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Japan Now and the United States Then: Lessons from the Parallels

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For much of the last decade, Japan's banking crisis has been at the center of attention in the ongoing discussion of that country's broader economic difficulties and of what public policy actions could alleviate them. The enormous loan losses and balance sheet erosion that nearly all Japanese banks have sustained during this period, and the resulting impairment of their ability to carry out ordinary credit creation activities, have been both a consequence and a cause of Japan's prolonged economic stagnation. Of the 21 institutions that made up the standard list of Japanese ''large banks'' in 1990, by the decade's end two had disappeared through failure and nationalization, and four others were consolidated into two by merger. At the time of writing, five of the remaining 17 are in the process of merging into two new entities, thus reducing the list to 14. But few observers think the shrinkage is over, or that the banks that remain are now healthy institutions. Questions about what further steps the Japanese authorities should take to foster the banks' recovery—and to ensure their soundness once they have recovered—therefore continue to be pertinent.

A decade ago, it was US banks, and even more so the US savings and loan (S&L) industry, that were in crisis. These institutions too suffered major loan losses, experienced failure rates unprecedented since the depression of the 1930s (especially among S&Ls, but among banks as

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well), and saw the market capitalization of survivors fall to a small fraction of its precrisis level. Resolution of the crisis took significant government intervention, both in the provision of public funds to pay off the depositors of institutions that failed outright and in managing the process of consolidation among those that did not (at least not formally). And although the 1990-91 business recession in the United States was neither severe nor protracted, growth during the initial years of the recovery was unusually sluggish, and many observers cited continuing problems at credit-creating institutions as one of the chief obstacles—"headwinds," as Alan Greenspan called them—that the economy had to overcome.

This essay reviews the parallels between Japan's banking crisis of the 1990s and the US banking and S&L crisis of a decade ago, with the object of drawing lessons from US experience to bear on the public policy decisions that Japan still faces today. In so doing, it is important at the outset to highlight two caveats. First, these two situations are not identical, and the story told here is not merely one of parallels. As the discussion below makes clear, in some respects the two are not parallel at all. There are significant differences, some of which bear directly on matters of appropriate public policy. Second, it is most surely not the case that the lessons to be drawn for Japan today consist entirely of applying what the United States did a decade ago. To the contrary, both the US government in general and the specific authorities responsible for dealing with the banking and S&L crisis acted, in some key respects, in ways that worsened the situation and increased its ultimate cost to the economy and to the public treasury. The lessons to be drawn from that experience stem in part from observing what to do but also from observing what not to do.

Some of the most interesting questions that one would most want to put to these two experiences, either in parallel or considered entirely separately, remain largely outside the scope of this essay: Most basically, to what extent have Japan's banking problems been a cause, rather than merely a consequence, of the subpar growth that began in 1992 and continues today? And, looking forward, will these problems in the banking system prevent Japan from achieving full economic recovery once other ingredients for renewed expansion, such as appropriate fiscal and monetary policies, are in place?

The fundamental difficulty in addressing such questions is that of distinguishing supply shocks from demand shocks in a market—namely, the market for credit—in which important elements of the relevant price vector, as well as key determinants of both supply and demand, are unobservable. Growth in Japanese banks' outstanding volume of loans slowed sharply during the course of 1991, but so did growth of nonfinancial economic activity. Similarly, by 1993 both loan growth and real economic growth hit approximately zero. As the economy staged a short-lived recovery in 1995 and 1996, so too did loan growth. By 1998, both loan volume and the gross domestic product were shrinking. Moreover, all the while a variety of other factors that might plausibly have affected credit creation or nonfinancial activity or both—changes in fiscal and monetary policies, in asset values, in the regulatory environment, in the pace of economic activity outside Japan, and so on—were at work. No doubt the roughly congruent co-movements of Japanese banks' loans and Japanese GDP during the 1990s will provide fodder for econometric tests of what was causing what for years to come.

For the purposes of policymakers trying to look forward, this more fundamental uncertainty surrounding the importance of Japan's banking crisis in accounting for the country's persistent economic difficulties is compounded by the effect of falling asset values. There is no need to dwell on the well-known role of falling prices of equities, and especially real estate, both in undermining the Japanese banks' loan portfolios and in depressing Japanese economic activity more generally. (The discussion below lists this factor, of course, but the entire subject has been voluminously documented elsewhere.) But falling asset prices also render confusing what are ordinarily reliable market signals, and therefore cloud policymakers' ability to assess even the contemporary situation. Most obviously, when prices in general are falling, low nominal interest rates do not necessarily mean low real rates. In addition, when either low or falling asset prices erode nonfinancial firms' net worth, even low real interest rates on government securities and on obligations of other highly rated borrowers do not necessarily mean a low cost of credit to other would-be borrowers. Similarly, even highly liquid bank balance sheets do not mean "easy money" if banks are unwilling or unable to lend because of concerns about the quality of their own assets or those of would-be borrowers.

These ambiguities notwithstanding, the central theme argued in this essay is that there *are* important parallels between Japan's banking crisis and that experienced not long ago in the United States, and, further, that these parallels are instructive with respect to actions that Japan should or should not take in its current situation. Moreover, in drawing the lessons of these parallels, it is useful to distinguish between the approach the United States took to addressing the problems in its commercial banking industry, which involved a variety of regulatory actions but no direct use of public funds, and the quite different approach taken in the S&L industry, which at last tally had cost US taxpayers $126 billion.

