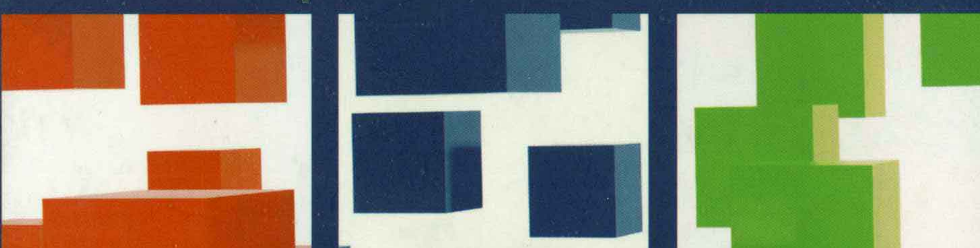
PALGRAVE MACMILLAN STUDIES IN BANKING AND FINANCIAL INSTITUTIONS
SERIES EDITOR: PHILIP MOLYNEUX

Japan's Financial Slump

Collapse of the Monitoring System under Institutional and Transition Failures



Yasushi Suzuki

Japan's Financial Slump

Collapse of the Monitoring System under Institutional and Transition Failures

Yasushi Suzuki
Professor of Finance, Ritsumeikan Asia Pacific University, Japan

palgrave
macmillan

First published 2011 by
PALGRAVE MACMILLAN

Palgrave Macmillan in the UK is an imprint of Macmillan Publishers Limited, registered in England, company number 785998, of Houndmills, Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan in the US is a division of St Martin's Press LLC, 175 Fifth Avenue, New York, NY 10010.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

ISBN 978–0–230–29034–1 hardback

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data
Suzuki, Yasushi, 1963–
Japan's financial slump : collapse of the monitoring system under institutional and transition failures / Yasushi Suzuki.
p. cm. — (Palgrave Macmillan studies in banking and financial institutions)
Includes index.
ISBN 978–0–230–29034–1 (hardback)
1. Bank failures—Japan. 2. Banks and banking—Japan. 3. Financial institutions—Japan. 4. Financial crises—Japan. 5. Nihon Choki Shin'yo Ginko. I. Title.
HG3767.J34S99 2011
332.10952—dc22 2011002016

10 9 8 7 6 5 4 3 2 1
20 19 18 17 16 15 14 13 12 11

Printed and bound in Great Britain by
CPI Antony Rowe, Chippenham and Eastbourne

Preface

The arguments contained in this book are based primarily on the perspective of institutional requirements of a financial system to perform its *credit monitoring and supervising* functions. This book, I believe, explores a new hypothesis that can help to shed light on why the Japanese banks and regulators are still trapped in a unique type of 'transition failure' at the end of the 2000 decade.

My analysis suggests that it was not feasible for the Japanese financial system to effectively transform into the Anglo-American system for a number of reasons. In particular, in the latter system, individual investors and households have demonstrated a willingness to absorb the risk and uncertainty implicit in investments in the corporate sector in a frontier economy. This broad investor base was absent in the Japanese economy. The types of financial institutions that may work better in the Japanese frontier economy require further institutional analysis and practical experimentation. Meanwhile, it is very important to recognize the significance of improving the 'hybrid' system that characterizes the Japanese financial sector, consisting of both an emerging 'direct-finance' market and a predominant 'indirect-finance' market. In particular, an efficient indirect-finance mechanism run by banks is still critical for the overall Japanese financial system. It follows that Japanese banks have to develop and adapt their monitoring system for the corporate sector because this type of long-term lending is not amenable to a fully codified and algorithmic mode of monitoring as was implicitly attempted in the *Big Bang* and subsequent reforms in Japan.

This book recognizes that the traditional system of monitoring by lead banks had run into trouble and could not be continued. But we believe that lead banks could have exercised a substantially higher degree of effort in collaboration with regulators to use the network relationships that they had enjoyed to develop new ways of classifying and monitoring uncertainty and risk. A reform attempt that built on the strengths of the Japanese financial system rather than attempting to abandon it entirely would probably have had a greater chance of success and would have been more consistent with Keynes and post-Keynesian heterodox analysis of the non-quantifiability of uncertainty in frontier investments. This book does not propose an alternative financial structure because such a structure can only be constructively adapted through a process of trial and error. Rather, our policy conclusion is that the direction of experimentation in Japan has not been the most effective one.

