Lessons from the Japanese Banking Crisis

Speech given by
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I am grateful for Chatham House and Daiwa, two leading policy institutes in the UK and Japan, for the invitation to speak at this joint seminar.

Last month I happened to be in London on the next day of the Rugby World Cup game between Japan and South Africa held in Brighton. Many whom I met in London congratulated me for the victory of Japan over the two-time champion, which indeed came as a surprise.

Japan recorded one victory at the 1991 World Cup, but in 1995, 1999 and 2003, Japan lost all the games. In 2007 and 2011, there were draws but no wins. This year, however, Japan won three out of the four games it played. Given that the Japanese economy is now exiting from deflation and stagnation, I would dare to say that one may find a statistically significant correlation between the games lost and the economy lost, and between the two resurrections from the lost decades.

We are here to discuss “Lessons for and Challenges to Economic Stability in the EU and Japan.” On my part, I would like to talk about the lessons we have learnt from the experience of our banking crisis in 1990s and its aftermath. Of course they might not fully fit the issues our European friends face today. But some argue that the developed nations as a whole are entering into a secular stagnation, and in this regard, unfortunately, Japan can be considered as a front-runner. You thus might find some useful points in my remarks.

Three phases experienced since the asset price bust

We often think an asset price boom and its bust cause a financial crisis and if we end the crisis the economy will start to recover. Our experience, however, has been somewhat more nuanced. We had two phases in the crisis and a third phase ensuing it.

The first phase of the crisis was characterised by the deteriorated *balance sheets* of borrower companies, which resulted from the real estate price collapse. On the other hand, the second phase was marked by the deterioration in borrower *profitability,* mainly caused by stagnation in the real economy. Banks had to address their non-performing loans throughout, but in the first phase, problems were mainly confined to their exposures to real estate and construction sectors, while in the second phase loans to other industries such as distributors and manufacturers went sour. Japan spent the 1990s to exit from the first phase, and years in the early 2000s to exit from the second phase and to end the crisis.

More than ten years have passed since the end of the crisis, but stagnation has ensued and the legacy of the crisis is still felt. With the Abenomics, we are currently exiting from this third phase.

I think three lessons can be drawn from our experience in these three phases.

First, rebuilding solid balance sheets is important but not sufficient. It is a precondition for ending a crisis that banks and borrower companies rebuild their impaired balance sheets. But once the behaviours of banks, firms, and regulators are optimized to attain balance-sheet clean-up, the economy tends to fall in a deflationary spiral. We need to mind this secondary effect.

Second, a credible public safety net helps us end the first phase promptly and thus can alleviate the behavioural inertia which can cause second phase problems. We should aim to build public confidence that public funds are properly used and thereby secure support for the use in

unavoidable cases.

Third, we need both stability and growth. Growth cannot be attained without financial stability of course, but if we focus on financial stability only, a lasting damage can be incurred to the growth.

Let's look at these points slightly more in detail, reviewing what happened in each of the three stages. The commercial land price index for the six largest cities of Japan quadrupled during the five years till September 1990, when the index peaked out. During the ensuing five years, the index lost two-thirds of its value and continued to decline even after that.

During the boom, many companies borrowed from banks and acquired real estate. Value of the assets bought disappeared after the bust but the debts remained. Banks believed their loans were safe as they were collateralized, but borrowers' businesses and the value of collaterals were exposed to the same real estate price risk. Balance sheets of borrowers and banks were impaired and the first phase of the crisis started.

It is already well known that Japan failed to resolve this first phase promptly: there was no effective public safety net available at the time, the size of the needed balance-sheet adjustment implied that a rapid adjustment may endanger the whole system if done without a safety net, and thus it was thought that bad loans could be written off to the extent income can cover. Amid the systemic crisis in 1998, the parliament enacted laws enabling temporary nationalization of a failed bank and precautionary injection of public fund into a distressed bank. After this the disposal of bad loans was accelerated.

Had we had an effective safety net in advance, the first phase would have been much shorter, and the problems in the second and third phases may have been less damaging. How can we secure public support for the use of public funds? Our experience seems to indicate that when we use public funds, we should see to it that the supported banks demonstrate their positive contribution to the economy when they recover, that responsibilities of the bankers who caused the problems are strictly

pursued, and that taxpayers' money is fully paid back.

Although the newly installed safety net helped us finally end the first phase, new types of bad loans started to grow. In the early 2000s, due to the lasting economic stagnation, companies faced deterioration in the profitability of their main businesses, and some went insolvent without having engaged with real estate investment.

