(Japanese cases)

Is the 90's the lost decade? Could they help us now?

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Disclaimer

The views I expressed are my own and not necessarily the views of the FLB or the BOJ.

Purpose of my presentation

- Try to give you some clues to look back Japanese cases in and after 1990's.

(FNs)

- History repeats itself.
- Each history should be interpreted in the context.

Shirakawa (2008) at International Conf. hosted by IMES of BOJ (May 28)

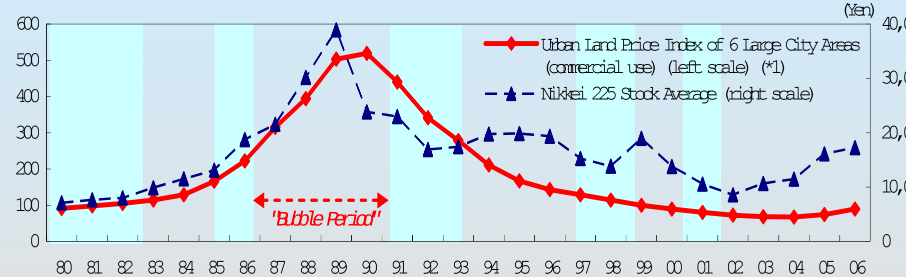
"There are also similarities. Arguably, the bubble was formed, expanded, and burst. It is also common in both cases that a plunge in asset prices exerted adverse effects on the real economy through the deterioration of the financial side. Based on Japan's experience, how the negative feedback loop of tighter financial conditions, a decline in asset prices, and the deteriorating real economy will evolve could be key to the future course of the economy. ..."

What caused the Japanese financial crisis?

- Sharp swings in asset prices
  - Real estate, stock and ...
- Destabilizing effect on financial institutions
- Deteriorating effect on real economy
- Vicious feedback loop lead to piles of non-performing loans and...

Bubble Economy and its Collapse in Japan

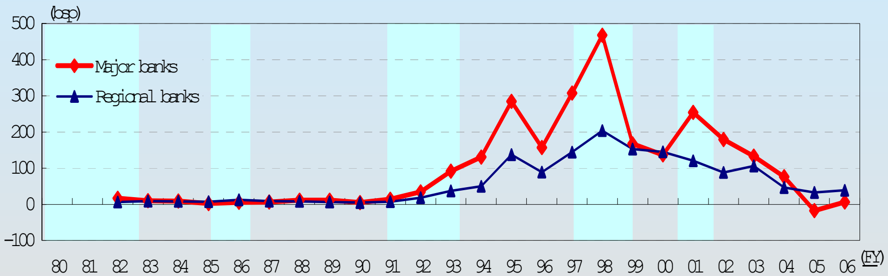
(1) Urban Land Price Index (Commercial Use) and Nikkei 225 Stock Average



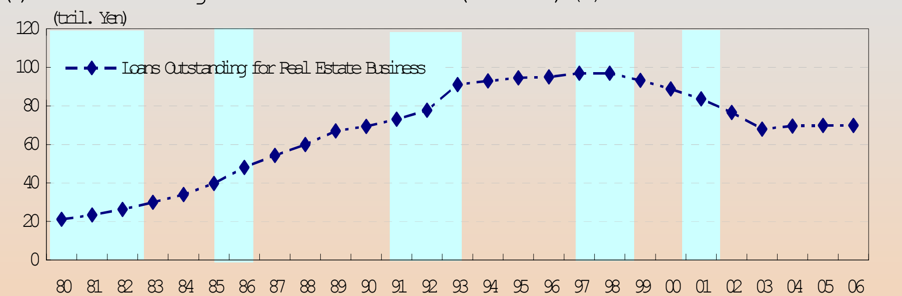
(Source) Japan Real Estate Institute, Nippon Keizai Shinbun

Left scale: (End of FY)
Right scale: (End of CY)

(4) Credit Cost Ratio (*3) (*4)