This book challenges the conventional explanations of Japan's prolonged financial slump and suggests a different set of failures that affected the Japanese banking system. We argue that, firstly, an important driver behind the structural failure was the inability of Japanese banks to respond to the 'uncertainty' created in the economic environment as a result of the changes introduced in the 1980s as Japanese banks tried to integrate into a global financial market in a context in which Japan was itself transforming from a 'catching-up' economy into a frontier one. Secondly, we argue that the problem of adaptation was in fact compounded by an ill-planned transition to the Anglo-American monitoring system and Basel requirements. This new system failed to address how Japanese lenders were to manage intensifying uncertainty in the new international system *given the specificities of the Japanese financial context*. Finally, we argue that the internal collapse of *trust* in the system can explain how the Japanese financial system has fallen into a unique type of 'transition failure' that prevents it from responding to the obvious failings of its financial structure. We suggest that these problems result from a significant lack of complementarity between the viable parts of the pre-existing Japanese financial system and the parts of the Anglo-American system that were being added. In other words, the emergent 'mixed' institutional structure had more serious problems compared to the pre-existing 'main bank' system or the coherent versions of Anglo-American banking system operating in countries where it had gradually evolved over time.

Acknowledgements

The collapse of the Long-Term Credit Bank of Japan (LTCB) was not only a collapse on a scale that shocked most observers, it also revealed significant features of the ongoing Japanese financial slump. The causes that beset the LTCB turned out to be quite general ones affecting a wide swathe of Japanese banks. How can we make sense of the LTCB collapse? This was the motivation for the writing of this book, because I was in the collapse as a bank manager.

In the first place, I would like to express my gratitude to Mushtaq Khan for his advice throughout my research. I owe my biggest debt to him. He provided me with continuous encouragement and support with his truly academic rigour and passions in research, which exceptionally enriched my growth as an academic. I also sincerely thank Gabriel Palma and Ha-Joon Chang who kindly provided helpful and valuable suggestions.

I am grateful to those seniors and colleagues at the LTCB, who encouraged and supported my research as well as the subsequent academic life. During my stay in the LTCB I had a satisfying working life with many supervisors and colleagues. Particular thanks are due to Koji Hirao, Akira Kagiichi, Masaharu Kuhara, Mike Tanji, Hiroshi Sasaki, Al Arakawa, Tetsuya Fujisaki, Kotaro Aoki, Chen H-F., Yasuyuki Matsumoto, Seiji Shintani, Masaaki Sakaguchi, Hiroyuki Miyake, Katsuhiko Fujimoto, whose continuous help in different ways, even after I left the bank, was invaluable.

I benefited substantially from discussions with Yoshimasa Nishimura at Waseda University and Kotaro Tsuru at the Research Institute of Economy, Trade and Industry. They read parts of the earlier versions of the manuscript and made helpful comments.

I would also like to acknowledge the encouragement of Masanori Namba, the former Dean of the College of International Management of Ristumeikan Asia Pacific University (APU), and Susumu Yamagami, the former Dean of the College of Asia Pacific Studies of APU during my research. In addition, six consecutive years of my academic life at APU gave me time to contemplate the arguments in this book. The support, comments and criticisms from my colleagues were invaluable. In particular I would like to acknowledge Md. Dulal Miah, Bishnu K. Adhikary, A.S.M. Sohel Azad and Manjula K. Wanniarachchige.

This book reminds me of my old days of research at the School of Oriental and African Studies (SOAS) and of good times with my friends, including Gaku Kato, Henry Ma, Yasuyuki Matsumoto and An-Yu Shih. I am grateful to Yasuhiro Tsutsumiguchi, Vibhav Upadhyay and Neerendra Upadhyay who kindly supported these good years at London.

Finally, I would like to thank my wife, Akiko Suzuki, for her constant support. During the last 15 years, we have moved to various places: Jakarta, Singapore, Holborn, New York, Putney, Marble Arch, Kanazawa, Tokyo and Beppu. Without her encouragement and significant contributions, this research – along with the long journey – would not have been completed. This book is dedicated to her.

Yasushi Suzuki

Contents

List of Tables

List of Figures

1
Introduction and Summary

1.1 Fundamental questions about Japan's financial monitoring system

In the 1980s, Japan's financial system – and, in particular, its banking system – was the largest in the world. In terms of loan asset size nine of the world's top ten banks were Japanese, including the Long-Term Credit Bank of Japan Limited (LTCB). They were expanding their international banking operations vigorously and accounted for 34 per cent of the world's international lending business, supported in part by the strength of the Japanese Yen. Today, the picture is very different. In contrast to the buoyant 1980s, the 'bank-led' financial system has been in a slump. The LTCB collapsed in October 1998. Japanese banks, with the exception of the Mitsubishi-UFJ Financial Group,[1] no longer rank among the world's top ten and their credit ratings have declined dramatically.

