Japan's Financial Crisis

Institutional Rigidity and Reluctant Change

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FOR MY PARENTS

Abbreviations

ATF	Bureau of Alcohol, Tobacco, & Firearms, U.S. Treasury Department
AVM	Administrative Vice Minister
BIS	Bank of International Settlements
BOJ	Bank of Japan
BOT	Bank of Tokyo
BOT-M	Bank of Tokyo-Mitsubishi
CBO	(U.S.) Congressional Budget Office
CD	Certificate of Deposit
CFTC	(U.S.) Committee of the Fair Trade Commission
CPC	Cooperative Purchasing Corporation
DICJ	Deposit Insurance Corporation of Japan
DKB	Dai-ichi Kangyo Bank
DPJ	Democratic Party of Japan
DSP	Democratic Socialist Party
EPA	Economic Planning Agency
FDIC	(U.S.) Federal Deposit Insurance Corporation
FILP	Fiscal Investment and Loan Program
FRC	Financial Reconstruction Commission
FSA	Financial Supervisory Agency (June 1998–June 2000) Financial Services Agency (from July 2000)
FTC	Fair Trade Commission
GDP	Gross Domestic Product
GNP	Gross National Product
IBJ	Industrial Bank of Japan
IFMP	Institute for Fiscal and Monetary Policy (of the MOF)
IMF	International Monetary Fund
IRCJ	Industrial Revitalization Corporation, Japan
IRS	(U.S.) Internal Revenue Service
JBA	Japanese Bankers Association
JCP	Japan Communist Party
JDA	Japan Defense Agency
JDB	Japan Development Bank
JGB	Japanese Government Bond
JETRO	Japan External Trade Organization
JICPA	Japanese Institute of Certified Public Accountants
JSP	Japan Socialist Party
KAMCO	Korean Asset Management Corporation

KDB	Korean Development Bank
LDP	Liberal Democratic Party
LIBOR	London Inter-bank Offer Rate
LTCB	Long Term Credit Bank
MAFF	Ministry of Agriculture, Forestry, and Fisheries
MCA	Management and Coordination Agency
METI	Ministry of Economy, Trade, and Industry (formerly known as MITI)
MFA	Ministry of Foreign Affairs
MHA	Ministry of Home Affairs
MHW	Ministry of Health and Welfare
MITI	Ministry of International Trade and Industry (known as METI from 2001)
MOC	Ministry of Construction
MOE	Ministry of Education
MOF	Ministry of Finance
MOJ	Ministry of Justice
MOL	Ministry of Labor
MOT	Ministry of Transportation
MPT	Ministry of Posts and Telecommunications
NAIC	(U.S.) National Association of Insurance Commissioners
NCB	Nippon Credit Bank
NPA	National Personnel Authority
NPL	Nonperforming Loan
NTA	National Tax Administration
NTT	Nippon Telephone and Telegraph
OB	"Old Boy" or alumnus/alumna
OCC	(U.S.) Office of the Comptroller of the Currency
ODA	Overseas Development Assistance
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
PARC	Policy Affairs Research Council (of the LDP)
RCC	Resolution and Collection Corporation
SDP	Social Democratic Party of Japan
SEC	(U.S.) Securities and Exchange Commission
SESC	Securities and Exchange Surveillance Commission
SMBC	Sumitomo-Mitsui Banking Corporation
SME	Small- or Medium-sized Enterprise
TSE	Tokyo Stock Exchange
UFJ	United Financial of Japan (Bank)

A Note on Conventions

Japanese personal names are presented throughout the text in Japanese form—that is, with the surname followed by the given name. An exception is made when a Japanese author is listed for an English language work. In such instances, the western form is utilized instead. Macrons have been used where appropriate in all cases except when the word in question appears commonly in English without macrons, as is the case with "Tokyo." All dollar figures converted from yen are given at the exchange rate prevailing at the time in question.

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While my doctoral research focused on explaining the breakdown in Japanese financial regulation through 1997, this book extends the time frame of analysis to include the process of institutional transformation that commenced thereafter. From 1998 to 2001, my research focused on this process of institutional change while a post-doctoral fellow (1998–2000), and then as a research fellow (2000–2001), in the Department of Political and Social Change, Research School of Pacific and Asian Studies, Australian National University (ANU). My time at ANU benefited tremendously from the support and feedback from numerous colleagues.

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The chapters that follow also reflect comments and feedback received at a number of academic forums. From 1999 to 2001, I was privileged to be a participant in the Heisei Bubble Research Group (*Heisei Baburu Kenkyūkai*) based in Tokyo and sponsored by the National Institute for Research Advancement. The project provided financial support to travel to Tokyo on a number of occasions. Additional support from the Department of Political and Social Change at ANU enabled me to extend these visits to carry out field research. I am grateful to Muramatsu Michio for the invitation to join the project and to Mabuchi Masaru, Kume Ikuo, and other project members for critical feedback on my work, and for enriching my understanding of the political and economic dynamics of the bubble and post-bubble periods.

