them off are so uneven even within the same class of institutions as well as among the different classes. The required public money is linked not so much to the overall magnitude of bad loans as to the scale of insolvencies. The latter is essentially the function of uneven distribution of bad loans, given the funds available from Deposit Insurance Corporation contributed by private financial institutions. The scale of the required public funds or the cost of the resolution of insolvent institutions to taxpayers is, therefore, equivalent to the part of the aggregate negative net worth of the institutions that is not paid by the financially healthy institutions. Although the resolution of the jusen problem accounts for nearly one-third of total bad loans of 50 trillion yen, the public money requested by the Government is only 0.685 trillion yen. This is because major banks and regional banks are in a position to write off the jusen-associated loan losses. One important resource for writing-off is handsome operating profits, greatly helped by easy monetary policy and associated low short-term money market rates and CDs of around only 0.5 percent. Another resource is capital gains realized in the stock market. The Nikkei index has risen by 40 percent from 15,000 yen to 21,000 yen. This has happened since the introduction of such easy monetary policy in early July 1995 and the induced correction of the overshooting of the yen appreciation from ¥80 per dollar in the middle of 1995 to above ¥ 105 per dollar in recent months of 1996. It is reported that 21 major banks enjoyed capital gains of more than three trillion yen for the 1996 fiscal year (ending March 1996), more less equivalent to those for the 1995 fiscal year.

On average, it will take 21 major banks a few more years to virtually resolve the remaining bad asset problems. Over the past two years (March 1994-March 1996), the accumulated total amount of both direct and indirect writing off already amounted to 10 trillion yen, including jusen losses, accounting for half of non-recoverable bad assets.

Of course, we can not rule out the possibility of the insolvency of a few large banks for the same reason of the uneven distribution of both non-performing assets and the financial capacity to resolve them. However, the currently conducted "earning-out" policy, though it is implicit, has been so far "successful" and may in effect considerably reduce the exposure to loan losses of such latent insolvent large banks. If not, the policy of "too big to close down" policy will be inevitably adopted by the authorities for the purpose of preventing any overall systemic crisis. I intentionally use the phrase of "too big to close down", instead of the traditional usage of "too big to fail". This is because both management and shareholders of any insolvent banks should assume responsibility, by retiring and making losses, respectively, that is, they should "fail". And yet, a big bank will continue to conduct the business operation instead of closing down the operation so as to protect the financial system from systemic crisis.

Two important issues arise in this context. One is whether the Japan premium in the

international money market reflects the risk of possible bank runs with large banks in Japan or something else. The other is whether the aforementioned "earning-out" policy can work out despite the protracted recession, the weak recovery of the economy and declining prices of commercial lands.

(b) What does the Japan premium reflect?

The Japan premium, that is, 20-30 basis points higher interest rates charged on Japanese large banks over and above LIBO, is essentially a reflection of the aftermath of the aforementioned no bank failure and convoy policy. Due both to the insufficient fund availability of the nominal deposit insurance scheme and to the history of the administratively guided purchase (P) and assumption (A) operations, the regulatory authorities have continued to request major banks to bear more-than-proportional burden of bearing losses of smaller institutions Though with increasingly greater resistance, large banks have eventually conceded to such requests even after the bursting of the bubble, due to the leverage held by the regulatory authorities over the banks in the incompletely liberalized financial markets. In other words, the more explicit burden sharing scheme is yet to be established under the strengthened Deposit Insurance Corporation, as mentioned above. In the transition, however, the more-than-proportionate burden on the shoulder of large banks certainly undermine their financial strength and international competitions as well as their capacity to write off their own non-performing assets under the diminished charter value and intense global competition. Thus, the Japan premium reflects the weakened and hence riskier large banks not just due to the non-performing assets but due to the legacy of the policies which have becoming increasingly out of date. The Japan premium all the more points out the urgent task of establishing the new regulatory framework of the nation's banking industry as a whole.

What further complicates this task in Japan is that while the establishment of the explicit deposit insurance scheme is to take care of traditional systemic crisis associated with the orthodox traditional banking business of issuing deposits and making loans, the introduction of newer regulations will be needed to take care of the inherently fragile mixture of issuing deposits and taking high-return, high risk businesses, including derivatives, under the declining charter value. Therefore, the Japanese financial regulatory system confronts the double tasks at one time.

(c) Recovery of the real economy decoupled from the banking problem: why?

