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The Facts of the Japanese Financial Crisis

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There would be no objection among economists to the view that the two most serious economic problems of the 20th century were the Great Depression of the 1930s and the financial crises of the late 1980s to early 1990s in the United States, Europe, Japan, and newly industrialized East Asian countries. Of course, the former was really *the* great depression—the deepest worldwide depression, which inflicted immense damage not only upon the United States but also the entire world. However, the current depression in Japan is not the type of recession that is part of ordinary business cycles, which Japan has experienced several times since the end of World War I.

Ordinary and Extraordinary Business Cycles and Economic Crises

The extraordinary nature of the present Heisei depression is revealed in the prolonged, 10-year stagnation of Japan's economy, the huge socioeconomic losses, and the lack of evidence for a vigorous recovery. A common feature of the recent financial crises and the Great Depression, however, is that during the period before each, a long boom created a euphoric atmosphere that originated in the financial and real estate sectors and finally turned into the "bubble" state of speculation. Almost everyone expected profit, which depended upon future price rises, in which one

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believed almost with certainty. Yet this euphoria could not sustain itself in the long run. Sooner or later, this bubble would be pricked. Everyone's expectations would be turned around 180 degrees, and the real sectors of the economy would be damaged severely.

The immediate question is whether the difference between an ordinary business cycle and an extraordinary boom, crash, and depression cycle (EBC) is just a matter of degree or whether it depends on the nature of the regime. If there is a difference in nature between them, should the appropriate policies to address them be different?

There are three basic types of ordinary business cycles—the inventory cycle, the typical main business cycle, and the construction cycle. These cycles are caused by the gap between demand and supply in the investment components of national products—inventory investment, plant and equipment investment, and construction investment. Business cycle theory is one of the most contentious fields in economics. The causes and processes of business cycles have been argued over by many economists. Economists are divided into two broad schools—the monetary business cycle school and the real business cycle school. However, in the past, not enough attention has been paid to the institutional aspect.[1]

Tentatively, we can call an institutional policy framework a "regime." In some business cycles, this "regime" factor will not play an important role, but in others it will be the critical factor. We define an ordinary business cycle as one in which the gap between aggregate demand and aggregate supply is the main problem and the existing regime is not critical. In an ordinary business cycle, stabilization policy seeks to adjust either aggregate demand or aggregate supply, or both, to full employment equilibrium. And even without such a policy, there would be self-adjustment toward equilibrium as part of the ordinary business cycle. No policy would be better than another, in some cases, if the self-healing is fast and efficient. In this case, the business cycle might be interpreted as an automatic adjustment process of the economy to maintain the existing regime.

However, as noted above, there exists another type of violent economic fluctuation, the EBC—such as the Great Depression during the 1930s and Japan's current Heisei depression. In these EBC cases, a euphoric socioeconomic atmosphere is generated during a long-lasting boom, which leads to excessive speculation in the market, particularly of assets such as stocks and real estate. Sooner or later, this excessive speculation is ended by a policy or some inherent economic constraint. This is the life cycle of the economic "bubble." If no appropriate macroeconomic

1. By "institutional" we mean the institutional framework, particularly channels of savings and investment, structures of corporations, rules of markets and transactions, and economic and business conventions.

policy response is taken, there will be danger of a deflationary spiral and economic stagnation.

This kind of EBC crisis, because it is so different from an ordinary business cycle, will not have a self-correcting force to recover under the existing regime, and to maintain the economic system itself will be very difficult. It is in this respect that there seems to be a considerable qualitative difference between an ordinary business cycle and an EBC. We might interpret an EBC as evidence that economic progress and development are becoming less effective or even impossible under the existing regime. For example, was the Great Depression simply a gigantic ordinary business cycle depression, or a symptom of maladjustment between a source of power for economic development and the regime within which that innovative economic power must work?

It is clear that the decade after World War I was the transitional period from the international gold standard of the pound sterling to the dollar key-currency system. Domestically in the United States, this was the beginning of corporate finance by the masses through the stock market, the mass consumption of durable goods, and weaker banking supervision and no provision of safety nets for bank depositors (despite the rapid development of the banking business, including stock brokerages).

In Japan, after World War II, the government implemented an industrial policy of giving subsidies and various kinds of administrative guidance to industries and banks. This was successful until Japan caught up with the Western industrial nations toward the late 1970s, by which time the ability of the government to target appropriate industries had greatly weakened. Since Japan has now caught up economically with the industrial countries, it needs to target industries in coordination with market forces and the insights of entrepreneurs. To fulfill this goal, the industry-government complex and the cross holding of stock among corporations and banks must be transformed. Corporate governance by stockholders must be established, and the adoption of global standards must be promoted. These changes have become imperative for potential Japanese innovative power to develop fully. Answering the question of why this power and the existing regime came into conflict is fundamental to understanding the country's economic difficulties.