What has caused this dramatic change in fortunes? For one, a large proportion of the non-performing loans (NPL) held by the Japanese banking sector became a drag on its economy after the bursting of the 'bubble'. Particularly until the mid-2000s, Japan had been trapped in a vicious circle, where a massive overhang of non-performing debt in the banking sector hampered the growth and recovery of the whole economy. At the same time, lingering economic stagnation exacerbated the overhang. Fundamentally, effective screening and monitoring by lenders and investors are critical for the proper functioning of financial markets, at least in terms of preventing the rapid build-up of NPL. In normal financial markets, it is the case that individuals and firms usually seek more funds than there are available. From the perspective of asymmetric information facing lenders and borrowers, the efficient allocation of scarce funds requires *ex ante* monitoring by lenders for selecting projects to be funded, *ongoing* monitoring to track how the allocated funds are used, and then *ex post* monitoring to identify financial outcomes and take action based on them. To the extent that lenders and borrowers face fundamental uncertainty (in the sense that the *ex ante* risk associated with many investment activities is arithmetically unquantifiable), the lender's ongoing monitoring activities become even more significant and are now required on a continuous basis to protect the lender.

It is widely argued that the accumulation of a huge volume of NPL in Japanese banks represented a malfunction of the traditional mode of monitoring. Commonly accepted theories suggest that (1) this problem was due to a *protective* institutional framework in the traditional 'main bank' and 'convoy' monitoring system (see section 3.3 for details), which created a false sense of security that Japanese banks would not be allowed to go bust. This in turn created a moral hazard problem since banks arguably believed that any dismal loan portfolio would be finally bailed out by the regulator (for instance, see IMF 2000; Patrick 1998; Saito 1998; Harada 1999; Takeda 2001; Hoshi and Kashyap 2001; Ikeo 2006). Other theories suggest that this problem was compounded by (2) Japan's slow process of transforming its traditional system towards the Anglo-American mode of monitoring promoted in the name of financial deregulation by the US since the mid-1980s (for instance, see IMF 2000; Cabinet Office 2001; Kanaya and Woo 2000; Chan-Lau 2001; Miyoda 1994). This book challenges these theories and suggests that as far as arguments such as (1) above are concerned, moral hazard was a relatively minor problem for the Japanese banking system as it had its own effective form of monitoring. Rather, the crisis can be better explained in terms of an intensification of 'uncertainty' which magnified previously manageable structural and institutional problems in the Japanese financial system. In respect of arguments like (2) above, the book argues that it was in fact the badly planned transition to an monitoring framework based on the Anglo-American and Basel model that further contributed to Japan's prolonged slump in financial intermediation. In order to justify these objections, this book aims to analyse the institutional change in the Japanese financial system from the point of view of the institutional setting necessary for carrying out an effective reform of its mode of monitoring. The mode of monitoring here includes the method of credit risk screening and monitoring by banks as lenders (or investors in general), as well as the mode of monitoring and supervising by the financial authorities as regulators and monitoring agents of banks. This book suggests that the institutional failure in the transition of the mode of monitoring was the root cause of the prolonged financial stagnation after the hard landing of the bubble economy.

This book aims to answer the following questions:

1 Why was the Japanese traditional mode of monitoring, which had been fairly effective during the high-growth period, no longer effective? What institutional characteristics of the traditional mode were effective during the high-growth period and what institutional settings were hindering effective monitoring in the subsequent period? How can we understand the relation between the institutional settings and the associated costs of monitoring?
2 Given the external pressures to change from the higher cost of monitoring in the traditional mode to the Anglo-American and Basel mode of monitoring, to what extent was the transition feasible? What were the foundations and institutional settings necessary for the transition to the Anglo-American and Basle-type mode? Did Japan possess these foundations?

1.2 Economic realities

To analyse the factors that constrained screening and monitoring activities, which had an impact on Japan's prolonged financial slump, this book divides the structural change in Japan's economy into the following phases:

1 The 'catching-up' period, that is, the period up to the mid-1970s when Japan's economy enjoyed 'high economic growth'.
2 The 'moderate economic growth' period from the mid-1970s until the hard landing of the 'bubble' economy. During this period, many Japanese industries had already reached the international technology frontier. By the end of this period, Japan had become what we can describe as a 'frontier economy' in terms of technology.
3 The period of prolonged 'economic and financial stagnation' since the onset of financial crisis when the bubble finally burst.