Despite all these difficulties associated with the daunting reconstruction task of the Japanese financial system and regulatory framework as a whole, it is noteworthy that the real economy has started to recovery in the 1996 calendar year. Probably the annual growth rate will be 2.5 percent in 1996 after having stagnated at only 0.6 percent annual growth rate during the protracted four year recession in 1992-95 (Table 3). A main reason for the protracted recession was the 20 percent large cumulative decline in business investment in 1992-94 due to the downward capital stock adjustment by private companies, which more than offset the discretionary stimulative fiscal policies as measured by increases in cyclically adjusted budgetary

deficit accounting for more than 4 percent of GDP in 1992-94. In 1995, the overshooting of the yen exchange rate dragged down real GDP by nearly one percent of real GDP through cutting down substantially net exports (Table 3).

Such downward capital stock adjustment was completed at the end of 1994. That is the annual rate of increase in the capital stock of all industries declined to 4 percent toward the end of 1994 from a unsustainable rate of 9 percent at the end of the last boom period. Reflecting the completion of the capital stock adjustment of overall business investment started to recover in 1995, led by a 13 percent increase in manufacturing investment, strongly supported by investment in information technology industries such as personal computers, cellular and personal home telephones, semi-conductors, liquid crystal displays, ceramics, etc. This de-coupling of the recovery of the real economy from the serious banking problems points out the fundamental nature of the present banking problems in Japan. That is, the banking problems have very much concentrated in defaults of the real estate sector alone. The huge magnitude of non-performing assets may suggest that the Japanese banking problem should be a macroeconomic problem like the Great Depression in the 1930s. During the Great Depression, the serious deflation caused many general enterprises in the real economy to go bankrupt and default due to the increased value of bank debt in real terms, which in turn caused commercial banks to suffer from the increasing amount of non-performing assets and hence insolvencies and eventually systemic banking crisis. In other words, the serious deflation in the goods and service market was the essential cause of the banking crisis during the Great Depression. The cause and effect linkage ran essentially from the deflation-ridden overall real economy to the banking industry. In the current Japanese economy, such casualty linkage hardly exists. Mainly the defaults in the real estate sector are responsible for the banking problems, although the magnitude of the resultant non-performing assets is so large that the problem looks like macro-economic. Helped by the recovery of the real sector as well as by the continued easy monetary policy, commercial land prices will bottom out in the second half of 1996.

A more interesting and unsettled question is whether the capital-impaired banks will produce the so-called credit crunch so that the real economy can not recover so quickly. This credit crunch problem may not become very serious for two reasons. First, capital-impaired banks have withdrawn their foreign assets rather than domestic assets as indicated by the absolute decline in outstanding loans by branches and foreign subsidiaries of Japanese parent banks after the bursting of the bubble. Second, not large but small-and medium-scale enterprises which do not have access to the domestic capital market may suffer from credit crunch. It is indeed true that business investment by small- and medium-scale enterprises used to lead the recovery of overall business investment but that this did not happen during the recent recovery period, possibly caused by a credit crunch. However, the proportion of small- and medium-scale enterprises which complain difficulties in obtaining bank loans has been declining. Furthermore, there are indications that their business investment has started to recover in recent months. For these two reasons, the magnitude of credit crunch, if any, appears rather limited and hence the recovery of the real economy will hardly be undermined by credit crunch.

Another noteworthy fact of the real economy in Japan is that whereas Europe suffers from high unemployment and the U.S. is concerned with the widening income disparity, Japan has not shared either of the problems. During the latest protracted recession, the rate of unemployment increased, but only up to 3.4 percent from 2.2 percent of the preceding boom period. Although there remains a serious problem of under-employment within companies, particularly among white-collar workers at the middle age and above, the over-time working hours have been increasing at the annual rate of 4.5 percent and the job offers to seekers ratio has also improving from the second half of 1995, respectively. A profit-sharing scheme in the form of bonus payments which account for nearly one-third of annual salaries worked so well under the latest recession, that the effective labor income share in net national income hardly rose in sharp contrast to previous recessions. During the latest recession, private consumption in real terms increased by 1.5 percent per annum (Table 3), helped also by lower inflation rates in the goods and service market. Over the past two years, corporate profits have been recovering by 15-20 percent per year helped by this implicit profit-sharing scheme and restructuring undertaken by private companies (Chart 2).

Conclusion

In conclusion, the recent performance and recovery of the real economy is decoupled and isolated from the banking "crisis" in Japan. Therefore, if both the Government and the public correctly handle the jusen liquidation and other banking problems through overhauling the current financial and regulatory system, the Japanese economy will launch on the new underlying growth path of 3 percent or so with better shape of both real and financial sectors.