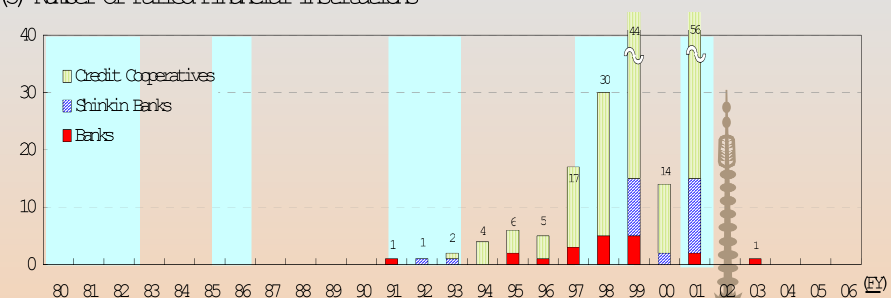
(2) Loans Outstanding for Real Estate Business (All Banks) (*2)



(Source) Bank of Japan, "Financial and Economic Statistics"

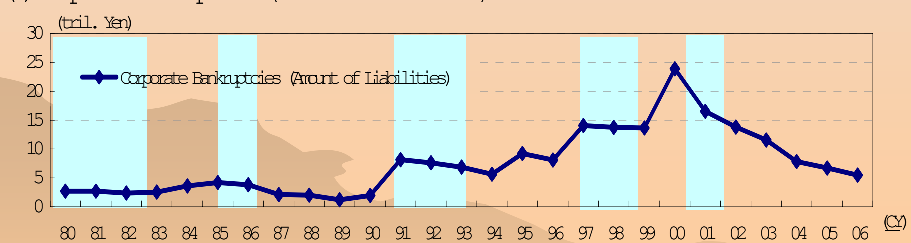
(End of CY)

(5) Number of Failed Financial Institutions



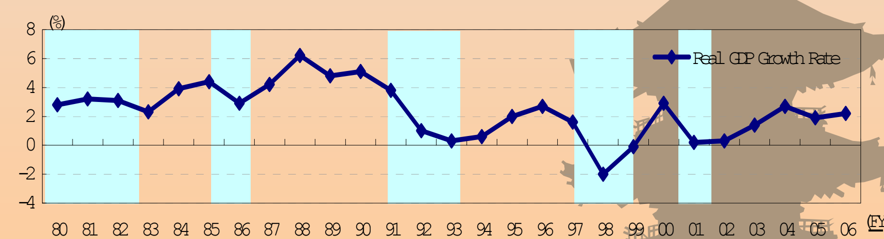
(Source) Deposit Insurance Corporation of Japan

(3) Corporate Bankruptcies (Amount of Liabilities)



(Source) Tokyo Shoko Research Ltd.

(6) Real GDP Growth Rate



(Source) Cabinet Office, "National Accounts"

(Note) 1. 6 major cities refer to Tokyo, Yokohama, Nagoya, Kyoto, Osaka and Kobe. Base period of the index is the end of FY1999 (End of Mar. 2000) (= 100).
2. Real estate business = Real estate + Construction
3. Credit Costs include (1) net transfers/reversals to loan-loss provisions, (2) write-offs, and (3) losses incurred when nonperforming loans are disposed of or are sold to external parties. Data before 1981 is unavailable.
4. Credit cost ratio = credit costs/total outstanding loans. From fiscal 2000 to 2006, the figures include credit costs of subsidiary companies for corporate revitalization.
5. Shaded area indicates recessions.

Underlying Factors?