Debt forgiveness alone was not enough to deal with such second phase cases. Borrowers' main business had to be restructured and made profitable. The Industrial Revitalization Corporation was established to perform the task and I still clearly remember the days I worked as a member of the team which launched it.

As the public safety net had been augmented and made more effective by early 2000s, we could resolve the Resona Bank and the Ashikaga Bank without harming the regional economy they served. We finally overcame the second phase by around 2004 and the crisis was over. But this was not the end of the story.

Companies continued to use their profits for repaying their debts and for piling up cash at hand. Investments in new activities did not pick up. Banks' dedication to the maintenance of their clean balance sheets has led to lending practices relying on collaterals and guarantees, rather than on their assessments of borrowers' business prospects. More and more assets of banks were allocated to government bonds. In addition, lasting deflation led the household sector to keep their assets in the form of bank deposit.

Companies, banks, households and regulators were all determined never to repeat the crisis. The stability was the first priority. Individually players believed that their behaviour enhanced their own stability, but collectively they contributed to the protracted contraction of the economy.

The behaviour and the deflationary flow of funds persisted, and their effects were compounded by the factors common to developed nations

such as aging of the population and reduced share of manufacturing industry in the economy. The third phase stagnation lasted more than a decade.

The Abenomics is finally ending this third phase. We at the Financial Services Agency are encouraging banks to find business models in which stability and growth do not trade off with each other but are mutually reinforced.

If a bank tries to attain stability by lending only to customers with stable businesses and with reliable collaterals or guarantees, it has to compete for a limited group of customers which others also want to attract. It has to offer lower lending rates, and reduced margin will make it more difficult for them to take risks or to provide values to their customers other than low cost funding. This spiral can weaken the bank's stability in the end.

On the other hand, if a bank aims to grow together with their customers by creating shared value with them, the bank's customer base can grow without the bank engaging in rate-cut competition. Stability can be attained without relying too much on collaterals and guarantees, as the bank, with its deeper engagement with their customers, is in a better position in assessing and supporting their customers' businesses.

However, it is easier said than done, and there would be no one-size-fits-all solutions. Each bank faces the difficult task of designing its own strategies for a success. But the efforts will make it possible for banks to attain both stability and growth and for Japan to get out of the third phase. We at the Japan FSA are determined to provide a regulatory environment conductive to such efforts.

Global regulatory reforms

Let me now turn briefly to the ongoing global regulatory reforms, as I think our experience may have some bearing on them.

Since the global financial crisis in 2008, colossal international efforts have

been made to attain extensive financial regulatory reforms, and most of the initially planned reforms have reached agreement. This indeed is an impressive achievement.

The reforms aim at stability, and key elements of them focus on the balance sheets of banks. The theory is that if banks have solid balance sheets, the financial system will be more stable. This reminds me of our thinking in our first phase days. We learned in our second phase that strong balance sheets are not enough to attain stability. We also learned in our third phase that well intended dedication to stability can inflict a lasting harm on growth.

Even though seven years have passed since the global crisis, new regulations are still being proposed every year. There are growing concerns about the costs of the regulatory reforms, which eventually will be borne by customers, and about unintended consequences on SME finance, infrastructure finance, trade finance and finance to emerging markets.

Financial stability is not a goal in itself. It is a means to ensure sustainable growth. I felt this sense is shared by the G20 leaders when I read their communique issued last November. They said, “Raising global growth to deliver better living standards and quality jobs for people across the world is our highest priority.” They also stated, “Strengthening the resilience of the global economy and stability of the financial system are crucial to sustaining growth and development.”

We welcome that the global regulatory community has embarked on a review of the effects and ramifications of the regulatory reforms. The Japan FSA intends to make our contribution to the review building on the three lessons we have learned from our experience.

In conclusion

In concluding my remarks, I would like to touch upon rugby once more. Eddie Jones, the head coach of the Japanese national team since 2012,

commented in an interview that his first task as the head coach was changing the mind-set held by the players.[1] The Abenomics, which was launched in the year when Eddy Jones became the head coach, is also changing the mind-set of bankers, regulators, entrepreneurs, and households which had been entrenched during the three phases I described. The Financial Services Agency will continue to contribute to this reform endeavour.

If you are interested in what more specifically we currently do in this regard, please refer to our *Strategic Directions and Priorities for 2015-2016*. Summary slides are available in English on our website.

Thank you for your kind attention.

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1 *Nikkei Veritas*, February 22, 2015