Japanese Financial Crisis and Crisis Management

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Japan Center for Economic Research
Mitsuhiro Fukao
fukao@jcer.or.jp
Origin of Japanese Financial Crisis in 1997-2002

Speculative bubble in real estate and stock markets

1. Overheating of the economy in 1987-88 and slow response of monetary policy
   - Excessive loosening of monetary policy after a large appreciation of
     the yen after the Plaza agreement
   - Excessive response to the sharp temporary fall in stock prices in 1987

2. Tax distortions favoring real estate investment
   - Inheritance tax and corporate income tax favored unrealized capital gains
     in real estate

3. Excessive reliance in real estate collateral by banks

4. General perception that real estate prices will never fall

5. Real estate prices started to fall in 1990 after the monetary policy tightening in 1989
Notes: 1. Urban Land price index (6 large urban areas, second half of fiscal 1999 <end of Mar. 2000>=100) / Nominal GDP index (second half of fiscal 2000=100)
2. Data until second half of fiscal 1979 = 68SNA basis
Data from first half of fiscal 1980 = 93SNA basis
Market Value GDP Ratio
Tokyo Stock Exchange 1st Section
Origin of Japanese Financial Crisis in 1997-2002

Sharp appreciation of the yen in 1995 pushed Japan into mild deflation

Real Effective Exchange Rate of Japan

Source: Bank of Japan
Origin of Japanese Financial Crisis in 1997-2002

Increasing distrust of disclosures by financial institutions

1. Financial institutions and regulators postponed the disposal of bad loans
   Deterioration of non-bank housing loan companies (Jusen companies) was obvious by 1992-93 but MOF did not move
   In 1995, MOF finally used public money to take care Jusen failures
   Strong negative public opinion on the use of public money tied hands of the MOF until the financial crisis in 1997-98

2. Distrust on external auditors and financial supervision gradually increased
   Banks postponed the recognition of loan losses by window dressings
Financial Crisis of 1997-98

Successive failures of financial institutions started a panic in the market

November 4, 1997:  Sanyo Securities filed bankruptcy

   First failure of a publicly listed security company since the war

November 17, 1997:  Hokkaido Takushoku Bank asked BOJ for emergency loan

   First failure of a City Bank since the war

November 22, 1997:  Yamaichi Securities started voluntary liquidation

   One of top four security companies failed.

March 1998:  First capital injection (1.8 trillion yen for 21 banks) was too small to stabilize the market
Financial Crisis of 1997-98

A severe credit crunch started at the end of 1997

Diffusion Index of Lending Attitude of Financial Institutions
(Based on the Short-term Economic Survey of All Enterprises in Japan < 'Accommodative' - 'Severe' >; % points)
Financial Crisis of 1997-98

The turmoil in the financial market deteriorated as the Diet was debating laws to stabilize banks.
Financial Crisis of 1997-98

The turmoil in the financial market deteriorated as the Diet was debating laws to stabilize banks.

October 1998: Diet finally passed a strong and usable bankruptcy law for banks and a law for public capital injection.

    All the LTCB shares lost value.

    All the NCB shares lost value.

    Succeed to stabilize financial market: Japan premium largely disappeared.
Crisis Management by the Government (1)

July 1995: Ministry of Finance announced that DIC would protect all deposits for five years (until then, insurance was limited to 10 million yen per person)

June 1996: Deposit Insurance Law was amended to allow DIC to protect all deposits and other liabilities of banks until March 2001

March 1998: First attempt of recapitalization of banks by the government could not stabilize the market

October 1998: The Diet passed Financial Revitalization Act (bankruptcy procedure for banks without stopping payments) and Bank Recapitalization Act
Crisis Management by the Government (2)

March 1999: Second attempt of recapitalization by the government could stabilize the market

- Japan premium mostly disappeared by the injection
- Could not stop deterioration of bank asset due to recession

March 1999: Bank were allowed to show deferred tax asset by new accounting standard

- Deferred tax asset was much abused by banks to show fake asset
- FSA tacitly approved this abuse

By 2002-03: Bank capital was almost depleted due to new bad loans

- Capital injection without economic recovery did not work
## Capital in the Japanese banking sector

<table>
<thead>
<tr>
<th>Market value of shares held by banks (trillion yen)</th>
<th>Book value of shares held by banks</th>
<th>Capital account (Core capital)</th>
<th>Deferred tax asset</th>
<th>Estimated Under-reserving</th>
<th>Equity capital held by the government</th>
<th>Net capital account</th>
<th>Nikkei225 Index</th>
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<tbody>
<tr>
<td>A</td>
<td>B</td>
<td>C</td>
<td>D</td>
<td>E</td>
<td>F</td>
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Note: The table represents the banking accounts of all banks in Japan.