The first section begins by acknowledging some significant ways in which Japan's banking crisis and what happened in the United States are *not* similar. The second section takes up the main theme of the essay by listing some of the most important parallels between the two situations. The third section suggests implications for Japanese policymakers. The fourth section concludes by raising several questions from the perspective of the political economy of Japan's banking crisis and the public policy response to it.

Some Dissimilarities

Nobody would argue that two countries as different as Japan and the United States, or two financial systems as dissimilar as these two countries', would undergo precisely parallel experiences of banking-sector crisis. Any view that is not so naïve as to be useless must be more nuanced. It is helpful at the outset, therefore, to take note of some significant differences that bear quite directly on the extent to which what happened in the United States can yield eight lessons for Japan in this area.

1. The banking system is more important in Japan than in the United States, both as an intermediator of savings and as a creator of credit. In Japan, approximately a third of all household savings goes into bank deposits of one form or other. In the United States, only 13 percent of household savings consists of accounts in banks and other depository institutions. (Direct holdings of equities plus holdings of mutual fund shares represent 33 percent of US household savings, 36 percent is in life insurance and pension reserves, and another 7 percent is in nonbank credit market instruments. In Japan, equity and mutual fund holdings represent only 7 percent of household savings, and 28 percent is in insurance reserves.) Analogous comparisons are not available for the importance of banks' lending because of noncomparability of Japanese and US financial statistics, but the share of their total credit that Japanese nonfinancial business corporations draw from banks is surely greater than the 11 percent for US nonfinancial firms.[1]

2. The Japanese banking system has traditionally been a concentrated industry with high barriers to entry and, until only recently, barriers to exit almost as high. As of the beginning of the 1990s, the 21 ''large banks''—11 city banks, 7 trust banks, and 3 long-term-credit banks—held 73 percent of Japan's banking assets. Moreover, new institutions, like the *jusen* (home mortgage lending companies) established in the early 1970s, have often been funded and principally controlled by the same group of large banks. As might be expected in a system with so few distinct players and little movement in or out, the extent of public disclosure of banks' loan portfolios, balance sheets, and profitability was traditionally limited. Indeed, from the end of World War II until

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1. Hoshi and Kashyap (forthcoming) provide data that, while not fully comparable to US statistics, illustrate the importance of bank lending to business in Japan; see especially tables 7.8, 7.9, and 7.10.

1995, no Japanese bank ever publicly reported an annual loss, presumably not because no bank ever actually ran an operating loss but because the banks that did would have found it disadvantageous to reveal their losses, and weak disclosure requirements allowed them not to do so.

By contrast, as of 1985 the United States had more than 14,000 banks and more than 3,000 savings and loan associations. New institutions were frequently chartered (420 new banks, and even more S&Ls, were started between 1980 and 1990), and some quickly acquired significant market share. At the same time, many institutions disappeared (more through merger than failure, although there were some large failures, such as Franklin National in 1978 and Continental Illinois in 1984). Also, bank regulators and, in the case of publicly traded companies, the Securities and Exchange Commission and the national stock exchanges impose disclosure requirements far more stringent than in Japan.

3. In addition to the 34 percent of Japanese household savings held in bank deposits, another 19 percent is in the Postal Savings System, so that more than half of all Japanese household savings is government insured. But at least for bank deposits, deposit insurance has always been much more informal in Japan than in the United States. Japan did not have any formal deposit insurance until 1971, and the Deposit Insurance Corporation (DIC) created then has never been used directly to pay off depositors of a failed institution. Indeed, until 1992 the DIC was never used at all, and even then it merely provided funds to aid in a rescue merger. Instead of closing and liquidating a failed bank, the Japanese authorities typically relied on informal intervention to arrange a purchase-and-assumption by a viable institution.

   By contrast, in the United States the Federal Deposit Insurance Corporation (FDIC) (and, when it was in existence, the Federal Savings and Loan Insurance Corporation, or FSLIC) sometimes handles failures through purchase-and-assumption transactions but also sometimes liquidates the institution and pays off the insured depositors. As Milhaupt (1999) has pointed out, in addition to the frequently suggested cultural origins of this different approach to dealing with problems more generally, part of the reason for the difference was probably that until 1998 Japanese law treated the outright failure of a bank as if it were the bankruptcy of a nonfinancial operating company. By contrast, US law—recognizing the potential for cascading collateral damage if *all* of a *bank's* creditors have to wait while the mess is sorted out before receiving what they are due—explicitly exempts banks from the commercial bankruptcy code.

4. Japanese banks can and do own equity securities on their own account, and the value of the equities they hold is included in their capital for

regulatory purposes. By contrast, under the 1933 Glass-Steagall Act, US banks could not normally hold equities. Even now, after Congress has repealed Glass-Steagall, any equities that a bank owns must be in a separate account distinct from the bank's primary balance sheet.