(Over)

Table 1

Non-performing loans, etc. of Japanese Deposit-taking Financial Institutions

(as of the end of March 1996 (provisional figures))

(¥ billion)

	Total Assets		Outstandings of Non-performing and Restructured Loans			Reserves for Possible Loan Losses		Net Operating Profit		On realized Gains on Listed Securities
		Loans	Total	LBB PDL*	Restructured Loans		Provisions in Special Accounts for Loan Loss Write Offs	Annual Average of 90FY-94FY	Apr. 95-Sep. 95	
City Banks	432.3	274.6	13.1	8.1	5.0	4.2	3.3	2.1	1.8	8.1
Long-term Credit Banks	87.3	54.5	4.0	2.1	1.9	1.0	842.0	299.0	327.0	2.5
Trust Banks	250.9	61.5	6.3	2.8	3.5	950.0	767.0	324.0	274.0	2.2
Major Banks Subtotal	770.5	390.6	23.4	13.0	10.4	6.2	4.9	2.7	2.4	12.8
Regional Banks	199.3	133.6	5.0	3.3	1.7	1.3	845.0	1.0	701.0	5.1
Regional Banks II	68.9	51.0	2.8	2.2	581.0	600.0	439.0	341.0	260.0	838.0
Regional Banks Subtotal	268.2	184.6	7.7	5.5	2.2	1.9	1,284.0	1.4	961.0	5.9
Total of All Banks	1,038.6	575.2	31.1	18.5	12.6	8.0	6,166.0	4.0	3.4	18.7
Cooperative Type Financial Institutions	263.9	129.1	6.3	6.0	332.0	1.5	793.0	1.1	746.0	1.6
TOTAL	3,379.9	1,854.7	99.7	61.5	950.3	1,574.1	11,144.2	976.3	3,276.6	894.9

Source: Ministry of Finance

LBB=Loans to Borrowers in Legal Bankruptcy, PDL=Past Due Loans

Table 2

Characteristics of the Business Cycles in Japan (Boom Periods)

Period	GNP	Private Final Consumption	Private Gross Investment	Private Residential Investment	Private Capital Investment	Government Consumption	Exports etc.	Imports etc.	Unemployment Rate	GNP Deflator	TOPIX	Land Price Index of Six Largest Cities	Contracted Interest Rates on Loans	M 2 C D
1. 1958 June 1961 Dec	10.5	9.34	23.8	17.2	24.4	5.85	8.54	19.9	1.78	5.82	28.7	40.1	8.14	20.5
2. 1962 Oct 1964 Oct	9.92	9.83	15.6	22.2	12.0	5.29	13.3	17.2	1.23	5.60	0.01	17.0	7.85	21.8
3. 1965 Oct 1970 July	10.5	8.95	17.5	16.4	16.6	4.02	18.5	14.6	1.21	5.50	14.4	9.53	7.45	16.7
4. 1971 Dec 1973 Nov	8.08	9.06	10.7	16.7	8.33	5.35	6.28	17.3	1.35	9.29	48.4	24.3	7.08	23.4
5. 1975 March 1977 Jan	4.38	3.55	2.09	7.81	0.08	4.97	11.2	3.27	1.93	7.07	9.06	1.93	8.56	14.3
6. 1977 Oct 1980 Feb	5.25	5.61	6.20	1.61	7.66	4.59	5.84	8.92	2.14	3.70	8.48	6.38	6.42	11.6
7. 1983 Feb 1985 June	3.91	2.37	5.34	3.22	6.24	2.82	9.95	4.08	2.67	1.89	23.4	5.72	6.85	7.66
8. 1986 Nov 1990 Oct	5.05	4.51	11.7	10.1	11.6	1.66	10.3	16.6	2.46	1.12	19.3	26.3	5.51	10.8

Notes: The figures are average rates of change (in percentage terms) against the same quarter of a year earlier except unemployment rate and contracted interest rate on loans. The figures of unemployment rate and contracted interest rate on loans are percent.

