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GLOBAL MARKET COMMENT: THE DEBATE ABOUT JAPANESE BANKING REFORM

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The Debate about Japanese Banking Reform

Over the last few months, there has been a flurry of activity in Japan about finally cleaning up its banking system. The Bank of Japan, Ministry of Finance, Financial Service Agency (FSA), and the Koizumi Administration appear to have called a ceasefire to their squabbling in order to unite behind the financial reform effort. Prime Minister Koizumi not only promised to restructure the banking industry, tackle deflation, and eliminate bad loans, he also appointed an advocate of aggressive bank reform, Heizo Takenaka, to serve as head of the FSA, the bank-regulating agency. Takenaka promptly issued a controversial bank reform package, which was immediately savaged by both pro- and anti-reformers within the ruling party for being either too timid or too aggressive. Subsequent talk of nationalizing banks sent shareholders running to the exits; bank share prices plunged, and the market capitalization of major banks has since dropped to an all-time low (see Tables A and B). The furor prompted Koizumi and Takenaka to craft a compromise package that includes the following proposals:

- The Bank of Japan will purchase equities from distressed banks;
- Banks must accelerate the disposal of their non-performing loans (NPLs), completing the clean-up by fiscal year 2004;
- Banks must toughen their loan classification standards by adopting more realistic provisioning for problem loans using present value accounting instead of their current methodology based on historical bankruptcy rates;
- The Bank of Japan would consider injecting public funds into banks if the provisioning process depletes their capital and jeopardizes their solvency; and
- The government will establish a new public entity that would purchase loans of companies that have a reasonable chance of survival, while the existing body, the Resolution and Collection Corporation, would purchase company loans where there is a high probability of bankruptcy, then liquidate the companies.

While pro-reformers complained that the government caved in to the anti-reformists, the government's burst of activity, even with the compromise proposals, represents a stark contrast to its gradualist approach of the last decade. Of course, it is too early to determine whether the plan will follow the fate of its predecessors by dissolving into rhetoric, or whether it genuinely represents the start of meaningful change.

In general terms, there are two points of view about Takenaka's plan that differ in terms of how much pain the plan will inflict, how long the pain will last, and who the plan will hurt and benefit most. By and large, the first school approves of the plan because it believes that cutting off deadbeat borrowers would promptly jumpstart the economy, ultimately benefiting the Japanese people, the government, and equity investors. The second school is firmly opposed to the plan, worrying that it would generate devastating negative forces that would benefit a small portion of society, while in the aggregate savaging the vast bulk of the Japanese population.

The Enormity of the Problem

In terms of the scale of the NPL problem, the value of bad loans are estimated to range from official estimates of ¥43 trillion to ¥52 trillion (US$230 billion to US$418 billion) to private sector estimates of up to ¥236 trillion (US$1.9 trillion); the latter figure approximately 50% of Japan's GDP. In comparison, the Savings & Loan crisis in the United States represented 1% of its GDP. If banks followed Takenaka's plan and increased their loan loss reserves or applied stricter loan classification criteria, their capital base would erode significantly. In this event, the government has pledged to step in to shore up their balance sheets. Approximations of how much capital the government might have to inject range from ¥6 trillion to ¥50 trillion. In comparison, the government pumped ¥9 trillion into the banking system as a result of its last major rescue package in 1999.

Tough Love

Members of the Tough Love school believe that Japan's economic problems are rooted in bad loans that the government should move quickly and decisively to dispose. Keeping deadbeat corporate borrowers on life-support prohibits their healthier rivals from obtaining their business, and delaying the remedy would only prolong deflation and create more bad loans. Foreclosing on loans allows company resources, which are currently trapped beneath a pile of debt, to be transferred to a new owner and new usage. Surviving companies will acquire the assets and revenues of the defunct companies, thereby creating significant economies of scale, while financial intermediation will be restored because slimmed-down banks will finally be able to properly price credit and risk. One prominent advocate of Tough Love, Morgan Stanley's chief Japan economist Robert Feldman, is confident that decisive action would eliminate deflation "overnight," while other supporters foresee higher deflationary pressures, but only over the short term.

