5

Discussions of the Financial Crisis: Robert Glauber and Anil Kashyap

ROBERT R. GLAUBER

My comments are directed to the parallels between the US banking and savings and loan (S&L) crises and Japan's ongoing banking crisis. I also want to suggest some lessons from US experience that may be relevant for Japan. To this purpose, let me start with some comments on the essays by Friedman and Shimizu.

Friedman puts forward a long, comprehensive, and entirely sensible list of similarities between US and Japanese banking experiences. Prominent among the similarities are the large role of real estate as collateral and the impact of falling real estate prices, regulatory relaxation, moral hazard arising from deposit insurance and deregulation, lax supervisory standards, substantial overcapacity in the banking system, regulatory forbearance, and governmental paralysis arising from the need to get public funds to rehabilitate the banking system. To this list of similarities I would add nontransparent accounting; the "too big to fail" doctrine, which engendered moral hazard behavior; and undercapitalization of the banking system arising from overcapacity.

Against this list of similarities, Friedman notes several differences between US and Japanese experiences. As he suggests, banks play a more important capital market role in Japan than in the United States, and the Japanese banking system is more concentrated. He also suggests that purchase and assumption (P&A) transactions, a process that "resolves" insolvent banks without reducing excess capacity in the banking system,

---

Robert R. Glauber is professor at the John F. Kennedy School of Government, Harvard University.

played a large role in Japan but not in the United States. In fact, in the 1980s, P&A transactions were the standard resolution procedure used by the Federal Deposit Insurance Corporation, and were as ill conceived in the United States as they were in Japan. Also, Friedman points to the corrosive effects of deposit insurance and the ''too big to fail'' (TBTF) doctrine, and he suggests that these were a far more serious problem in Japan than the United States. I would suggest that the same corrosive effects of deposit insurance and TBTF are evident in the sad history of the S&L debacle of the 1980s and the banking crisis of 1989-92.

In the same vein, Shimizu cites a number of differences between the two banking systems that have made it more difficult for the Japanese government to deal effectively with the banking crisis. Here I think he is letting the government off a bit too easily. The differences are not that great and hardly excuse the government's delay in dealing with the crisis. (In fairness, I should note that the US government's record in dealing with the S&L crisis is hardly one that engenders great pride.)

Shimizu's list begins with the large decline in the value of land and real estate collateral, which makes it hard to securitize loans and mortgages at current prices. But loans and mortgages on the balance sheets at US S&Ls were under water as well, and any sale through securitization or other means required recognizing losses. This is the essence of resolving these insolvent, or nearly insolvent, institutions. Bad assets must be written down to market value and sold to market buyers, and losses must be recognized and written off against equity. They simply cannot be disposed of at current prices.

The second distinctive characteristic of the Japanese crisis cited by Shimizu is the need for large amounts of public funds to close down insolvent institutions and pay off depositors. This need, he suggests, accounts for (and perhaps excuses) the delay in government action. But the same need for public funds existed in the United States; the S&L debacle cost US taxpayers about $175 billion, perhaps a ''small'' sum compared with the likely price tag in Japan, but large by US historical measures. In both countries, there is little doubt that the government's timidity in informing taxpayers of the full cost to resolve the crisis produced a large, unnecessary delay. The delay in both cases turned a relatively small cost into a staggeringly large one. Dealing with these crises takes political leadership, a quality often not in large supply.

The final point that Shimizu makes is that the real estate market recovered in the United States in the early 1990s, reducing banking and S&L problems and making it easier to resolve the crises. Here I think he has the cart before the horse. The US real estate market recovered *because* financial institutions were forced to sell their real estate assets into the market at whatever (low) prices the market dictated, and take the write-downs. Only when these assets passed from weak hands (S&Ls and banks) into strong hands (market participants that wanted to own real estate at marked-down prices) could the market recover. Markets do not recover when there is a large inventory overhanging them, waiting for sale. Waiting around for the market to recover before forcing distressed assets out of the banks is a hopeless endeavor.

These are all important lessons, many of which I fear the Japanese regulators have not fully comprehended. There are other lessons that can be learned from the US experience, and it is to them that I would like to turn. In doing so, I should emphasize that whatever wisdom can be found from analyzing the US experience comes in substantial measure from understanding the mistakes of US regulators. Japan has the opportunity to go to school on these mistakes.