This difference has had two important implications in Japan. First, a declining stock market directly affects not just banks' customers but the banks themselves. Second, the valuation of equity holdings for purposes of calculating banks' capital—for example, how to treat unrealized capital gains and losses—is a significant regulatory issue in Japan but not in the United States. For example, because of the different treatment of realized versus unrealized gains, Japanese banks sold long-held (and therefore low cost-basis) equities, even into a declining market, in order to record gains with which to offset pretax losses from nonperforming loans.

5. The Japanese banking crisis has had no equivalent to the extraordinary regional disparity at the core of US banking problems, and especially the S&L problems, of a decade ago. Of the 1,617 US *banks* that failed during 1980-94, 599 were in Texas and another 122 in neighboring Oklahoma. Although the banks that failed in Oklahoma were mostly small, the Texas failures collectively had $60 billion in assets (vs. $146 billion for all 49 other states combined). The problem in the savings and loan industry was even more geographically concentrated. Of the 747 S&L failures formally resolved by the Resolution Trust Corporation (RTC), 137 were in Texas and another 52 in neighboring Louisiana, while 73 were in California.

   The heavy concentration of these problems in Texas highlights the role of a price decline for a single commodity—namely, oil—in triggering what happened in the United States. And the point is relevant not just economically but politically. California's is the largest US congressional delegation, Texas' the second-largest. During the mid- and late 1980s, when the crisis was building but the government systematically delayed action, Californian Ronald Reagan was president and Texan Jim Wright was speaker of the House of Representatives. Because it was in the interest of the owners and managers of underwater banks and S&Ls to keep these institutions operating, the ability to bring political pressure to bear at top levels of the executive and legislative branches of government delayed action that it would have been in the public interest to take earlier.

6. In the end, however, in the United States' social and political culture it did prove possible substantially to wipe out an entire financial industry—the S&Ls. Savings and loan associations had existed in the United States for more than half a century. At their peak, S&Ls accounted for 9 percent of US household savings and held 48 percent of US home

mortgages. Historically, the industry had played a significant part in achieving the popular postwar goal of making individual home ownership more widespread. The S&Ls had their own government-sponsored insurance system, the FSLIC, and several highly effective lobbying organizations, including the US League of Savings Associations and the National Council of Savings Associations. As of the beginning of the 1990s, S&Ls also provided jobs for nearly 350,000 employees.

Even so, as Kaufman observed, commenting not just on the S&L crisis but on the banking industry more generally, ''At the height of the crisis, neither bankers nor bank regulators had sufficient public credibility and stature to effectively fight the reforms'' (1997, 16). Once the mounting costs of keeping the industry going became clear, most Americans either supported shutting it down or were at least indifferent, and the country's political structure responded accordingly. It is not at all clear that Japan would, or could, act similarly under analogous circumstances. Indeed, despite the widely discussed antipathy toward the banks exhibited by much of the Japanese public, the public authorities have taken few actions likely to result in closing banks or putting bank managers out of work.

7. A big part of the story of how a large number of US banks survived and then recovered in the first half of the 1990s was the persistence of high interest rates by historical standards, and in particular wide spreads between lending rates and deposit rates, during much of the first half of the 1990s. On average, during 1992-95 (the recession ended in 1991), the US *prime* commercial lending rate was 7.06 percent, versus 4.07 percent for *Treasury bills* and substantially less for most forms of bank deposits. (In earlier US recovery periods, the prime vs. Treasury spread had averaged 1.97 percent during 1976-79 and 2.35 percent during 1983-85.) By contrast, Japanese banks' *average* loan-to-deposit spread has mostly hovered in the 1.60-1.75 percent range since mid-1993.

8. As many observers have emphasized, Japanese monetary policy has literally hit the constraint at zero nominal interest rates. This unusual phenomenon matters in two ways for purposes of the banking crisis. At the macroeconomic level, as has been widely discussed, hitting the zero constraint limits what the Bank of Japan can do to pursue a more expansionary monetary policy.[2] More narrowly with respect to Japan's banks, hitting the zero constraint almost surely implies a compression

2. Contrary to repeated assertions by the Bank and some members of its Policy Committee, this does *not* mean that there is *nothing* further that monetary policy can do to stimulate economic expansion; see, e.g., Bernanke's essay in this volume.

of the interest rate structure, including a narrowing of spreads of lending rates over deposit rates. In contrast to this aspect of Japan's current situation, the United States in modern times has never approached zero nominal interest rates. The monthly average low point for 3-month US Treasury bills in the aftermath of the 1990-91 recession was 2.86 percent in October 1992.

Parallels: Origins of the Crises and Responses to Them

These differences notwithstanding, the central argument of this essay is that the banking crisis in Japan now and in the United States then have reflected important parallels, enough so that what happened in the United States is capable of providing helpful lessons for Japanese policymakers. Some of these parallels are widely recognized, others less so. To gain a sense of the overall congruence between the two countries' experiences, it is useful to review them together, looking first at aspects of what caused the respective crisis and second at policymakers' responses.

Origins of the Two Crises

1. Almost all observers of both these situations have emphasized the role of falling asset prices as a major trigger of the crisis. In Japan, the average price of metropolitan residential land approximately doubled in the first half of the 1980s, then approximately tripled in the second half. Residential land then lost roughly 50 percent of that peak value in the first half of the 1990s. The fluctuation in the price of commercial land was apparently more extreme, although commercial real estate values are typically harder to measure because of the paucity of sufficiently comparable transactions. The Nikkei average stock price rose from barely ¥7,000 in 1982 to nearly ¥39,000 at year-end 1989, and then fell to below ¥13,000 in 1998.