Some pundits argue that over the short-term this aggressive program would most benefit equity investors. Although the Takenaka plan might initially send the equity market into a nosedive, it would roar back shortly afterwards into a V-shaped recovery. This dynamic was played out in South Korea during its 1997 foreign exchange crisis. At that time, the IMF forced the Korean government to order banks to eliminate most of their NPLs by selling their underlying assets to government agencies that determined whether the debt would be restructured or written off. The government offset the deflationary effects by pumping $150 billion (about 30% of GDP) into its financial system. Most banks were nationalized, merged, or closed, and about half their staff was dismissed. The Korean economy contracted 6%, but quickly rebounded; banks that survived emerged stronger and better equipped to allocate capital rationally.

Deflationists

The second camp worries that the medicine will kill the patient. Accelerating the disposal of NPLs, particularly without substantial fiscal or monetary offsets from the government would throw the economy into a vicious deflationary cycle, driven by the knock-on effects of falling employment, consumer spending, production, and profits. Accelerating the pace of disposing NPLs would substantially reduce economic growth. Some pundits have predicted that it would cause economic growth in fiscal year 2003 to fall to zero, while others foresee a contraction of 3% to 4% over the next two years. The number of bankruptcies would jump significantly, probably by five times the current rate, as tens of thousands of firms go belly up over the next three to five years. With several million people likely to lose their jobs, unemployment has been predicted to increase from the current rate of 5.5% to 7.0% or 8.0%. While these may be low figures relative to Western standards, for Japan the current rate is a postwar high. Without effective monetary and fiscal stimulus, interest rates, equity prices, land prices, and the average standard of living would fall even further than they have to date.

Some members of this school argue that most of the population and much of the government (beyond conservative LDP members) are opposed to the plan. Over the last decade, because consumer prices have fallen faster than wages, an enormous amount of wealth has been transferred to the public at the expense of the corporate sector. Furthermore, the public is not extremely concerned about the persistent slide in the equity market, as only 5% of their financial assets are held in equities. With 55% of their assets deposited in banks, households are more worried about the stability of the overall financial system. Therefore, it is quite reasonable to assume that the average citizen would want to prolong the *status quo* and delay the fall in their standard as living as long as possible. The government has little incentive to implement aggressive reforms given the popular support of the status quo. In addition, many pundits believe that policymakers actually agree with the Deflationist point of view and are more interested in portraying the *appearance* of aggressive resolution of the NPL problem in light of recent international political pressure than in generating meaningful reform.

Many pundits who worry that Takenaka's plan would unleash uncontrollable deflationary forces believe not only that the government *should* maintain the status quo because the banking industry had been making steady progress with reform and should be allowed to write off bad loans over time. Progress made prior to the announcement of the Takenaka plan has included reducing the risk of their loan portfolios, raising their returns, aggressively cutting costs, and getting in control of their bad debt problems. The former head of the FSA, Hakuo Yanagisawa, was a prominent proponent of this gradualist approach, a view that ultimately cost him his ministerial position. The Deflationists acknowledge that the status quo means another decade of subpar economic growth, but its benefit is stability. The financial system will probably suffer the occasional crises, but the government will quickly extinguish them with stopgap measures.