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I am deeply indebted to many Japanese government officials, elected representatives, and industry actors who gave generously of their time to share insights and personal experiences, and introduced me to many others who did the same. Interviewees included numerous current and former officials of various ranks from Japan's Ministry of Finance, Bank of Japan (BOJ), Financial Supervisory/Services Agency (FSA), Ministry of Economy Trade and Industry (METI—formerly the Ministry of International Trade and Industry or MITI), Economic Planning Agency (EPA), and other government agencies and councils; Diet members representing the Liberal Democratic Party (LDP), Democratic Party of Japan (DPJ), Kōmeitō, and those with no party affiliation; policy secretaries of Diet members; current and former staff of the Japanese Bankers Association (formerly the All Japan Bankers' Federation); journalists, academics, and banking sector analysts; individuals sent from private and quasi-governmental corporations to work at some point in their careers on temporary assignment at the MOF; and, employees of Japanese and foreign banks and brokerages operating in Japan. My debt is particularly heavy to Furuya Masahiko, Hamanaka Hideichirō, Higuchi Yoshio, Itō Yutaka, Iwamoto Tatsuo, Karube Kensuke, Kawamura Tadaaki, Miyahara Takashi, Nagahara Yoshiyuki, Nishimura Yoshimasa, Nohara Satoshi, Nomura Eigo, Ōkubo Isao, Ono Masato, Sasajima Katsuhito, Shibanuma Shun'ichi, Taketani Atsushi, Tanaka Seiwa, Yoshida Satoru, Yoshida Yasuhiko, and Waki Yasuo. I alone am accountable for any errors in fact or interpretation.

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Introduction

FROM 1985 TO 1990, Japan experienced an asset bubble of unprecedented proportions. The Nikkei Stock Index surged in these five years from below 7,000 to over 39,000, while the price of other assets—and real estate, in particular—multiplied many times over. During this period, the central bank maintained an extremely loose monetary policy, holding interest rates at postwar lows. Japanese banks engaged in a lending frenzy and, in doing so, helped to fuel the surge in asset prices. They extended many loans for purposes of investment in the stock or real estate markets. They extended many more for the buildup of industrial capacity on a scale that could only be fully utilized if bubble-period consumption trends persisted.

From 1990, this bubble began to burst—first with a plunge in the Nikkei Stock Index, followed in early 1992 by a tumble in land prices. Both developments had a severe impact on the ability of corporate and individual borrowers to repay loans. The bursting of the bubble thus left banks throughout Japan—both large and small—in financial distress, burdened with massive amounts of bad debt.[1] This bad debt, in turn, weakened bank capital ratios, sharply raising their likelihood of collapse and severely impairing the capacity of banks to extend credit to new borrowers.

History is replete with financial crises, however.[2] In recent decades, many countries have experienced distress in their banking sectors, in particular.[3] Since the 1980s, crisis has struck several major Latin American and African countries, Russia, and numerous countries in East Asia. Even advanced industrial nations with highly advanced financial systems and seemingly strong banking regulators such as the United States and the Scandinavian countries have experienced severe crises. So, why a book about Japan's financial crisis? At least two features of the Japanese case stand out as distinctive; both are intimately related and pose important substantive and theoretical puzzles.

The first feature is the extraordinary delay by Japanese government officials before intervening to aggressively address the bad debt problem in the nation's banking system. The resolution of banking crises typically requires the use of public funds to recapitalize banks, augment the depositor safety net, and establish a temporary agency to take control of failed banks and dispose of their assets. Since an injection of public funds is always politically unpopular, governments often delay before mustering the political will to allocate taxpayer money to this end. Nonetheless, mechanisms seem to exist in other countries to spur a more prompt response to financial crisis than that seen in Japan.

According to an International Monetary Fund (IMF) study, those countries that made the greatest progress in the wake of financial crisis took a little less than ten months on average before embarking on systemic bank restructuring while those countries making the slowest progress took, on average, approximately four years.[4] In Japan, eight years passed from the onset of severe financial distress before the government initiated aggressive measures to tackle the bad debt problem and institute fundamental financial system reforms. As a result of this delay, what might have been relatively small costs of clean up in economic terms turned into staggering costs. By the time of this action, the amount of bad debt held by Japanese banks was estimated to total 1 trillion dollars or approximately 30 percent of the gross domestic product (GDP).[5] Clearly Japan's extraordinary delay places the country well outside even the upper bounds of normalcy.[6]

A second distinctive feature of the Japanese case is the ineffectiveness of the government's financial reform and recovery efforts, once initiated. As of this writing in mid-2003, thirteen years after the bursting of the bubble, Japan's financial sector problems remain unresolved. Indeed, regardless of the metric one chooses to use, financial reform outcomes have been abysmal to date. This is the case whether we measure success by the speed and degree to which confidence is restored to the financial system, the fiscal costs incurred in restructuring the financial system, or the length of the crisis recovery period, with recovery measured in such terms as percentage of nonperforming loans in the banking system or health of financial institutions as reflected in capital ratios or profitability.

The elusive outcomes are particularly puzzling on the surface given the seemingly dramatic nature of reforms implemented since late 1998. In October of this year, Japanese legislators at last readied large amounts of public funds for use in recapitalizing the banking sector. At the same time, they established a new legal framework for dealing with ailing banks, enhanced the independence of a newly established Financial Supervisory Agency, set up a commission to oversee financial reconstruction, revised the Deposit Insurance Law, and strengthened the functions of the Resolution and Collection Corporation (RCC), a newly established government-backed asset management corporation (AMC) to aid in the disposal of bad debt. In the wake of these changes, new norms emerged concerning appropriate relationships between regulators and financial firms, and new expectations about standards of transparency were likewise estab-