   In the United States, at least at the national level, fluctuations in vacancy rates and new construction can take the place of hard-to-measure price levels in conveying a sense of the scale of this dimension of the banking problems that ensued. The vacancy rate for commercial office space in major metropolitan markets rose from 4 percent in 1980 to 18 percent in 1986, despite the fact that 1980 was a recession year and 1986 was the fourth year of a robust economic expansion. Completions of new office space in those same markets, which had totaled 99 million square feet during the first half of the 1980s and another 101 million during the latter half of the decade, collapsed to just 28 million during the first half of the 1990s. Similar patterns of boom and bust, although less severe, also characterized the retail and industrial real estate markets. In Texas, where the 1986 break in oil prices had devastating effects on much of the local economy, all of these fluctuations were far more extreme.

2. In both Japan and the United States, lending on real estate rose sharply as a share of banks' credit creation in the years preceding the crisis—and, interestingly, continued to rise as the crisis unfolded. The share of Japanese banks' total loans extended directly to the real estate industry rose from less than 6 percent in 1980 to nearly 12 percent in 1990, and rose modestly further by the mid-1990s. The share of bank credit *indirectly* resting on real estate collateral was far greater, however, because as prices rose so much of the tangible wealth of both corporate and household borrowers consisted of land values.

   Among US commercial banks, real estate loans rose from 32 percent of all bank loans and leases in 1980 to 43 percent in 1990, and from 18 to 27 percent of total bank assets. While all categories of real estate loans increased as a share of banks' portfolios during the 1980s, by far the largest percentage increases were in loans for construction and land development and in loans on nonfarm nonresidential properties—both of which almost doubled as a share of the aggregate portfolio. Not surprisingly, banks that subsequently failed started off the decade on average with a distinctly larger share of their overall real estate loan portfolios devoted to loans on commercial property than did banks that did not fail (43 vs. 32 percent), and the average difference widened steadily thereafter (by 1990, 51 percent vs. the same 32 percent as before).

3. In both countries, the increase in banks' lending activity directed toward real estate partly reflected the decline of their traditional core business of lending to established nonfinancial operating companies. In the United States, this is a story of very long standing, one that has advanced apparently inexorably throughout the postwar period. Major elements underlying this structural shift include the development of the commercial paper market and the increasing importance of the corporate bond market, both of which have primarily worked to the advantage of the larger, better-known borrowers, and the rise of nonbank finance companies (for example, G.E. Credit), which now aggressively compete for the business of smaller borrowers. Although the share of US banks' total assets held in commercial and industrial loans has fluctuated fairly narrowly in recent decades (it is usually in the 18-20 percent range), the borrower base has progressively shifted to smaller, less secure firms. The share of nonfinancial business corporations' liabilities owed to banks has mostly declined over the years, from 16 percent in 1960 to 11 percent today.

Many of these same developments—for example, the emergence of a commercial paper market—have occurred in Japan as well, albeit with later timing. Even so, the dominant trend over time in both countries is for the banks to lose what used to be their core commercial lending business from which they once were reliably able to make a competitive market return while assuming only limited levels of risk. As a result of this structural change in their competitive environment, banks in the United States have repeatedly been led to seek profitability from new and greater forms of risk taking. (Recall the real estate investment trust problem of the 1970s, the developing-country debt crisis of the early 1980s, and the high-leverage exposure of the mid- to late 1980s, not to mention commercial real estate once again in the late 1980s and on into the early 1990s.) It appears that Japanese banks, facing a similar structural challenge, have taken some of the same missteps in response.

4. Banks, and in the United States especially savings and loan associations, have been better able to strike out in these new directions before the crisis occurred because both the US and Japanese governments progressively relaxed important regulatory restrictions. In the United States, the 1971 Hunt Commission Report and the House Banking Committee's 1975 report *Financial Institutions in the Nation's Economy* called for removing deposit interest rate ceilings, giving banks and S&Ls new lending and investment powers, eliminating restrictions on statewide branching, and taking other mostly expansive steps. The two pieces of legislation that incorporated most of these actions were the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Act of 1982. Garn-St. Germain also removed all existing statutory limits (such as aggregate percentage limits, maximum loan-to-value ratios, and minimum amortization terms) on real estate lending by nationally chartered banks, increased banks' loan limits for a single borrower from 10 to 15 percent of a bank's capital (25 percent if the loan is collateralized), and permitted S&Ls to invest up to 5 percent of their assets in commercial loans and up to 30 percent in consumer loans. Although the Office of the Comptroller of the Currency (OCC) was given authority to set restrictions on national banks' real estate lending, however, in keeping with the antiregulatory attitudes of the Reagan administration, the OCC opted to impose no limits.