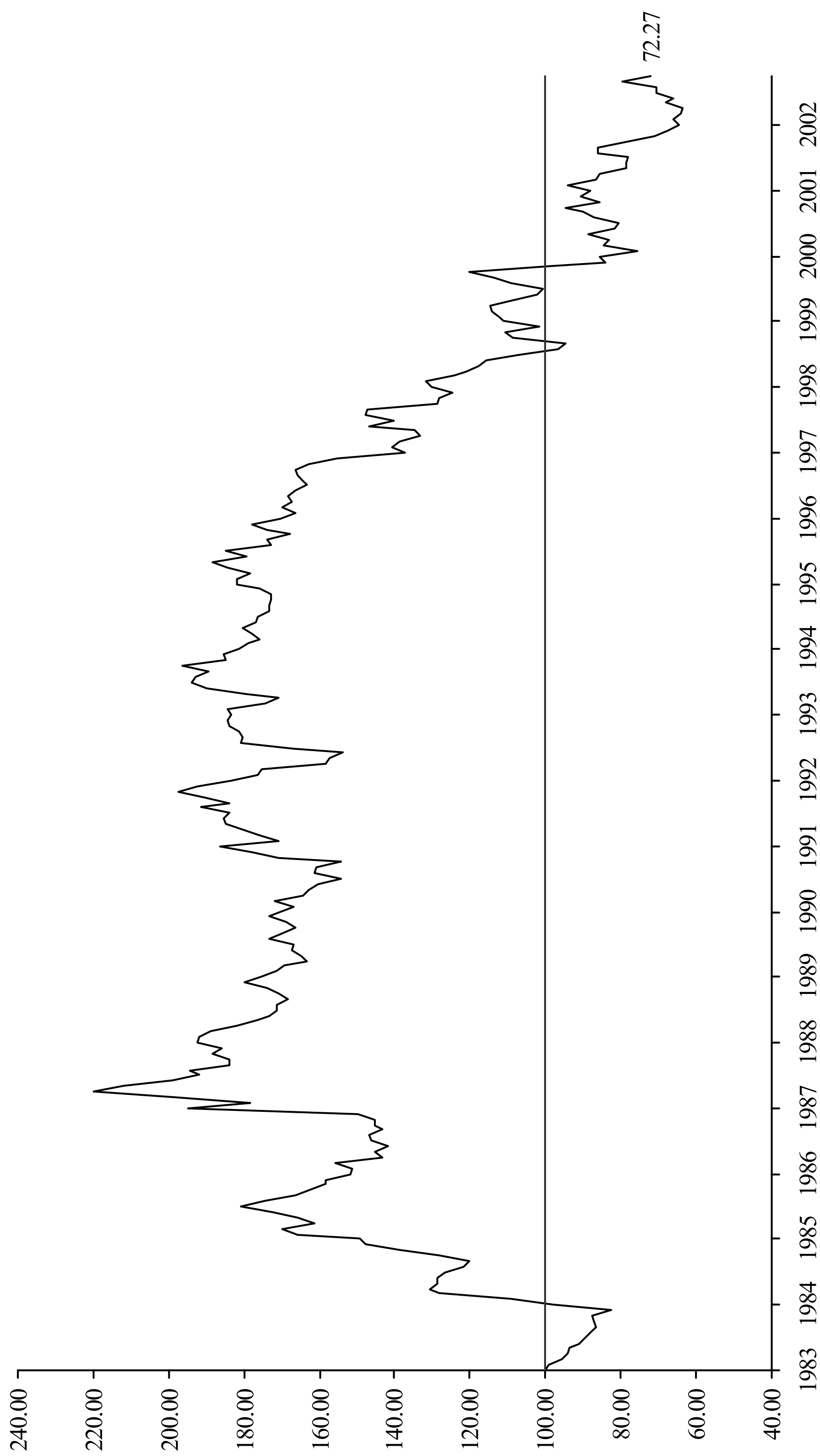
Comprehensive Package

In coming weeks the Koizumi Administration may announce a series of fiscal policies to allay the concerns of the Deflationists and secure their support for the Takenaka plan. Possible measures include shoring up the economy with massive stimulus, increasing unemployment benefits and expanding the social safety net, guaranteeing credit to small companies, and cutting taxes for households and the private sector. The absence of any such announcements or other attempts to assuage the Deflationists may signal a lack of seriousness about moving beyond rhetoric to reform the banking system. If on the other hand, the government maintains its recent momentum by allaying widespread fears, the Takenaka plan may represent the beginning of genuine structural reform.

