



# Reversing Japan's Downward Spiral

## Japan's Financial Crisis Requires a Comprehensive Solution

Research by Anil Kashyap | By Jessamine Chan

In the past 10 years, Japan has been hindered by an economic slump of dramatic proportions—including a stock market collapse, a sustained decline in real estate prices, and eventually, the first case of deflation since the 1930s. After averaging more than 3.8 percent between 1974 and 1991, economic growth in Japan has dropped to 1.1 percent since 1991. While much attention has been given to the problems of Japanese commercial banks and their role in these developments, there are equally important problems in the insurance sector and government-sponsored financial institutions, such as the Housing Loan Corporation.

In “Sorting Out Japan’s Financial Crisis,” Anil Kashyap suggests that Japan’s banks, insurance companies, and government financial agencies are so closely connected that any reform plan will have to tackle all three sectors concurrently. However, each sector suffers from different problems that require different solutions, all of which impede the resolution of the crisis and increase the cost.

While many of the ingredients necessary for a successful resolution are clear, the financial crisis is sufficiently broad and deep that the necessary institutional changes cannot be initiated or implemented right away.

“Banks in Japan just aren’t very profitable,” says Kashyap. “The banks are going to have to shrink and reinvent themselves, but there is tremendous resistance to change.”

The difference between the amount of deposits and the value of the assets of the financial institutions is conservatively estimated to be 120 trillion yen. This means that fully paying back the depositors will require a transfer from the government, financed either through higher taxes or reduced spending on other programs. But one way or another, Japanese taxpayers will end up bearing the costs.

To put this figure in perspective, one can convert it into dollars, and using an exchange of 120 yen per dollar implies an infusion of \$1 trillion. Because exchange rates are so volatile, economists often



Don Dry

Anil Kashyap is Edward Eagle Brown Professor of Economics and Finance. Kashyap's research focuses on banking, business cycles, corporate finance, and monetary policy. He has been a member of the GSB faculty since 1991.

express this figure as a proportion of GDP, which for the last few years in Japan has been about 500 trillion yen. This suggests a transfer of roughly 24 percent of GDP, eight times the size of the U.S. bailout of savings and loans. (All subsequent figures will be stated in yen but can be converted using either of these two methods.)

“We are fighting over President Bush’s tax cut and whether it should be made permanent or repealed,” says Kashyap. “But the amounts involved are a spit in the ocean compared to what we’re talking about in Japan.”

### A Financial System in Disarray

The collapse of the Japanese stock market in the early 1990s may receive most of the blame for the current financial crisis, but Kashyap points out that the losses are too large and persistent to be the result of the asset price collapse alone. Banking sector problems also reflect the weakened condition of borrowers, and underlying corporate sector issues must be addressed.

Until the late 1990s, Japanese banks offset their losses by recognizing capital gains on long-held stocks and land. There is currently little left to be collected from these sources. Since 1992, banks have recorded losses of approximately 83 trillion yen, including 32 trillion yen in outright write-offs. Losses are expected to continue for the foreseeable future.

This lack of profitability represents an important

## New research estimates that taxpayer liability for the Japanese financial crisis will total at least 24 percent of Japan’s GDP.

barrier to streamlining the Japanese banking system. In basic terms, the problem is that the banks consistently fail to generate enough revenue on their loans and other assets to repay their depositors and cover their operating costs. But at a deeper level, Japanese banks have very few product niches where they can successfully compete against global competitors. While Japanese banks are among the largest in the world in terms of assets, they are not world leaders for most product lines.

“For most complicated banking products, you wouldn’t

trust the Japanese banks,” says Kashyap.

These shortcomings are aggravated by the fact that Japanese banks often have to compete domestically against subsidized government firms. Furthermore, bank employees’ salaries are too high given the workers’ competencies, and banks did not invest enough in technology during the late 1990s. As a result, Japanese banks lag far behind the technological efficiency of many of their global competitors.

As the losses have piled up, the banks have seen their capital levels dwindle; they are now close to the regulatory minimums. This has led Japanese banks to roll over loans rather than pulling the plug on bankrupt firms, because pulling the plug would further deplete capital. These bailouts and rollovers keep deadbeat borrowers in business and distort competition. Thus, fewer new firms are created and existing profitable firms are less likely to expand. The combination of insolvent banks lending to insolvent firms is depressing the economy.

“In normal times and normal economies, you see a lot of loan renewals,” says Kashyap. “But here it’s being used as a mechanism to avoid recognizing bad news and losses.”