In the 'catching-up' period, when Japan's economy was trying to catch up with that of the US, the business model of absorbing and improving engineering know-how absorbed from abroad made a substantial contribution to Japan's high levels of economic growth.

This period was ended by the 'Oil Shock' of 1974. During the subsequent 'frontier economy' era, many Japanese industries were getting closer to or even reaching the international technology and marketing frontier. A number of empirical studies have observed a trend of 'internationalization' and 'technological change' in Japanese firms since the mid-1970s (Aoki *et al.* 1994; Schaberg 1998; Patrick 1998; Kanaya and Woo 2000; Hoshi and Kashyap 2001). This book suggests that the trend of internationalization and technological change intensified in the mid-1980s. Furthermore the frontier economy had seen a substantial increase in the share of the tertiary sector in the overall economy. It can be reasonably argued that the development paradigm for the Japanese economy shifted to that of a frontier economy around 1975. This period also comes to an end around 1991 when the financial bubble that had been developed eventually burst and the adverse macroeconomic consequences became significant. As a result, we take 1992 to be the starting point of the prolonged economic and financial slump. Table 1.1 illustrates the average real GDP growth rate in each phase.

This book considers the structural and macroeconomic environment changes that led to changes in the modes of monitoring used by Japanese banks from the catching-up period to the frontier economy period. We identify a number of 'structural failures' and 'transition failures' in the evolution of new modes of monitoring as the root cause of Japan's lingering financial slump. Structural failures refer to inadequacies in the structure of the new institutions for achieving efficiency, including efficient levels of monitoring, while transition failures refer to inadequacies in the pace and direction of institutional change to achieve better efficiency over time (Khan 1995).

Table 1.2 shows the typical changes in the sectoral shares of different types of activities in the Japanese economy as it matured over the period we are discussing in the three phases. From these data, it is evident that the shares of primary and secondary sectors were in decline, while the share of the tertiary sector was on the increase.

Table 1.1 Japan's average real GDP growth rates (at constant prices)

1966–1974[a]	*1975–1991*[a]	*1992–2008*[b]
8.82% p.a.	4.05% p.a.	1.20% p.a.

Notes: [a]base year = 1990, [b]base year = 2000.
Source: Author based on statistics of Cabinet Office and ESRI (2008).

Table 1.2 The changes of the share of each industry in Japan's GDP (at current prices)

Sector	*1966–1974[a]*	*1975–1991[a]*	*1992–2008[b]*
Primary	7.5%	3.8%	1.8%
Secondary	40.7%	36.7%	28.5%
Manufacturing	*33.5%*	*27.9%*	*21.3%*
Tertiary	51.8%	59.5%	69.6%

Source: Author based on statistics of Cabinet Office[a] and ESRI (2008)[b].

The recent stagnation of the Japanese economy, together with periods of negative growth, can be observed in Figure 1.1. One reason which has been suggested for this prolonged economic slump is the structural failure in the intermediation of financial resources (Cabinet Office 2001, 2008; Hoshi and Kashyap 2001; Ikeo 2006; Tsuru 2006). Since the mid-1990s the government had been operating its monetary policy of increasing the money supply. In spite of this, the level of lending by private banks was falling. The outstanding loans towards small and medium-sized enterprises (SME[2]) had dropped sharply – from ¥344.9 trillion in December 1998 to ¥260.3 trillion in December 2003, then to ¥253.1 trillion in December 2009 (see Figure 1.2). Clearly, the Japanese banks were very conservative when it came to assessing the credit risks of SME. According to SMEA (2009), the Survey on SME Business Conditions, which surveyed about 19,000 SME, including enterprises with capital of less than ¥20 million that were not covered by the Bank of Japan (BOJ) National Short-Term Economic Survey of Enterprises in Japan (referred to as *BOJ Tankan*), indicated that the SME's business conditions DI (Diffusion Index) continued to decline for 12 consecutive quarters, from second quarter of 2006 to first quarter of 2009. The Business conditions DI in the fourth quarter of 2008 had been the worst since the revision of the survey contents in 1994, until a new record was made in the first quarter of 2009.

The argument in this book has implications for such explanations of Japan's prolonged and deep financial slump. Explanations[3] that place much of the blame on the Ministry of Finance (MOF) as the regulator for persistent failures of omission and commission from the bursting of the bubble to the nationalization of the LTCB are insufficient. Such theories fail to explain why policy errors apparently continued over such a long period. In particular, why did the regulator change the financial policy radically to an Anglo-American rules-based supervision system, which had an adverse effect on banks that were already in financial trouble?