The original date come from the data base in Economic Planning Agency

Table 3

Annual Growth Rates of Major Components of Real GDP

(at 1990 prices, %)

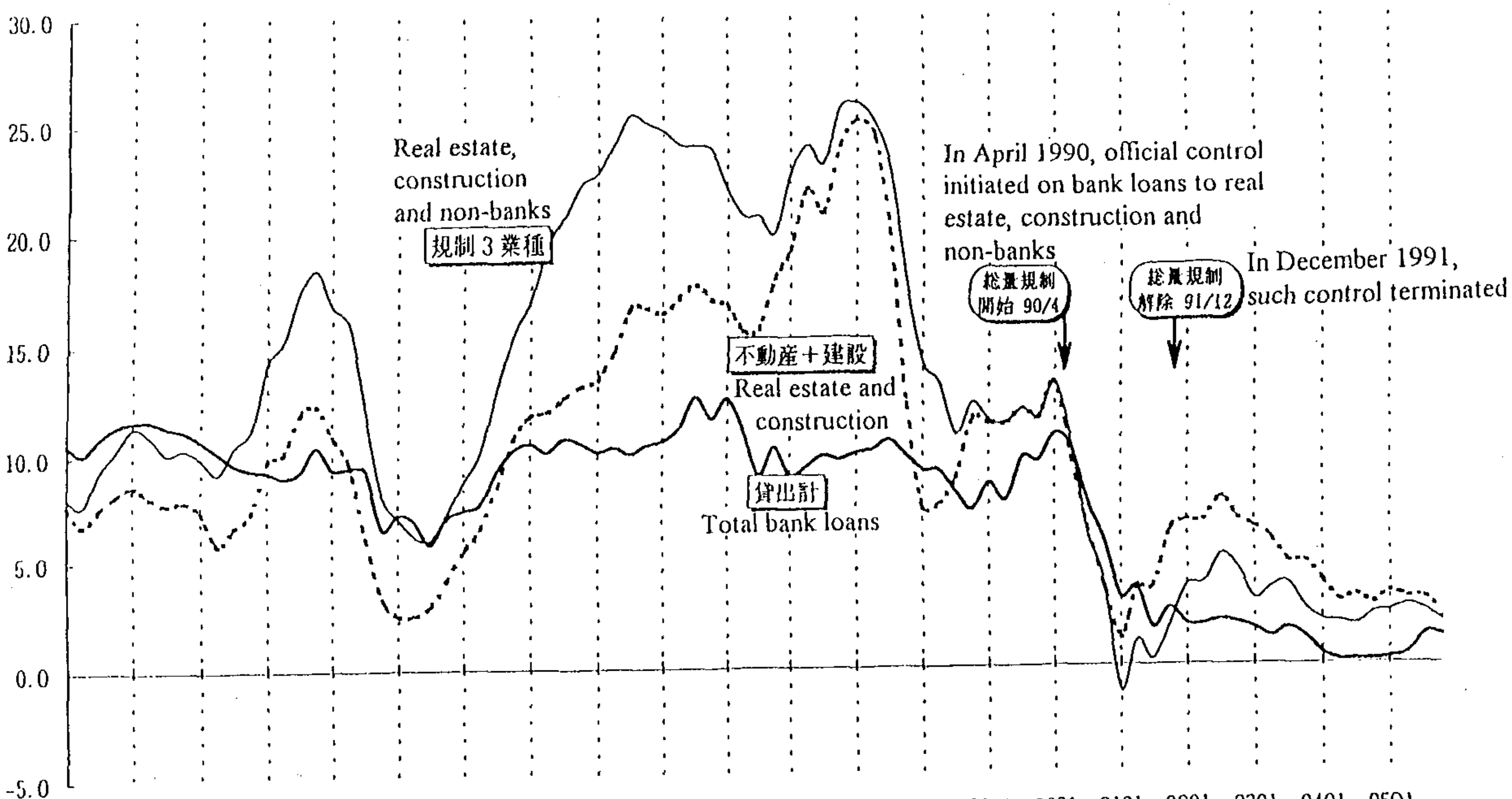
	1991	1992	1993	1994	1995	Oct-Dec 1995 compared with a year earlier
Private Consumption	2.5	2.1	1.2	1.8	1.6	2.4
Residential Investment	-8.5	-6.5	2.4	9.2	-6.1	-4.7
Non Rest. Investment	6.3	-5.6	-10.2	-6.0	2.9	5.4
Private Inventory	(0.3)	(-0.5)	(-0.1)	(-0.3)	(0.3)	(0.3)
Government Consumption	2.0	2.0	2.4	2.2	2.0	2.8
Public Investment	4.9	14.5	15.7	2.8	1.4	12.7
Public Inventory	(-0.1)	(0.0)	(-0.0)	(0.1)	(-0.0)	(-0.0)
Net Exports of Goods & Services	(1.0)	(0.6)	(-0.0)	(-0.3)	(-0.7)	(-0.7)
Exports of Goods & Services	5.4	4.9	1.3	4.6	5.0	3.6
Imports of Goods & Services	-4.7	-1.1	1.7	9.0	13.5	16.6
G D P	4.0	1.1	0.1	0.5	0.9	2.5
Deflator for GDP	2.7	1.7	0.6	0.3	-0.5	-0.5
Current Account Surplus / GDP	2.6	3.2	3.1	2.8	2.2	1.9