   In Japan, as Hoshi and Kashyap (1999) have emphasized, a parallel wave of deregulation has likewise fostered the transformation of banks' portfolios. On the borrowers' side, beginning in 1975 deregulation allowed the creation of Japanese bond and commercial paper markets, thereby freeing many nonfinancial operating companies from their traditional dependence on bank credit. Also, beginning in 1979 the Japanese authorities progressively relaxed restrictions on the banks' activities. Key steps in this latter process included permission for banks to issue and deal in certificates of deposit (1979), to lend in yen outside Japan (1982), to affiliate with mortgage securities companies (1983), to issue mortgage bonds on their own account (1986), and to underwrite and deal in commercial paper (1987).

5. In both countries, this progressive deregulation combined with deposit insurance (and limited shareholder liability) to create a classic moral hazard problem. In Japan, as noted above, the Deposit Insurance Corporation (DIC) was established in 1971. Membership was (and is) compulsory for virtually all depository institutions. Even more important, however, was the informal but strong presumption that the controlling authorities, principally the Ministry of Finance and the Bank of Japan, would arrange affairs so that no bank would fail in such a way as to cause depositors to suffer losses. In the event, that presumption proved correct. In the United States, deposit insurance had existed since the 1930s, but with a maximum coverage per account that left large deposits uninsured. Moreover, uninsured depositors occasionally did sustain losses in bank failures, so that the possibility of loss was well understood. In 1982, however, the Garn-St. Germain Act raised the insurance limit from $40,000 to $100,000.[3]

6. As numerous observers have emphasized, the ability of banks (and, in the United States, especially S&Ls) to exploit this moral hazard situation was enhanced by lax prudential supervision. In Japan, the close relationships between lending institutions and their supposed unit-level regulators and examiners has by now become the stuff of high-level national scandal. In the United States, the problem was less a matter of individual regulators' malfeasance or conflict of interest than a reflection of the antiregulatory mood of the Reagan era. At the same time that new legislation was expanding banks' scope of activities, the most severe business recession of the postwar period was creating record-level bankruptcies, and the developing-country debt crisis was breaking abroad, the number of bank examiners employed by the FDIC *fell* from 1,713 in 1979 to 1,389 in 1984, and the number employed by the OCC likewise *fell* from 2,151 to 1,722. Not surprisingly, the average interval between examinations increased significantly, even for banks with the lowest ratings. Although the matter is hard to describe except anecdotally, in both countries out-and-out criminal corruption and self-dealing also seem to have been a significant part of what happened.

3. In the original legislative discussion, the proposal was a more routine increase to $50,000, to allow for then-recent inflation. As Davison relates the relevant history, ''The lower figure remained in the bill, however, until it was replaced by the $100,000 limit at a late-night House-Senate conference. The decision, scarcely remarked at the time, would come to be viewed by many as having weighty consequences'' (1997, 93).

7. Even aside from credit problems that reached the level of crisis, the banking industries in both the United States and Japan have for some time faced the need to downsize and restructure, but in neither country is the road to renewed profitability clear. At least before Glass-Steagall was repealed, most US banks had apparently recognized the difficulty of finding new sources of revenue and had therefore turned to expense reduction as the most promising way of enhancing profits. Success at these efforts has been mixed, to say the least. No doubt banks' investment in technology will save expenses over some horizon, but in the short run (and, for many banks, the medium run as well) this investment has proved very costly. The banks that have invested the most also run the greatest risk of being leapfrogged as yet newer technology emerges.

   The other principal route US banks have taken in the effort to achieve expense reduction is consolidation. Although here too the motivating logic is clear enough, in practice to date the cost savings achieved by many US bank mergers have been disappointing. Meanwhile, Japanese banks are only just beginning to go down a similar path characterized by consolidation, investment in technology, and staff reductions. It is too soon to know whether they will be more successful in this regard than their US counterparts. It is also too soon to know how the repeal of Glass-Steagall will affect the situation in the United States. But the point remains that the industry in both countries needs to restructure.

Responses to the Crises

1. Once the crises were recognized, in neither country did the central bank resort to price inflation as a solution to the banks' problems. The recent high for US inflation, as measured by the chained GDP price index, was 3.9 percent in 1990. Since then, inflation has slowed almost without interruption. Inflation in 1999 was 1.4 percent, up only modestly from 1.2 percent in 1998. In Japan, the recent high for inflation, measured by the implicit GDP deflator, was 2.3 percent in 1989. By 1994, Japanese prices were falling. Since then, inflation has hovered near zero.

2. The main response of the banking authorities in both countries was, in the first instance, regulatory "forbearance"—in other words, either redefining the rules to make them less restrictive or simply looking the other way when restrictions were violated. In the United States, the most extreme form of regulatory forbearance was that practiced by the FSLIC, under which (as both Kane 1989 and White 1991 have emphasized in great detail) large numbers of insolvent and marginally solvent S&Ls were permitted to remain in operation for periods that

ran to several years. US bank regulators also, however, permitted some large banks (including some that subsequently failed) to operate for long periods with minimal capital. In some cases—for example, mutual savings banks in the Northeast and banks with troubled loans in the energy and agriculture sectors—this forbearance was even explicitly mandated by legislation.

