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GLOBAL MARKET COMMENT: JAPAN'S BANK CRISIS

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Robert Lang
Austin Fraser

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The Parlous State of Japan's Banks Approaching Systemic Crisis?

An event that captures the complexity and urgency of Japan's struggle with structural reform will occur on April 1, 2002. That is the day that the government will cease guaranteeing time deposits in excess of ¥10 million ($75,200) against the possibility of bank failure. This will leave an estimated ¥200 trillion ($1.5 trillion) in bank deposits unprotected—an amount roughly equivalent to 40% of Japan's GDP and more than three times the capital of its major banks. The imminence of the deposit insurance cap is prompting depositors to withdraw their money and stuff it under their tatamis or place their assets in insured bank deposits (though the limit on demand deposits will be introduced in 2003).

The government began providing the blanket deposit guarantee in 1998, in the wake of the widespread nervousness about bank runs following the failure of a large financial institution. The measure was never intended to be a permanent fixture of the banking industry and was initially set to expire in April 2000, but the deadline was extended because of persistent deterioration in the financial system. Some politicians and bank officials are now urging that the April deadline be pushed back again. While other observers expect that although the government will probably proceed with the plan to cap deposit insurance on April 1, 2002, if a bank fails it will immediately reinstate the unlimited guarantee.

Proponents of postponement seem to have a persuasive case. According to the government, as of September 2001, nonperforming loans (NPL) totaled ¥36.8 trillion ($320 billion), or about 8% of Japan's GDP, which is more than double the level of NPLs during the U.S. savings and loan crisis of the 1980s. Goldman Sachs, however, estimates that the total is ¥237 trillion, four to five times larger than the official estimate. Those who are arguing for a deferral of the deadline are worried that the limit on deposit insurance will prompt bank runs, especially among regional or second-tier banks whose financial positions are considered the weakest. This could escalate into popular concern about the viability of city banks, prompting a run on them as well.

Some analysts in the West have taken this nightmare scenario one step further, warning that a collapse in Japan's banks could trigger a systemic crisis in the country and send reverberations across the globe. As they see it, in order to protect depositors from losses, a large-scale government bailout or nationalization (*de facto* or outright) would require the Bank of Japan (BOJ) to inject at least $1 trillion, which is the total of their negative net worth. Public debt, which currently stands at 135% of GDP and is expected to rise to 160% over 2003 even without a bank run, would expand even further. The BOJ would probably finance these liabilities by issuing $1 trillion in Japanese Government Bonds (JGBs), pushing up their yields considerably. A sharp rise in interest rates would not only trigger a bond sell-off, but also set in motion bankruptcies throughout the nation. This could force corporate Japan to repatriate their assets, which also entails selling U.S. Treasuries (Japan is the largest holder of marketable Treasury securities, currently holding 11.2% of outstanding securities, or $335 billion as of November 30, 2001). This would wreak havoc on the US$, as well as interest rates in the United States. (Alternatively, some analysts suggest that this scenario would prompt an outflow of capital, which would put considerable downward pressure on the yen.)