- Myth on land price (California vs. royal palace)
- Whimsy valuation for loans and accounting for financial instruments

- Myth on financial institutions (→inadequate safety net, e.g. bankruptcy procedure and deposit insurance)
- Use (Injection) of taxpayers' money into financial institutions
- Competitiveness of financial institutions (incentive mechanism)

- Legal infrastructure

Quick Chronology

1992 First case for the use of assistance from the DIC

1995-96 Credit unions and regional banks failed
Housing finance companies (non-banks) problem

1997 Sanyo-Hokutaku-Yamaichi

1998 LTCB

1995-96 still early stages

- Issues on Liquidity
  - BOJ provides LLR when appropriate
- Housing finance companies (non-banks) problem
  →political issues on public money
  →optimistic reorganization plan, forbearance?
- Whimsy valuation for loans and accounting for financial instruments?
  - refinancing for interest payments
  - mark-to-market, lowest value, book value
- Board responsibility
  - whose fault? Business judgment or macro-circumstances?
  - euphoria for re-bubble? Forbearance again?

Financial Market Turmoil in Nov. 1997

- Failure of Sanyo Securities
  - First default in the history of the interbank market
- Failure of Hokkaido-takushoku Bank
- Failure of Yamaichi Securities
  - 18 overseas subs

Legislative response: Financial Stabilization Law (capital injection: 1.8 trillion yen)

Cf. monetary policy: discount window rate had been 0.5% since 1995. Zero interest rate policy started from 1999. Quantitative easing 2001-2006.

Oct. 1998 LTCB

- Desperately seeking for alliance with other financial institutions, but at end it failed.
- Temporary nationalization (special public management)

  -Issues on netting; events of default

- Legislative response:

Oct. 1998 Laws on emergency measures for revitalization and early strengthening of financial functions

(temporary nationalization,

capital injection: 8.6 trillion yen)

In 2000's……

2002 FSA Program for Financial Revival (work schedule)

2003 Bottom of Stock price (Nikkei below 8000)

2007 FSA Plan for strengthening the competitiveness of Japanese financial and capital markets

Underlying Factors Revisited

- Myth on land price

→→ Myth exploded

- Whimsy valuation and accounting
  (in a worse case, inspection evasion)

→→ DCF, ASBJ and so on

→ Accurate and timely recognition of losses are important.

→ Swift removal of impaired assets is also important.

Underlying Factors Revisited (cont.)

- Myth on financial institutions

→→ Safeguards have emerged. Series of revision of Deposit Insurance Law and relevant legislation (incl. emergency measures)

--- Financial assistance, Purchase of assets, Bridge bank, Full guarantee of all liabilities, Capital Injection, Nationalization

- Initially, to inject taxpayers' money had been opposed fiercely, but finally, based upon relevant legislation enacted, the public money was injected

Underlying Factors Revisited (cont.)

- Competitiveness of financial institutions

- Legal infrastructure

→→ Insolvency law reforms (total revision of Bankruptcy Law and Corporate Reorganization Law, enactment of Civil Rehabilitation Law, relevant revision on law on collateral<secured transaction>)

---to reduce NPLs, borrowers had to be reorganized or liquidated.

Cf. Third wave of law reform (Companies Act, Trust Law, Financial Instruments and Exchange Law)

Wrapping-up
More general comments

- It took years!

  What should have been done more speedily?

  - Accurate and timely recognition of losses
  - Effective internal control
  - Prompt corrective action
  - Prompt resolution with robust safety net
  - Swift removal of impaired assets
  - Replenishment of capital

  However, no annual 30% decline in real economy

  - nevertheless, the speed is important
  - ex post, the bottom of stock price was 2003.
  - ex ante, it might be difficult to declare it is over...

More general comments

- Necessity for adequate legal & regulatory infrastructure
  - Ad hoc emergency measures
  - Robust financial safety net
  - General legal reform
    - Meiji Restitution, WW , Third Wave
    - Rule of Law; Rules stipulated in the codes are more utilized.
    - Maybe calling it “lost decade” is not necessarily right
- Much has been achieved institutionally, although competitiveness of financial institutions and capital markets should be improved significantly
  - this objective has been recognized since two decades ago
    - Banks played predominant role in financial intermediations
    - Necessity to improve the competitiveness of CMs
    - Maybe calling it “lost decade” is not necessarily wrong