In Japan, regulatory forbearance began when the first Ministry of Finance inspection of the *jusen*, in 1991, showed 40 percent of all loans on the books to be nonperforming and the response was a 10-year regulatory restructuring window. (By 1995, 75 percent of all *jusen* assets were nonperforming, and this part of the industry had to be shut down.) Since then, the equivalent of regulatory forbearance in Japan has largely taken the form of weak supervision standards, which continually allowed banks to resist classifying as nonperforming their dubious or even underwater credits. As a result, most observers of the Japanese banking industry in time came to dismiss each successive private or official announcement of the scale of the ''bad loan'' problem as a gross understatement, and correspondingly to regard all banks' capital positions as overstated. By the late 1990s, it had become commonplace for private analysts to conclude that in aggregate the entire Japanese banking industry was insolvent, or even that each of the 21 large banks was individually insolvent.

3. The policy of regulatory forbearance in both countries was in part a reflection of the hope that in time a changed economic environment would take care of the problem (a hope that in the United States was eventually realized for most banks, but not for the S&Ls). But it was also a direct consequence of the delay in provision of public funds. After all, the alternative to regulatory forbearance often means closing an institution down. If the institution's liabilities exceed its assets, this takes an infusion of money. In both the United States and Japan, that money was slow to be provided, even after it became clear that the US FDIC and FSLIC, and the Japanese DIC, were out of money.

   In the United States, the first break came in 1987, when the Competitive Equality Banking Act (CEBA) provided just under $11 billion to recapitalize the FSLIC. (CEBA also mandated a forbearance program for weak but ''well-managed'' S&Ls.) Subsequent legislation created the Resolution Trust Corporation and its financing arm, the Resolution Finance Corporation, with the ability to issue securities directly against not only assets acquired but also a US government guarantee. The total amount of public funds that Congress authorized for the S&L rescue operation, in various pieces of legislation, was $159 billion. The eventual direct cost to taxpayers included $42 billion in costs reimbursed to the FSLIC for cases handled during 1986-89 and another $79 billion in costs borne through the RTC on cases handled from 1989 on.[4] In

4. These costs are net of the proceeds of asset liquidations, and they exclude author $6 billion in tax benefits awarded to private acquirers of failed S&Ls.

Japan, the first formal provision of public funds did not come until 1995, when the government put ¥7 trillion into a subsidiary of the DIC to allow it to acquire the remaining assets of the failed *jusen*. Two pieces of legislation passed in 1998 put up another ¥60 trillion—of which ¥17 trillion went into a special DIC account to bolster the protection of banks' deposits; ¥18 trillion went into an account to be used for bank liquidations, temporary nationalizations, and the creation of "bridge banks" to receive the assets of failed banks; and ¥25 trillion went for injections of funds to recapitalize surviving institutions. As of year-end 1999, 15 of the surviving large banks had drawn down ¥7.5 trillion from this third amount in exchange for issuing to the DIC new convertible preferred shares. (Soon after these capital infusions, the "Japan premium" in the interbank lending market mostly disappeared, and the prices of Japanese bank stocks rose sharply.) In far smaller amounts, the government has similarly injected capital into the most important regional banks. Hence, in both countries the government eventually did commit serious amounts of public funds, but delay in doing so—a delay due to a combination of reluctance to impose on taxpayers, reluctance to accept the consequences for individual institutions and reluctance to acknowledge bad news, all together with hopes that changing economic conditions would resolve the problem without needing any public funds—was a major part of the story.

4. In both countries, the banks themselves—in other words, the banks' shareholders—have borne part of the cost of the crisis. In the United States, the S&L industry directly bore $22 billion in FSLIC costs for 1985-89 resolutions (vs. $42 billion from taxpayers) and $6 billion in RTC costs for 1989-95 resolutions (versus $79 billion from taxpayers). Banks' deposit insurance premiums rose to cover costs of FDIC assistance to banks that failed. More important, many banks cut their dividends, in some cases to zero, and the shareholders of many banks saw the market value of their equity reduced to a fraction of what it had been before the crisis.

   In Japan, the market price of many bank stocks fell to only 10 percent or so of their previous peak value, before recovering sharply—but still only to levels far below their previous peaks—in 1999. As of the September 1999 reporting date, the cumulative loss taken on disposal of bad loans by all Japanese banks was ¥61 trillion (compared with 1998 GDP of ¥497 trillion). Moreover, the charge to Japanese bank shareholders is still ongoing. In 1999, 16 of the 17 surviving large banks (all but the recently merged Bank of Tokyo Mitsubishi) cut their dividends. Two of these, both trust banks, eliminated their dividends altogether.

Policy Implications for Japan

Six potentially important lessons, some narrowly focused on the banking industry's problems and others pertinent to the Japanese economy more generally, emerge from a consideration of these parallels (and differences) between Japan's banking crisis and that in the United States a decade or so ago.

1. *Act more promptly*. Careful studies of the US savings and loan cleanup have shown that a crucial factor influencing the cost of resolving individual institutions' insolvencies was delay by the responsible authorities. In short, delay is expensive. Ely and Varaiya (1997), for example, showed that delays in RTC resolutions significantly raised resolution costs and reduced the premiums received on auction sales of institutions taken into receivership. According to their estimates, each additional *1-month* delay reduced the auction premium by $118,000, compared with a mean premium received of $5.8 million and a median premium of just $712,000. The message from this experience is that delaying action—in the hope that either a change in the economic environment or some independent development may turn matters around, or perhaps merely out of an inability to overcome political or administrative obstacles even after everyone recognizes what needs to be done—is a policy with a price. Moreover, in the US experience, the price was high enough to make most such delays objects of regret after the fact.