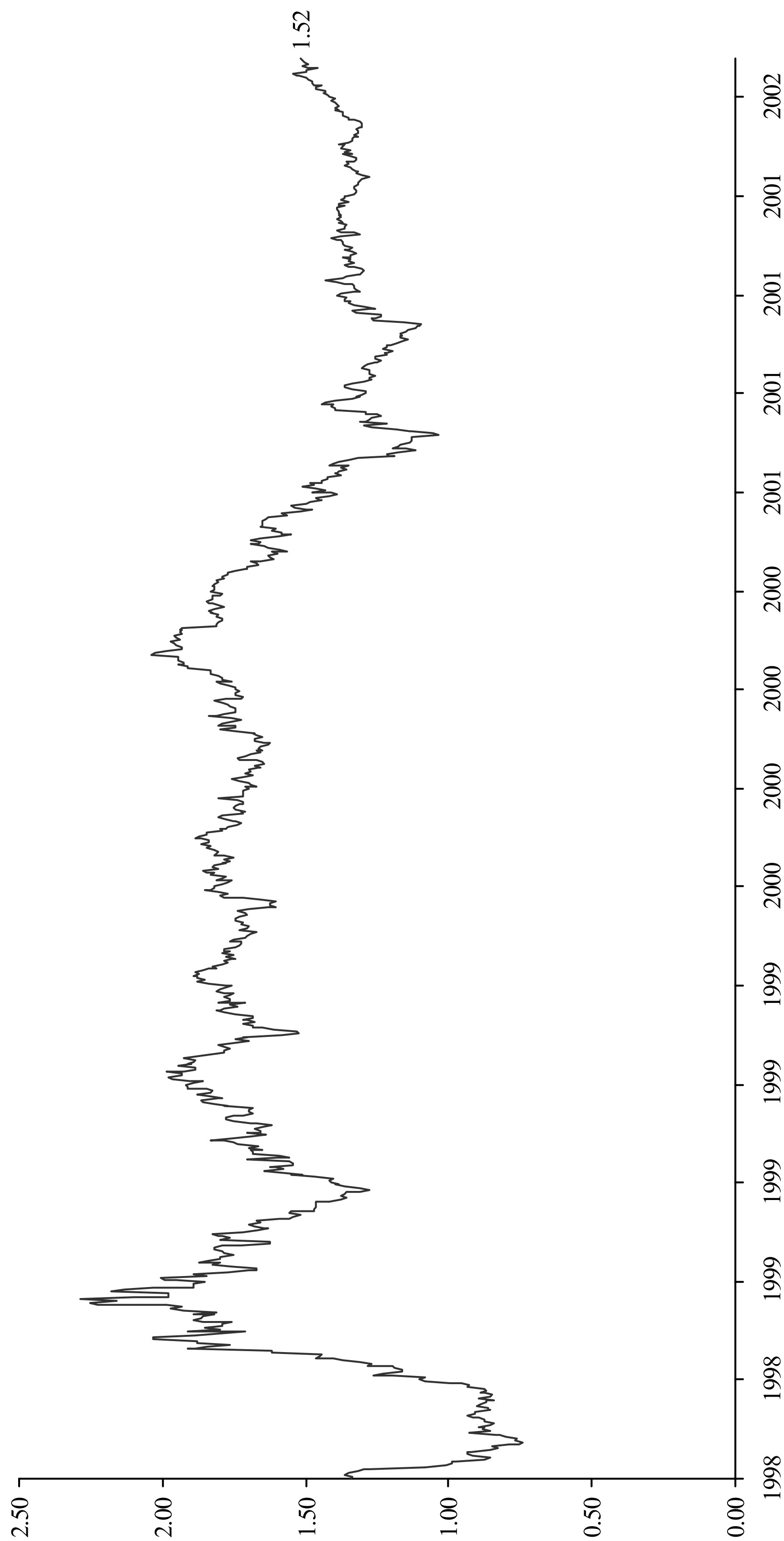
The probability of this doomsday scenario actually materializing if JGB yields spike is not very high, however. Demand for JGBs remains strong among domestic financial institutions and other Japanese investors who have few investment alternatives to the bond market. However, the relentless slide in consumer prices, the overall economy, equity prices, and bank shares has ratcheted up the risk of systemic failure, and there are already indications of mounting pressure. Interest rates have climbed over the last 12 months, with the ten-year benchmark Treasury yield increasing 48 basis points, from 1.04% to 1.52%. In addition, bank shares continue to weaken at an even faster rate than the broad market, returning -24.6% over the last three months and -45.2% over the last 12 months, compared to -8.3% and -25.3%, respectively (see Exhibits A and B). (Another factor weakening bank shares is the government requirement, also effective April 1, 2002, that banks mark-to-market their equity holdings. With their extensive holdings, and the Nikkei near an 18-year low, these write downs will be enormous.)

Until the economy shows signs of reflating, deflation will continue to savage the net worth of banks and their depositors. As we have noted repeatedly in recent years, risks in Japan remain high, as the economy must undergo significant transformation in order for sustained recovery. As the Koizumi reform agenda appears to have stalled, reflation does not appear imminent and the cap on deposit insurance is unlikely to be helpful in this regard. Investors brave enough to invest in Japan should look to managers with strong, bottom-up stock selection skills, as there is opportunity to add value.