We can conceptually distinguish an ordinary business cycle from an EBC. But it is very difficult to identify each of them in advance, particularly during the boom phase. This raises the difficult question for policymakers of how to adopt and implement macroeconomic countercyclical policy and structural policy to change regimes. When it is necessary to change regimes, it is right to reform through structural policy and wrong not to reform the regime. We may call this the Type One error. In contrast, when it is not necessary to reform, it is right not to do so. In fact, it is wrong to reform when it is not necessary to do so. We may call this the Type Two error.

In the prosperity phase of the business cycle, a precautionary restrictive stabilization policy stance might be taken, if the time lag of the policy's effect on the economy is large and if prosperity is of the ordinary business cycle type. However, our knowledge of economies and economic policy is not so reliable as to enable us to engage in activist policymaking. At this stage, it is extremely difficult to identify whether the necessity of reforming the existing regime exists.

As the economy approaches its peak, inflationary pressure gradually becomes evident. If a restrictive policy is not applied, the boom may turn out to be excessive, inflation will set in, and the cost of reducing inflationary expectations afterward will be large. Furthermore, the boom will continue and become euphoric. This might happen if the regime is mismatched with innovative economic power. If this is the case, we then have to take prompt and somewhat drastic corrective measures toward the regime.

If this structural policy has a depressive or a stimulative effect on the economy, it must be accompanied by the appropriate macroeconomic policy to offset this effect. A mix of structural policy and macrostabilization policy must be undertaken quickly and simultaneously. This promptness is required to minimize the cumulative loss due to the gap between the economic potential and the deterring regime. The regime reform must be somewhat drastic, because it is necessary to alter people's expectations. However, the complete offsetting of industrial policy by aggregate demand policy might not be best, because the motivation to reform would then be lessened. At this stage of the business cycle, the loss from the Type One error might be larger than that from the Type Two error.

When the EBC enters the crash phase and economic activity spirals down, competition-oriented structural reform might be harmful and endanger the economic system itself. Policies to prevent the downward spiral should be undertaken as emergency measures, but the reform of the regime must not be forgotten as the goal of medium- and long-term policy. It is very important to maintain the will and incentive for structural reform.

If there are two types of economic fluctuation—the ordinary business cycle and the extraordinary boom-crisis type of economic fluctuation—we must distinguish them and take appropriate measures. To do that, we have to increase our knowledge by identifying the difference between them, and determine the correct policies for each case. For this purpose, studies of different countries and various times are important.

As a study over time, comparison of the Great Depression of the 1930s with the present Japanese Heisei depression would be interesting. As a study across countries, research on the financial debacle of the United States, Japan, and other East Asian countries might contribute to our knowledge in this field. This research must clarify several important questions, such as why the mismatch of innovative economic growth power and the economic regime arises, how we should reform the regime, and when we should implement reform plans.

The Japanese Heisei Depression

We now take a retrospective look at the Japanese Heisei depression. Toward the end of the 1970s, the Japanese economy caught up with the Western industrial countries. It was time to alter the economic regime from the old to the new one—from indicative industrial policy administered by the government to the guidance of the free market; from a banking-securities sector heavily regulated by the Ministry of Finance to a less regulated, more competitive, globally standardized financial sector; from Japanese corporatism to transparent management of corporations—in short, from the Japanese standard to the global standard. However, neither the financial institutions nor the big corporations were willing to take off their protective heavy coat and work with their sleeves rolled up. Instead, deregulation has been conducted in a Japanese way by the Japanese government, with ''gradualism'' that preserves the interests of the beneficiaries of the old regime. Deregulation in Japan therefore has not brought about freer entry, new enterprises, and vigorous innovative activity, as it did in the United States.

To carry out the Plaza Accord in 1985, the Japanese government and the Bank of Japan (BOJ) implemented an easy monetary policy to mitigate the depressive effect of implementing the international agreement on the yen's appreciation against the dollar. Japan—surprised by the downfall of New York stock prices on Black Monday in 1987—continued its easy monetary policy for more than 2 years, unlike Germany. The prices of land and stocks soared to more than triple their 1985 level.