2. *Avoid regulatory forbearance*. The US experience shows that regulatory forbearance sometimes paid off but was mostly a bad idea. Further, the uses of forbearance that had more positive results—for example, the Net Worth Certificate Program, mandated under the Garn-St. Germain Act to enable insolvent mutual savings banks to hold out until what had been an extraordinary level of interest rates as well as an extraordinary yield curve reverted more nearly to normal (which both did)—were narrowly targeted in scope and applied in circumstances that minimized the resulting moral hazard problems. Hanc (1997) found that of the more than 1,650 commercial banks that failed during 1980-92, nearly 350 would have faced earlier closure if the ''prompt corrective action'' rules later put in place under the 1991 FDICIA legislation had been in effect all along. He concluded that, although these delays due to regulatory forbearance were mostly not costly, some were.

   In the case of S&Ls, it is clear that FSLIC forbearance in enforcing capital requirements provided support to many highly risky institutions and even some that in effect ran as Ponzi schemes. As Kane and Yu (1996) have shown, under any of several sets of assumptions it would have been far less expensive to taxpayers to close undercapitalized S&Ls more promptly. The main conclusion from this experience is that both kinds of delays are costly: delays in resolving failures once they have occurred, as well as delays in declaring that insolvent or undercapitalized institutions have failed and closing them. Japan's ''Prompt Corrective Action'' legislation (enacted in 1997, and loosely based on the US model), and the establishment of the Financial Supervisory Agency (FSA) as an independent regulatory body in 1998, were clearly useful steps. Closing the Hokkaido Takushoku Bank (in 1997) and temporarily nationalizing Long-Term Credit Bank and Nippon Credit Bank (both in 1998) just as clearly represented the end of, or at least a major change in, Japan's traditional ''convoy'' system of bank regulation. But undercapitalized or even insolvent banks remain a concern. Similarly, while the FSA's aggressive posture is certainly welcome—examples include the agency's more proactive stance on declaring loan losses and its role in seeking restructuring conditions as part of the injection of new capital into the 15 banks that took advantage of this opportunity—as of the time of writing, it is too early to conclude with confidence that this apparently new regime will mark a lasting break with the past. Hence regulatory forbearance remains a temptation to be avoided.

3. *Force consolidations*. Yet another reason for seeking to eliminate insolvent or undercapitalized lenders is to improve the competitive environment for the survivors. Because insolvency greatly magnifies the usual moral hazard problems, insolvent banks can and often do undercut solvent ones in competition for credit business, thus making it more difficult for the solvent banks to be profitable without bearing excessive risk. As of the time of writing, when little new bank lending is occurring in Japan anyway, it is hard to argue that this further aspect of regulatory forbearance is a currently active problem. But the object of Japanese policy in this area should be to recreate a banking system capable of supporting an economic expansion once other factors—most important, fiscal and monetary policies—produce one. Attempting to create that support by allowing insolvent institutions to provide the credit only ensures that neither the banking system nor the economic expansion will prove robust. A central lesson to remember from the US experience is that, despite years of excessive regulatory forbearance, in the end the principal use of public funds was *to put institutions out of business.* The new prevalence in Japan of mergers completed and mergers in progress, among not only regional banks but also the large ''city'' and ''trust'' banks—all presumably with approval from the Financial Reconstruction Commission (or FRC, established in 1998 to oversee the bank restructuring process)—suggests progress along just these lines. Even so, it remains to be seen whether this strategy repre-

sents the kind of effort to eliminate bank offices and duplicative functions that has motivated many large bank mergers in the United States (admittedly, with limited concrete payoff to date) or merely an attempt to "change the name over the door" while keeping in place an "overbanked" financial system.

Similarly, the potential role of foreign competitors remains, as always in Japan, an unresolved question. In 1999, the FRC approved the sale of Long-Term Credit Bank, which the DIC had nationalized the year before, to Ripplewood Holdings, a US investment firm. (Similar foreign acquisitions of failed Japanese firms have taken place outside the banking sector—e.g., Merrill Lynch's purchase of Yamaichi Securities and G.E. Capital's purchase of Japan Leasing.) But more recently the FRC, apparently under some political pressure, declined to approve an analogous sale of Nippon Credit Bank to a foreign buyer. More generally, the FRC has chosen thus far to conduct such negotiations mostly in secret, in contrast to the transparency achieved by the RTC's use of competitive auction procedures in the United States.

4. *Sell the collateral*. The Japanese authorities have already moved, in a limited way through the Cooperative Credit Purchasing Company (CCPC), to acquire nonperforming bank assets. Set up in 1993 and funded mostly during the following 2 years, the CCPC used ¥5.8 trillion to purchase more than 11,000 loans against more than 20,000 properties, consisting mostly of real estate. As of March 1999, the CCPC had sold roughly half of these properties and had realized ¥2.5 trillion from the sales. But the CCPC is a limited vehicle, not least because its purchase of a nonperforming loan is typically financed by its own borrowing from the selling bank (so that the bank removes a bad asset from its balance sheet and replaces it with a presumably good asset: the obligation of the CCPC). The US experience suggests that more of this kind of activity (however financed)—importantly including both the loan purchases and the collateral sales—would be helpful. It is easy to overstate concerns about the effect on real estate values due to sales of assumed loan collateral. In most cases, in the United States, the negative short-run impact from sales of government-assumed collateral was less than the market had anticipated. Moreover, the medium- to longer-run effect of eliminating the overhang of real estate held for sale was often beneficial. Everybody knows that this collateral will have to be sold sooner or later. Actually putting it on the block clears the air rather than spoiling the market.