Notes: Figures in parenthesis indicate contributions (% points) to GDP Growth

Chart 1

Graph1 1996/4/9

Rates of increase in loan outstanding by all banks



出所：経済統計月報（日本銀行）、長銀総合研究所推計
注：8901以前は第二地方銀行（旧相互銀行）は除く
9301以前は当座貸越を含まないベース
規制３業種は不動産＋建設＋ノンバンク（物品賃貸業＋その他金融）と定義

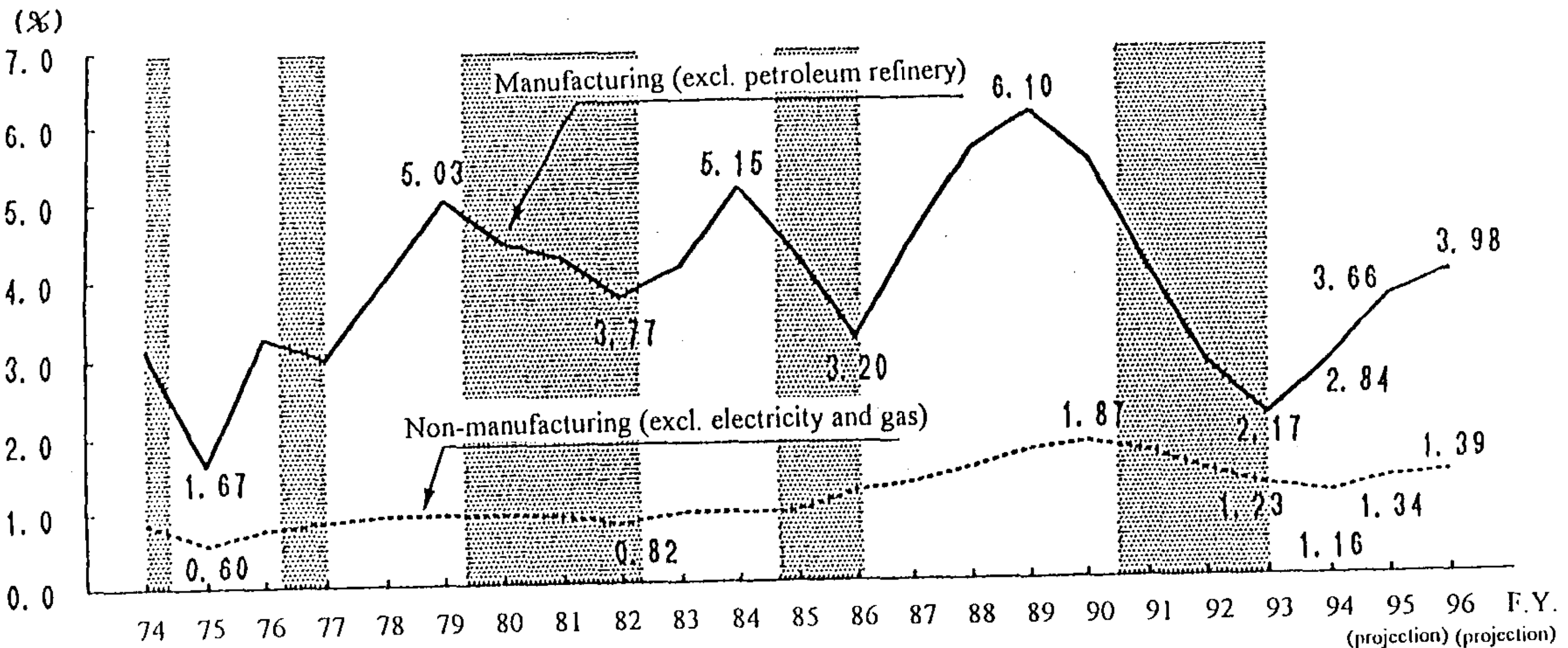
貸出.XLS

Source: The Bank of Japan, Monthly Economic Statistics, The Long-Term Credit Bank, Research Institute's estimates

Notes: Second tier regional banks (previously called mutual banks) are not included in bank loans until the first quarter of 1989.

Chart 2

Profit/Sales Rates of Large-scale Enterprises



Note: Shadow indicates recession period (Economic Planning Agency)

Source: Bank of Japan, Tankan, March 1996