Table A

JAPANESE BANKING SECTOR RELATIVE TO THE TOKYO STOCK EXCHANGE

February 1, 1983 - October 31, 2002



Source: Thomson Datastream.
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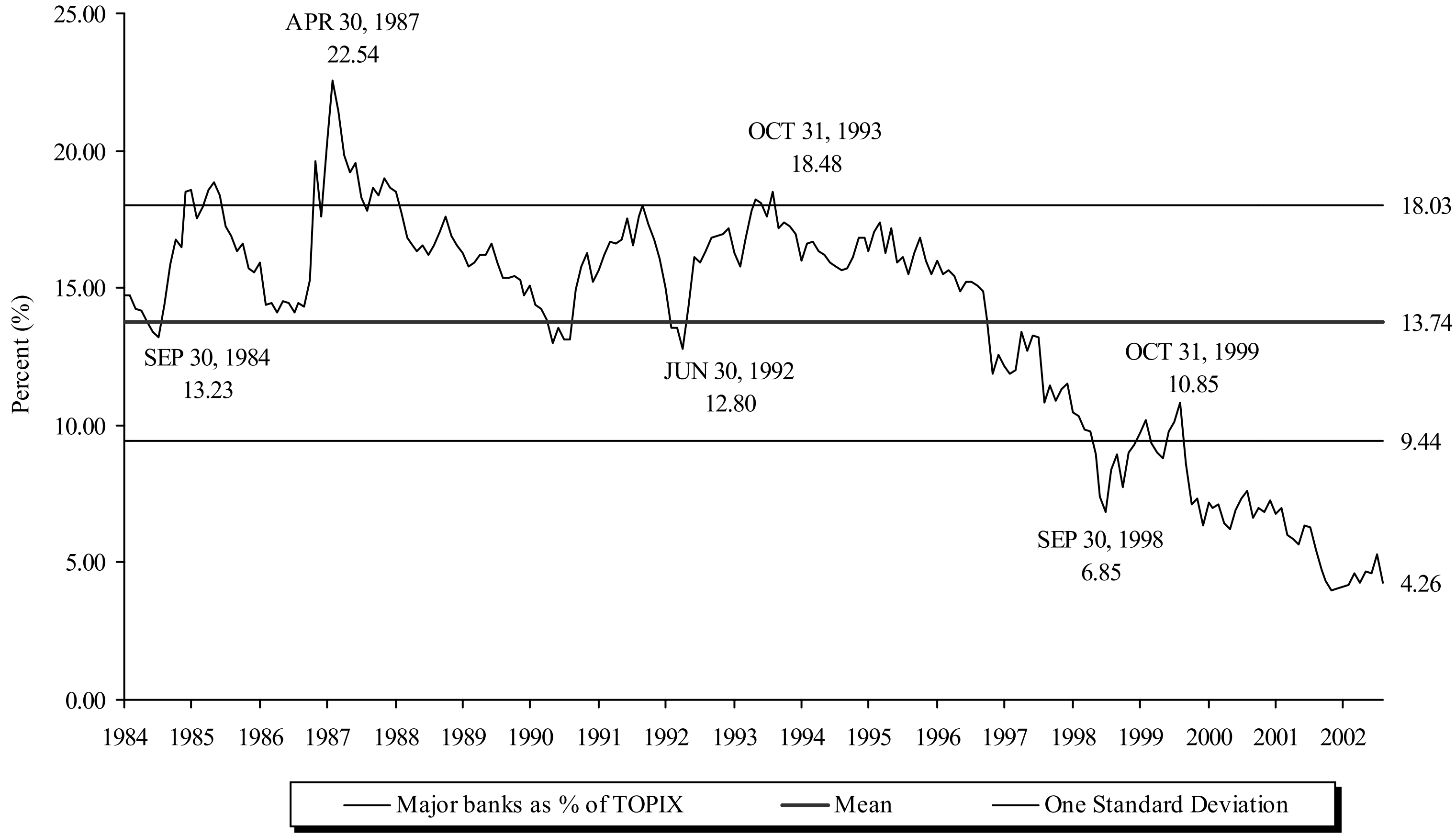
Table B

MARKET CAPITALIZATION OF MAJOR BANKS AS A PERCENTAGE OF TOPIX

March 31, 1984 - October 31, 2002



Sources: Goldman, Sachs & Co. and Thomson Datastream.

Note: Major banks (city banks) included are Mizuho Holdings, Inc., Mitsubishi Tokyo Financial Group, Inc., UFJ Holdings, Inc., Sumitomo Mitsui Banking Corp., and Resona Holdings, Inc.