5. *Penalize shareholders, not depositors*. There is no need for depositors, especially holders of small and medium-sized deposits, to bear losses in a banking crisis. Especially in the wake of the US S&L industry collapse, some economists have called for an end to deposit insurance.

But the answer to the moral hazard problem is not to eliminate deposit insurance altogether but rather to limit it by size of deposit and, even more important, to exercise effective prudential regulation and supervision. (Japan's plan to limit deposit insurance to ¥10 million per account, originally scheduled to take effect in March 2001 but now delayed until 2002, is a good idea; but the sooner the better.)

By contrast, when banks suffer losses, it is important for bank shareholders to lose their equity, and sometimes for bank managers to lose their jobs. Yes, there are limits on the appropriate reliance on market discipline. But as the US experience shows, the natural instinct of public authorities is to err by relying too little on market discipline, not too much. Nothing draws investors' attention to a problem more effectively than for shareholders of an insolvent firm to be told the truth: that the value of their investment is zero. Similarly, nothing teaches the value of good job performance better than seeing those who have performed poorly face directly the consequences of their institution's corporate failure, rather than continue to reap the usual personal rewards.

6. *Apply expansionary fiscal and monetary policies*. The record of the banking crises in both Japan and the United States makes clear that, while banking-sector problems can be a cause of poor economic growth, they are also a consequence. Conversely, the banks' (but not S&Ls') experience in the United States showed how fast a banking system can restore its capital position and rebuild profitability once insolvent institutions have been cleared away *and* the economy has staged a significant recovery. For this reason, it is all the more important to do what Japan should have been doing all along on other grounds—namely, using expansionary fiscal and monetary policy to foster economic expansion. Recently, both fiscal and monetary policies in Japan have taken important steps in the right direction. But much still remains to be done. In the fiscal area, as Posen (1998) has argued, the main policy thrust should center on tax cuts. In the monetary area, as Bernanke's essay in this volume forcefully makes clear, the Bank of Japan should first realize the error of its belief that hitting the zero bound on nominal interest rates precludes its doing anything more to ease monetary policy, and then go ahead and carry out yet further expansionary open market operations. Both fiscal policy and monetary policy lie beyond the scope of this essay, which focuses more directly on the banking sector, but the appropriate use of these macroeconomic instruments to spur a business recovery nonetheless is an important part of coping with Japan's banking crisis.

Some Questions of Political Economy

There is no need to summarize the six suggestions for Japanese policymakers offered immediately above on the basis of parallels between Japan's and the United States' respective banking crises. Instead, it is useful to conclude by posing several questions about the Japanese crisis from the perspective of political economy.

First, where did all the money go? It is important to keep in mind that what is at issue when banks and other lenders fail is not just numbers on balance sheets but transfers of real resources. In the US banking and S&L crises, it was clear after the fact that much of the money lost represented dissipation of the US economy's real resources in constructing office buildings, energy extraction facilities, and other physical projects that in the end the market did not value. (It was also probably true, though less straightforward to document, that much of the rest represented the transfer of resources to corrupt and self-dealing operators of depository institutions.) Such a judgment is harder to draw for Japan, because so much of the problem there centered on loans not for construction, although that was also important, but for what amounted to speculation in land or equities. To be sure, those who bought these assets at inflated prices lost their investment, and the lenders that backed them also lost. But for every investor who bought at the top there was also a seller. Did the Japanese banking crisis mostly amount to a huge transfer mechanism—*from* banks, taxpayers, and investors *to* yet other investors? In short, where did the money go?

Second, is it fair to treat Japanese banks as strictly private firms, whose shareholders and managers should appropriately be subject to market discipline when their institutions' affairs go badly? Under Japan's traditional system of administrative guidance of the entire financial sector—and, more broadly, in light of the consensual nature of Japanese society as a whole—perhaps the banks, in lending so aggressively against rapidly inflating real estate and equity values, were merely acting as agents of public policy. If so, then the conventional rationale underlying the argument for exposing these institutions and their managers to market discipline would not apply. At the same time, however, drawing that judgment would also then imply that these institutions were not truly private competitors and therefore that their earning a competitive market rate of return on average over time would not be warranted.

Finally, why the failure to address these costly problems—either the banking crisis or Japan's economic malaise more generally—for so many years? Normally, when a country is paralyzed in the face of costly problems like these, its inaction stems from some kind of internal structural conflict that prevents the society from reaching a consensus on what is to be done. But at least as most Westerners see Japan, its society is not particularly subject to such conflicts. Nor, at least with regard to the banking crisis, does there appear to be a real lack of consensus on what to do. Are Western observers missing some fundamental aspect of Japan's social makeup? Whatever the answer, one hopes that the progress made in addressing these problems in just the past year or two continues.

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