Broadly speaking, the objective of any regulatory action in Japan should be to enhance the safety and soundness of the banking system, ensuring that there are strong banks capable of supporting creditworthy domestic companies and capable of competing successfully in the global financial markets. This objective will be best served by several broad regulatory initiatives: First, strict supervision that enforces capital requirements and takes prompt corrective action against banks that fail to meet these requirements; second, a commitment to close insolvent institutions to eliminate excess capacity; and third, increased reporting transparency to reassure the markets. The need to close insolvent banks cannot be overemphasized. Only by doing so will the Japanese banking system avoid cutthroat competition, avoid spreading the system's capital too thinly across too many institutions, and move to reallocate capital and borrowers from weak to healthy banks.

These broad initiatives will be supported by specific actions. First, regulators should close, either directly or through merger, all insolvent banks. In this process, shareholders suffer complete losses, and the senior bank management retires. This closing process is crucial both as a political necessity and to reduce excess capacity in the banking system. Second, the good assets and the franchise of a closed bank should be sold to other solvent institutions. As part of the process, corporate borrowers in good financial health would be transferred to the buying institution—but only healthy borrowers would be transferred. Foreign institutions would be candidates to become buyers. Third, the Financial Supervisory Agency (FSA), the new banking supervision authority, should require transparent reporting.

Fourth, the bad assets (loans and real estate) of closed banks would be transferred to the Resolution and Collection Bank (RCB). The RCB would sell these assets as quickly as feasible, which would require that they be marked down to market value and that the RCB show substantial losses. This is the same course the RTC followed in the US S&L resolution process. The longer the RCB holds assets off the market, the less these assets will be worth and the longer it will take for the real estate market to recover.

Measured against this roadmap, how do recent regulatory activities in Japan stack up? There is some good news. The FSA has been more effective than many expected. It has imposed rigorous supervision and mandated more transparent accounting and loan loss reporting. A substantial number of mergers has been announced, with the effect that, of the 19 largest banks 2 years ago, two have been (temporarily) nationalized and the remaining 17 merged into eight new banks. The largest of these mergers, Industrial Bank of Japan/Dai-Ichi Kangyo/Fuji and Sumitomo/Sakura, will produce very large institutions. Interestingly, the Sumitomo/Sakura merger unites banks formerly allied with two different keiretsus. These mergers can be a mechanism to close insolvent banks, downsize capacity, and sell off bad loans on the balance sheet. They can be the vehicles to do very real restructuring of the financial industry.

The bad news is that the same mergers can provide an excuse to avoid the hard decisions necessary to accomplish real restructuring, which is needed for Japanese banks to provide domestic credit and compete in the global financial market. Will the merger process provide the needed restructuring?

There are reasons for some skepticism. Bank mergers are difficult to accomplish effectively. Particularly in Japan, these mergers require combining large bureaucracies into even larger ones. The integration process must proceed across different corporate cultures, even across keiretsu lines in one case. The record of success in the United States is not altogether reassuring; there, fewer than 50 percent of merged banks have been more profitable after merging than before.[1] What has been difficult in the United States could be even more so in Japan.

I must admit to having several concerns about the prospects of these mergers. They may produce just more delay before the necessary restructuring is accomplished. The mergers are typically announced with 1 to 2 years lead time, during which the organizations can be paralyzed. Asset sales can be delayed, and efforts to enter new profitable businesses, needed to meet the imperatives of globalization, can be put on hold. There is in fact little evidence that asset sales have begun in earnest. Perhaps it would be better to sell assets first, then proceed with the merger, or at least to commit to doing both at the same time.

It also appears that the mergers are being used to keep insolvent industrial companies on financial life support. As a condition imposed by the government for the purchase of Long-Term Credit Bank by a group of US financial institutions, the buyers cannot reduce the size of the bank's loan portfolio for 3 years. So the bank must continue to lend to weak or bankrupt firms in the old economy—steel, shipbuilding, construction—

1. Pilloff, Steven J., and Anthony M. Santomero. 1996. *The Value Effects of Bank Mergers and Acquisitions.* Wharton Financial Institutions Center Working Papers 97-07. Philadelphia: Wharton Financial Institutions Center, University of Pennsylvania.

and has little capacity to lend to potentially healthy emerging growth companies.

In dealing with a serious crisis in its financial system, Japan's regulators appeared for many years to have learned little from mistakes made by US regulators facing similar challenges. Recently, the new Japanese financial regulator has taken some encouraging steps. But there is still much to do, and some cause for concern that the mistakes are not over.