Estimated required loan loss reserves is defined as follows:

- 1% of category I loan + 20% of category II loan + 70% of category III + 100% of category IV loan

Since FSA terminated to disclose classified loan figures from March 2003, the classified loan figures and the required loan loss reserves were estimated from the disclosed bad loan figures.
## Profitability of Japanese Banking Sector

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<td>Other Revenue (B)</td>
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<td>Operating Costs (C)</td>
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<td>Salaries and Wages</td>
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<td>Gross Profit (D)=(A)+(B)-(C)</td>
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<td>2.0</td>
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<tr>
<td>Net Operating Profit (F)=(D)-(E)</td>
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<td>2.5</td>
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<td>-7.0</td>
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<td>-1.0</td>
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<td>2.7</td>
<td>5.4</td>
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<td>3.3</td>
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<td>Realized Capital Gains (G)</td>
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<td>2.0</td>
<td>3.2</td>
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<td>3.6</td>
<td>1.4</td>
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<td>-2.4</td>
<td>-4.1</td>
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<td>-0.1</td>
<td>0.5</td>
<td>0.2</td>
<td>0.1</td>
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<tr>
<td>Net Profit (F)+(G)</td>
<td>3.8</td>
<td>3.3</td>
<td>2.5</td>
<td>1.7</td>
<td>1.0</td>
<td>-2.6</td>
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<td>1.1</td>
<td>2.6</td>
<td>5.9</td>
<td>4.7</td>
<td>3.4</td>
</tr>
</tbody>
</table>

| Asset | 927.6 | 914.4 | 985.9 | 849.8 | 845.0 | 847.1 | 858.4 | 845.0 | 762.5 | 741.9 | 806.0 | 772.1 | 739.0 | 750.0 | 748.3 | 770.2 | 764.5 | 782.0 |
| Outstanding loans | 522.0 | 537.0 | 542.4 | 539.1 | 538.5 | 553.6 | 563.3 | 536.4 | 492.4 | 475.9 | 474.1 | 464.5 | 435.0 | 422.5 | 414.0 | 428.1 | 435.9 | 446.0 |

Note: Financial Statement of All Commercial Banks.

Other revenue (B) includes all the other profit such as dealing profits and fees but excludes realized capital gains of stocks and real estates.

Realized capital gains includes gains of stocks and real estates.

Source: Japan Center for Economic Research (2008)
March 2003: Many weakened banks were allowed to operate by showing massive deferred tax asset (DTA)
FSA adopted forbearance policy and waited for economic recovery
Too many bad banks for the government to nationalize

May 2003: Government injected 2 trillion yen of capital to Risona Bank as a sound bank even though it was clearly insolvent
Market rallied (so called moral hazard rally)

November 2003: Ashikaga Bank, a big regional bank was nationalized
## The Ratio of Deferred Tax Asset in the Core Capital of Major Japanese Banks

March 2003

<table>
<thead>
<tr>
<th></th>
<th>Core Capital (A) Billion yen</th>
<th>Net DTA (B) Billion Yen</th>
<th>Ratio (B/A) Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mitsubishi Tokyo Financial Group</td>
<td>3,338</td>
<td>1,303</td>
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<td>UFJ Holdings</td>
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<td>1,522</td>
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<td>Resona Holdings</td>
<td>635</td>
<td>522</td>
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<td>Sumitomo Mitsui Financial Group</td>
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<td>Mistui Trust Holdings</td>
<td>341</td>
<td>346</td>
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Source: Disclosure materials of individual banks.

Notes: Net DTA means deferred tax assets minus deferred tax liabilities.
### Distribution of Adjusted Capital/Asset Ratio of Major Japanese Banks

<table>
<thead>
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<th></th>
<th>Total</th>
<th>Less than -2%</th>
<th>-2% to 0%</th>
<th>0% to 2%</th>
<th>2% to 4%</th>
<th>4% to 6%</th>
<th>More than 6%</th>
<th>Weighted Average %</th>
<th>Nikkei 225 index</th>
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**Notes**

- Major banks include city banks, long-term credit banks, and major trust banks.
- We excluded three new but small trust banks; Nomura Trust, Mitsui Asset Trust, and Resona Trust.
- Two privatized long-term credit banks after nationalization maintain "More than 6%" capital.
- Adjusted Capital = Core Capital + Unrealized Capital Gains and Losses
  - + Loan Loss Reserves - Estimated Required Loan Loss Reserves
  - - Deferred Tax Asset
- Estimated Required Loan Loss Reserves = 100% of defaulted loans + 70% of risk loans
  - + 20% of doubtful loans + 1% of normal loans
- Adjusted Capital/Asset Ratio = Adjusted Capital/Gross Asset

**Source:** Japan Center for Economic Research (2001a, 2003b, 2006)
Strong Export Led Recovery since 2003 Cured Japanese Banks

The world financial crisis may undermine Japanese financial system

Industrial Production of Japan (2005=100)
Necessary Reforms to improve the quality of world financial system

Due diligence of all the major financial institutions is necessary.

The cause of the very high loss-ratio (91%) of Lehman debt should be investigated and the result should be released to the public.

- Yamaichi: 3% loss rate, Kizu Credit Union: 77% (the worst case in Japan.)
- Nippon Credit Bank: 29%, Long-term credit bank of Japan: 12%.

The government should establish a high degree of transparency on the financial statement of major financial institutions.
References