We have to investigate how this mistaken monetary policy was formulated and implemented. Was it the sole independent decision of the BOJ or the political decision of the government and politicians? (See Sakakibara's essay in this volume for a discussion of this topic.) It is deplorable that there is no serious official report on this apparently mistaken policy. This is the chronic Japanese disease. The transparency of monetary policymaking is as important as the result of the policy, both because of the need for policymakers to be accountable and also in order to advance the economics of central banking.

In retrospect, the BOJ officials and serious economists should not have permitted pseudo-economics to explain the high prices of land and stocks with various false assumptions. We should have put questions to ourselves, such as ''is there any balance between the monetary-financial sector and the real sector of economy?'' and ''if asset prices in Japan are far from equilibrium, what would happen to the Japanese economy if these prices fell drastically?" It would be too simplistic for central bankers to stick to a single policy goal, the stability of "flow" prices, without paying appropriate attention to others, such as stock prices and the associated overswing of the real economy (documented in the essay by Jinushi, Kuroki, and Miyao in this volume).

The bank loan with collateral, mainly real estate, has been a "regime" in Japanese bank-lending practice (documented in Shimizu's essay in this volume). If the price of real estate keeps rising, this is a very safe business convention for banks. If the price falls, it becomes a very risky practice. In a euphoric economic environment, it is very difficult for an individual to resist the social atmosphere and to build his own expectation differently from others.

Toward the end of the 1980s, it became evident to everyone that the soaring prices of land and stocks were having adverse effects not only on the economy but also on society itself. So, belatedly, BOJ began to raise its discount rate and to restrict the money supply, while the government undertook selective measures to control land prices. Finally, stock prices began to fall, and then urban land prices followed suit.

At this point in time, it was very difficult for policymakers to select the appropriate policies. However, after having confirmed the decline of prices to a normal level, we should have implemented an accommodative monetary policy and income-supportive fiscal policy. Nevertheless, the restrictive monetary policy actually continued, and the consumption tax rate was even raised. The Japanese economy has since plunged further into stagnation.

Unfortunately, Japanese banks have not wanted to dispose of their bad loan portfolios swiftly, and have been awaiting a recovery of asset prices that has yet to occur. Meanwhile, three big banks and one of the four largest security companies have failed. This has been the worst aspect of dealing with the economic crisis. Now, a huge amount of public money, amounting to about ¥60 trillion ($550 billion), has been poured into the reconstruction of the Japanese banking system. The gap between potential and actual GDP during the crisis period from 1992 through 1998 amounted to a huge sum (¥340 trillion, 68 percent of current GDP, under an assumption of the 4 percent average growth rate from 1976 through 1991; ¥180 trillion, 36 percent of current GDP, assuming a 3 percent growth rate).[2]

Toward Financial-Sector Reform

The Obuchi administration strongly emphasized macroeconomic recovery as its first priority and hardly paid attention to other aspects of the econ-

2. In Posen (1998, chapter 1 and appendix), Japanese potential output growth is estimated to decline 3 percent from 1988 to 1992, to an annual rate of 1.75 percent. This implies a cumulative output gap of 15 percent of current GDP.

omy (public debt, deregulation of industries, transparent banking supervision, etc.). If the restructuring of the Japanese economy should fail, why and for what are we paying this huge cost? When we think of the speedy, drastic solutions of financial crises in the United States, Sweden, and some other countries, we have to conclude that the distinction must be accounted for by the difference in the character of Japanese society and in the way the nation is governed. Is there a unique Japanese way to reform the regime? Is Japan special?

In November 1996, the Hashimoto cabinet published the Japanese Financial Big Bang plan and promised to attain its goals by the year 2001. The plan's two most important objectives were to complete the disposition of the banks' bad debt and establish the Tokyo financial market as a competitive international market of the caliber of New York and London. In other words, the set goals of financial reform were (1) for Japan to harvest the fruits of the ongoing information technology (IT) revolution and globalization of the world economy and (2) for the country to raise the efficiency of not only its financial sector but also its economy to levels as high as other advanced countries.

The harsh fact is that neither the elimination of the bad debt nor the internationalization of the Tokyo market has been realized. To attain these goals, fundamental reform of the financial sector of Japan is vital; however, the incumbent financial institutions will not change without competitive circumstances brought on by new entrants from abroad and the domestic nonbank sectors.

Generally speaking, the economic functions of the monetary and financial sectors are to provide the payments system for the economy, to serve as a financial intermediary between savers and investors (including transactions of existing assets and debts), and to create credit for new investments. These three are closely interrelated, but separable. However, historically, and especially in Japan, these functions were conducted mainly by banks until World War II. Recently in the United States and Europe, and even in Japan, financial intermediation for big corporations has been increasingly carried out through the capital markets.