ANIL K. KASHYAP

The essays in this volume nicely convey the range of opinions regarding both what happened in Japan in the 1990s and what policymakers might do to improve the current situation. Given the diversity of views, I will begin my remarks by reviewing the consensus position. Having set out the consensus, I will then identify the most novel observations made by the authors. I will close by pointing to the issues that I believe deserve the most attention at this time.

The Consensus Explanation for Japan's Economic and Financial Crises

Like most of the contributors to this volume, I believe that during the 1990s Japan faced both economic and financial crises, each of which was partially preventable. Because the causes of the financial collapse seem to be less controversial, let me begin my remarks by reviewing this evidence, before turning to the more contentious issue of the macroeconomic problems.

Background on the Banking and Financial Problems

According to most observers, the origins of the financial crisis can be traced to the financial liberalization that began in the late 1970s and is just now being completed (for an elaboration of what follows, see Hoshi and Kashyap 2000). Up until the middle of the 1970s, the financial system was heavily regulated, so corporations were virtually forced to rely on banks for funding (because other market options were restricted). Households also faced very restricted choices regarding where they could put their savings, so most of their wealth was held in deposit accounts. Although this system may not have been the most efficient way to fund corporate investment, it was at least internally consistent—as long as the banks did a good job of taking in deposits and making loans.

The system began to unravel with the onset of deregulation. The key problem came from three mutually inconsistent aspects of the changes. The first was the easing of restrictions on accessing capital markets, which undercut the banks' dominant position as suppliers of capital to the corporate sector (particularly for the largest firms). The second was slow and

---

Anil K. Kashyap is a professor at the Graduate School of Business, University of Chicago. He is a consultant with the Federal Reserve Bank of Chicago and research associate at the National Bureau of Economic Research. *The author thanks Takeo Hoshi for helpful discussions.* *The views in this essay do not reflect those of the Federal Reserve System or the Federal Reserve Bank of Chicago.*

incomplete easing of the restrictions on households' nonbank savings' options. The absence of full liberalization assured the banks of a large supply of deposits. The third was the even less complete expansion of bank powers and shareholders' rights, which not only prevented the banks from moving into new lines of business, but also made it difficult to force the banks to shrink as their traditional customers migrated to other sources of funding.

The inconsistencies among the changes played out during the 1980s as the deposit-bloated banks began looking for things to finance. Domestically, the banks shifted toward more small-business lending and really ramped up their real estate lending. There was also a large increase in overseas lending. By the end of the 1980s, the banks had transformed themselves so that they were more attached to these new customers, and they therefore faced a new set of risks.

The plummeting asset prices of the 1990s triggered the crisis by impairing the banks' capital. The banks were reluctant to recognize the losses, and regulators were slow to force them to do so (because this would have been an implicit acknowledgment of bungled supervision). This period of denial meant that the capital-impaired banks fell behind their international competitors in launching new products and offering new services that will be important once the financial services industry around the world is deregulated. Only when the losses became too large to hide did the government step in to force some reorganization.

Macroeconomic Events in the 1990s

The standard explanation for the macroeconomic stagnation in the 1990s also usually begins with the collapse of the stock market and subsequent decline in land prices. Most of the essays in this volume (except notably for that by Jinushi, Kuroki, and Miyao) do not say much about the cause of the break in asset prices, although it is common to point to monetary policy as having precipitated the decline. For our purposes, settling this issue is not essential, but I will offer some reasons to be skeptical about believing that the Bank of Japan (BOJ) caused a "bubble" to pop.

Regardless of the reason that asset prices did begin falling, it is clear that the price shifts adversely affected banks', consumers', and firms' balance sheets. This deterioration in net worth contributed to a spending decline, most clearly in investment. Initially, there was some easing by the BOJ, but in hindsight this was incomplete. Only by the end of the decade—when the BOJ had become independent and implemented its zero interest rate policy—did monetary policy become exceptionally loose.

Fiscal policy throughout most of the 1990s was also relatively tight. Although the government repeatedly announced stimulus packages, its actual spending was almost always far below the announced amounts. The major exception to this rule was the period 1995-96, during which growth was actually robust. The stance of fiscal policy shifted in April 1997, when the national consumption tax was increased from 3 to 5 percent. At the same time, the temporary income tax cut was discontinued and the copayment for national health insurance was increased. Growth during the rest of the year was much slower.