Exhibit A

JAPANESE TEN-YEAR BENCHMARK YIELDS SINCE THE ASIAN CRISIS

September 1, 1998 - February 20, 2002

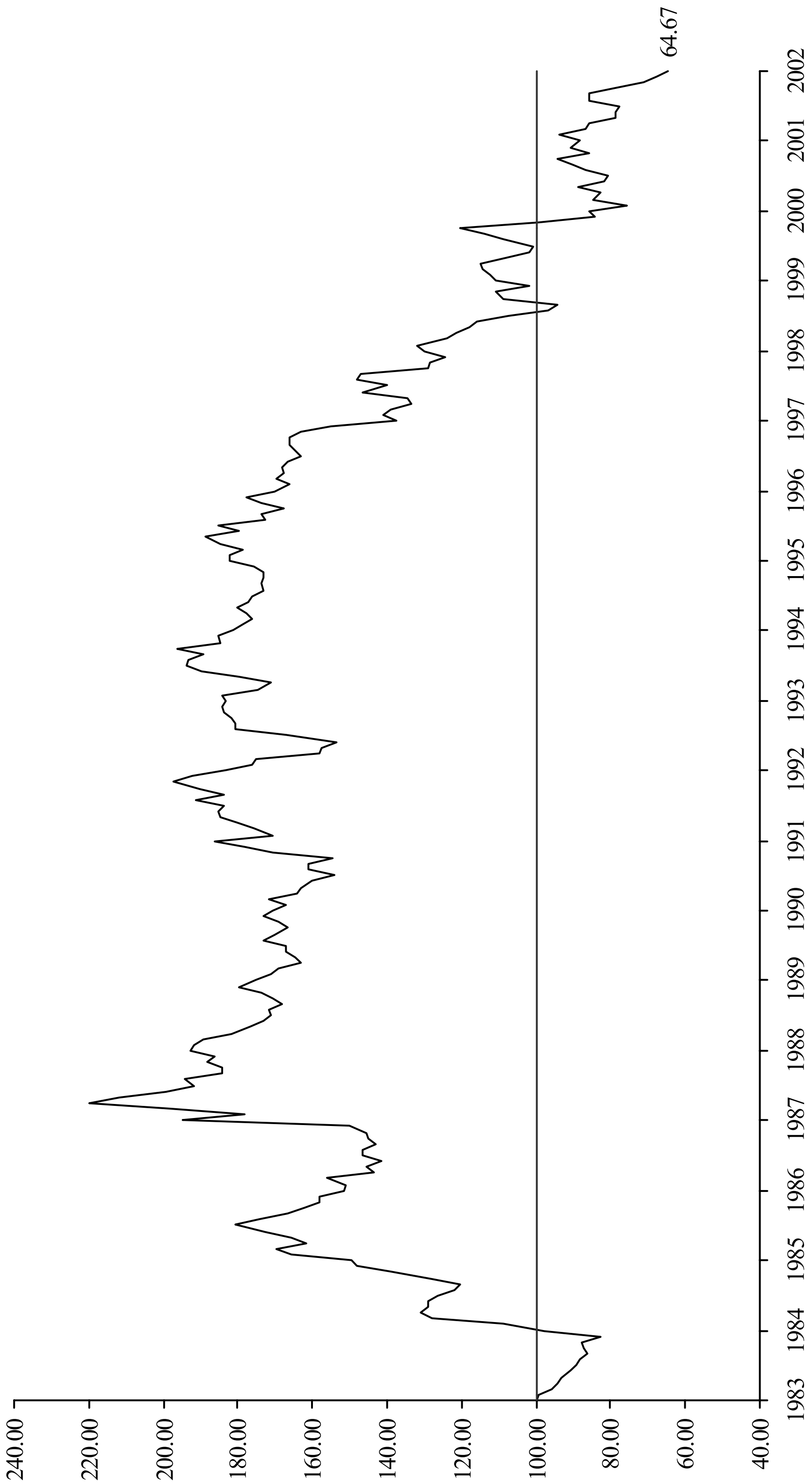


Source: Datastream International.