Over the past two decades, information technology has been developing tremendously, immensely increasing capacities to communicate, process, and analyze information. This IT revolution has had an enormous impact upon the financial sector. First, it has decreased the cost of monetary transactions in the payments system and raised the level of convenience for the public (e.g., 24-hour automated teller machines). In the fields of financial intermediation and credit creation, transaction costs have greatly decreased, risk has become more diversified, and the scope of financial assets and debts has broadened.

A little more than 5 years ago, there were 21 "big" banks in Japan (city, long-term-credit, and trust banks). Now the country has three gigantic (megasized) banking groups (as of July 2000)—Tokyo Mitsubishi-Mitsubishi Trust group, Mizuho group (Fuji, Dai-Ichi Kangyo, IBJ), and Mitsui-Sumitomo group (Sakura and Sumitomo); two large regional banking groups—Asahi and Daiwa; and two restructured banks—Shinsei (the former Long-Term Credit Bank of Japan, taken over by the Ripplewood Holdings Co. of the United States) and a new bank (the former Nippon Saiken Bank, taken over by the Softbank group in Japan). The Hokkaido Takushoku Bank was the only big bank in 1997 to go bankrupt (not big enough not to fail!). At present the mergers and acquisitions movement of banks in Japan seems to have not yet finished. The remaining independent banks will sooner or later merge or be absorbed, and in the near future only five or so megabanks from the previous 21 will remain.

Since the end of 1998, three conspicuous changes have been developing in Japanese banking. The first was the merger of the big banks. The combined assets of the four gigantic banking groups now are about ¥100 trillion, which constitutes more than 50 percent of the total assets of all banks in Japan. However, the strategy for their future management is not clear. The four groups appear to want to be engaged in all three fields of banking (investment, retail, and regional banking), although each group has its own field of emphasis.

The second unprecedented event was the purchase of failed banks by foreign financial concerns and domestic nonbank businesses. The third event is the proposal to establish new banks by nonbank businesses (e.g., the 7-11 convenience store company, with 8,000 stores) and by high-technology companies in Internet businesses (e.g., Sony). The market for banking would be divided into three submarkets: retail, regional, and wholesale banking (wholesale banking is usually called investment banking).

In wholesale banking, transactions are large, the playing field is the global market, and customers are big corporations, governments, and billionaires. A wholesale bank's main resources are in its capability to evaluate future investment risks and returns. The customers of retail banks are the multitude of consumers and income earners. These banks' main business is to facilitate the payment of countless small transactions, take care of small savers, and perhaps make loans to common consumers. In between are the regional banks, whose main activity is to provide services to small and medium-sized businesses.

Until recently, almost all big Japanese banks engaged in all three kinds of banking services; however, nonprice competition was common, and sometimes they cooperated with each other under the guidance of the Ministry of Finance. If there are economies of scope (i.e., synergy effects) gained by conducting activities in two or three markets under a single roof, universal banking (in this sense) is rational and productive not only for the banking sector but also for the economy as a whole. The issue now is whether the ongoing IT revolution is amplifying this synergy or not. We must wait for rigorous empirical research for complete understanding, but recent developments in the United States and Europe suggest that the IT revolution is decreasing rather than increasing synergy. Therefore, the segmentation of banking activity into three areas—each with separate management—will raise the productivity of each submarket and also make the whole banking industry stronger.

There is a hopeful sign in Japan for this direction. But there is also a danger. If the gigantic banking groups collude to form a monopoly in the money transfer system and also in the market for small savers, they may reap the rent from this monopoly and use the excess profit as a kind of internal subsidy to support their investment banking departments' competition with nonbank entities. This unfair competition will not produce the optimum results of financial reform, but rather create a loss for the economy. To prevent this loss, it is very important that new requirements for entry into the financial sector create free-market conditions, and also that banks disclose as much information about their management as possible.

At present, thanks to the entry of new foreign banks and domestic nonbank firms, retail banking in Japan is becoming considerably more competitive. But we must be vigilant against any monopoly in this field. In investment banking, the competition from overseas and domestic securities firms will be as keen as ever. The problem is the middle market of regional banking. In this area, Schumpeterian bankers can play an active role as fund suppliers for innovative small and medium-sized firms. This is very important for the dynamic development of the Japanese economy. Unfortunately, it seems to me that we cannot expect much from the incumbent regional banks in Japan, because they are too accustomed to the outmoded Japanese bank-management system. Here again, we need competitive incentives from outsiders and nonbank firms in the form of venture capital. One of the basic challenges left for economists is how to separate Japan's banking and commerce.

Reference

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