### Double-Gearing

The life insurance sector is the second-largest part of the Japanese financial system. Kashyap estimates that insurance companies own 10 percent of the equity of each major Japanese bank. Japanese banks hold a significant amount of insurance company debt as well, usually in the form of subordinated loans or surplus notes.

As a result of this “double-gearing,” the amount of actual capital in each sector is overstated. The total amount of money needed to buy two firms linked in this way is less than the apparent value of each company, since a buyer purchasing one already gains a stake in the second. More importantly, any losses in one firm will spill over to the other. Since many Japanese life insurance companies are in poor financial condition, this hypothetical concern is of considerable practical importance.

Life insurance companies have many of the same problems as commercial banks: bad loans, exposure to changes in the stock market, and competition from government-sponsored institutions. But Kashyap suggests the bigger

problem is that insurers promised to pay their policyholders more than they have been able to earn. This has caused a number of life insurers to go bankrupt, and more are likely to fail in the next few years. In the meantime, the double-gearing should be reduced so that when these troubles surface, they do not lead to further banking problems.

### The Need to Compete with Subsidies

Government financial institutions provide an array of services in Japan, from life insurance to financing highway development. Many of these agencies are losing money and will require taxpayer buyout, which constrains the money available for insurance and banking restructuring.

Japanese banks and life insurance companies face stiff competition from government financial institutions. The postal system in Japan offers checking and savings accounts and sells life insurance. Besides offering the convenience of having 40 times the number of offices as the largest banking group, the postal savings program charges no maintenance fees and comes with the added benefit of a full government guarantee on deposits.

The postal life insurance program sells about one-third of the life insurance in Japan. Premiums paid into postal insurance accounts are often recycled to finance other (money-losing) government programs.

The government-subsidized Housing Loan Corporation (HLC) is another institution that compromises the commercial banking system's ability to make money through mortgage lending. The HLC passes on its subsidies as savings to consumers, and as a result it originates approximately 40 percent of all home mortgages.

These types of government-sponsored financial institutions will need to be reined in if Japanese banks are to regain profitability—a fact widely recognized outside Japan. However, these programs are popular with the public, who remain unconvinced that such programs are contributing to the banking troubles.

In 2002, Prime Minister Junichiro Koizumi appointed Heizo Takenaka as Japan's financial services minister. Takenaka subsequently formed the Financial Sector Emergency Response Project Team to study the bad debt problem. Takenaka's task force suggested the following: reducing the length of time that could be used to claim tax credit as part of banks' capital; tightening loan assessment standards; and forcing banks to increase provisions for

losses. However, many politicians have fought the Koizumi administration's reform efforts.

"Politicians know what needs to be done," says Kashyap. "It's just a question of imposing the pain."

A major public policy issue is whether government agencies should continue to compete with private-sector firms. The problems marring these government institutions include inadequate recognition of losses (sometimes reporting past losses on agency books as assets) and overvaluing physical assets.

The sheer size of the losses makes politicians hesitant to acknowledge them. Kashyap recommends building public recognition of the losses and suggests the following intermediate steps:

- Reduce the flow of government money to insolvent borrowers.
- Restructure the operation of unprofitable government-sponsored agencies.
- Level the playing field between government agencies and the private sector.

### When Will the Crisis End?

Kashyap warns that banking system problems will persist until problems with the insurance sector and government-sponsored financial institutions are addressed. The government will have to be willing to force the restructuring needed to create a profitable banking sector. These measures will inevitably lead to business closures and job losses.

The reluctance to address the underlying insolvency of the corporate sector partly accounts for the current gridlock. However, Kashyap sees an end to the crisis within the next decade.

"Eventually, when this crisis is resolved, the yen will likely weaken," says Kashyap. "I think 10 years from now, Japan's financial system will look a lot more like ours." ■

**ON THE WEB** To read the complete paper or to learn more about Kashyap's research, visit [gsbwww.uchicago.edu/news/gsbchicago/facultylinks.html](http://gsbwww.uchicago.edu/news/gsbchicago/facultylinks.html).

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For more information or to request a copy of Kashyap's paper, visit [gsbwww.uchicago.edu/news/capideas/](http://gsbwww.uchicago.edu/news/capideas/) or e-mail the editor at [capital.ideas@gsb.uchicago.edu](mailto:capital.ideas@gsb.uchicago.edu).