Exhibit B

JAPANESE BANKING SECTOR RELATIVE TO THE TOKYO STOCK EXCHANGE

February 1, 1983 - January 31, 2002



Source: Datastream International.
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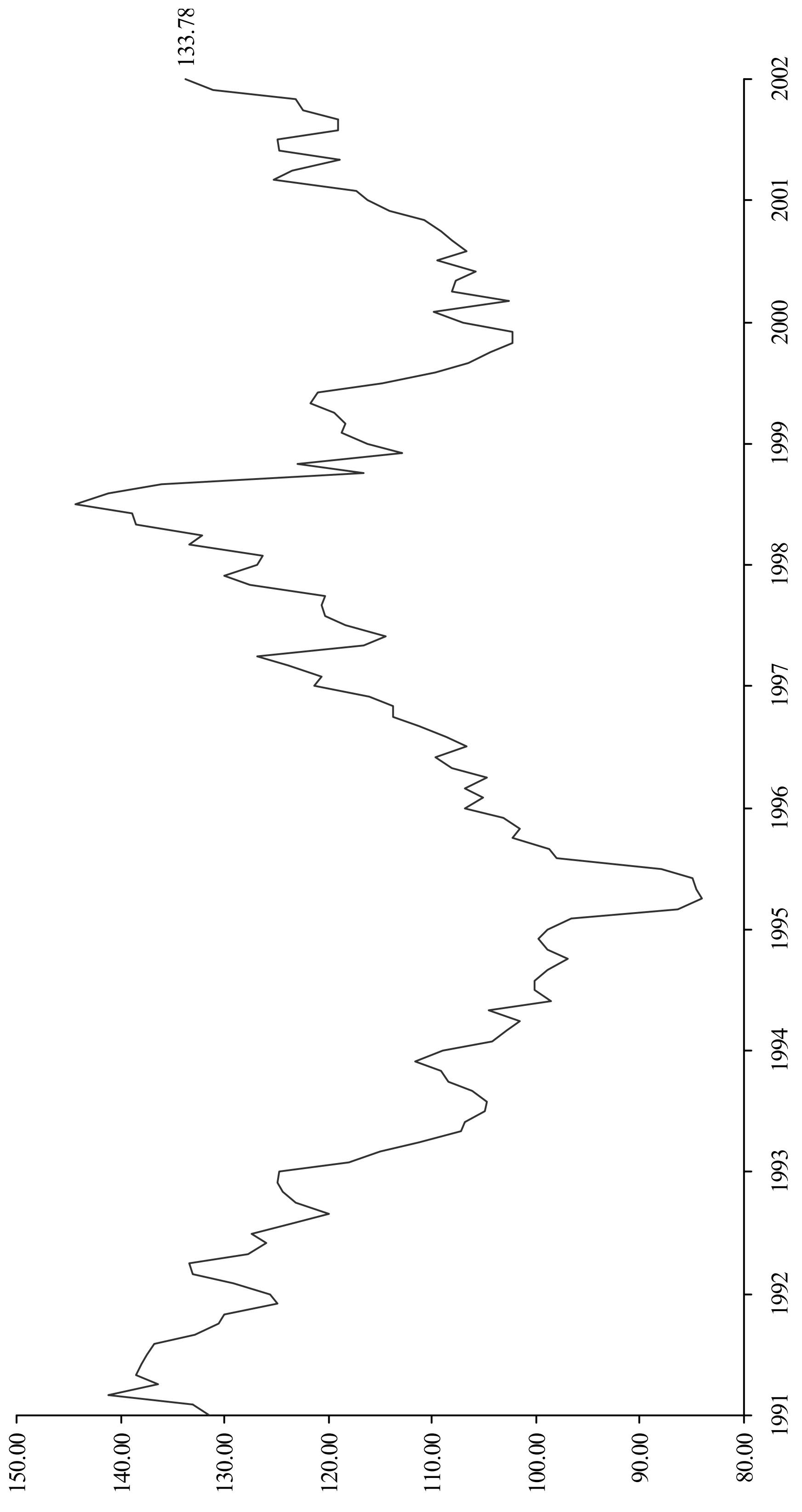
Exhibit C

EXCHANGE RATE OF THE JAPANESE YEN TO THE U.S. DOLLAR

January 31, 1991 - January 31, 2002



Source: Datastream International.