In the fall of 1997, the banking crisis came into full view as several large financial institutions failed. Bank credit and investment spending both dropped markedly, and nominal GDP growth for the next 2 years was actually negative. Banks were forced to accept some capital in the spring of 1998, but it took a year before a serious injection of public money was offered. By the beginning of 2000, a recovery had begun that appears to be taking hold.

Novel Observations Made by the Authors

Although this general picture is painted by almost all the authors of the essays in this volume, each chooses to emphasize slightly different things. To keep these comments brief, I will highlight only those observations that I find most intriguing. I will also add my reactions to these main points.

Perspectives on the Banking Crisis

Shimizu makes three noteworthy points. First, he argues persuasively that the long-term-credit banks were the most disenfranchised by the deregulation, so it is not surprising that they were the most hurt. Second, the banks' shift toward more real estate lending could be rationalized as an appropriate (and perhaps even optimal) response to having to switch to lending to more risky customers. Third, he notes that up until the 1990s there was clear evidence that land price shifts preceded loans, particularly for smaller firms.

I agree that the demise of the long-term-credit banks was in many respects inevitable: They were more dependent on large manufacturing firms than the other major banks, and they also had enjoyed the advantage of being the only serious long-term lenders. Once these niches disappeared, they became organizations with no clear reason to exist and no comparative advantage.

I am less convinced that the real estate lending boom was fully rational. As mentioned above, the lack of corporate control insulated the banks from a pressure to shrink and maintain profitability. More important, the terms of many of the loans were not always as conservative as one would expect if property lending were really being driven by concerns about risk. For instance, in the late 1980s it was common to hear of real estate loans for which the ratio of loan to value was above 100 percent at the time credit was extended, because "land prices never decline in Japan."

I also see this interpretation as being consistent with the potential shift in the correlation between lending flows and land price changes. In particular, perhaps one reason why the land price declines did not initially lead to a sharp drop in lending was the lack of strong corporate governance for the banks. Because there was no immediate pressure to maintain profitability, many loans with little chance of netting a profit were extended and then rolled over.

The political economy of the crisis figures heavily in Friedman's essay. He offers six strong pieces of advice about what should be done in Japan: (1) act "more" promptly; (2) avoid regulatory forbearance; (3) force consolidations; (4) sell the collateral; (5) penalize shareholders, not depositors; and (6) apply expansionary fiscal and monetary policies. I concur with all these suggestions.

However, I see the need to force consolidation as the most urgent priority. Throughout the 1990s, the major Japanese banks were simultaneously among the largest banks in the world, and the least profitable. This situation cannot continue much longer, and unfortunately it is hard to see how a recovery in profitability could occur. At this point, the banks have virtually no competitive advantage vis-à-vis the other global banks; put differently, it is hard to think of a single product or service line in which the Japanese banks could compete head-to-head with the world leaders and win much business. Thus, an attempt to take on the world's major financial services firms in offering new products and services is likely to fail.

Given these circumstances, the obvious alternative is for the banks to retreat from most global activities and focus on those core areas of banking within Japan for which full foreign competition is likely to be less acute. This would imply a major shakeout in the industry—one that is probably inevitable anyway, because during the next few years, savers will be able to access nondeposit financing more easily, and borrowers will continue to migrate to capital market financing.

The consolidation that I imagine involves significant downsizing, not just in the number of banks but, more important, in the *overall scale* of the banking sector. As a benchmark, table 5.1 reports data from Gilson (1998) showing that it was common for mergers between large banks in the United States in the late 1980s and early 1990s to involve targeted cost cuts of 30-40 percent. The contrast with the large Japanese mergers since the fall of 1999 is striking. For instance, in the merger of Dai-Ichi Kangyo Bank, Fuji Bank, and the Industrial Bank of Japan, only 3 extra branch closings and 38 additional employees were to be let go (relative to what the individual banks had announced when they received their

Table 5.1 Cost savings for selected large US bank mergers

Year	Acquiring bank / acquired bank	Cost savings as a percentage of smaller bank's expenses
1986	Wells Fargo / Crocker	31
1987	Hartford National / Shawmut	33
1987	Bank of New York / Irving	37
1989	MNC / Equitable	39
1989	Core States / First Pennsylvania	39
1991	Chemical / Manufacturers Hanover	33
1991	Commercial / Manufacturers National	37
1995	Fleet / Shawmut	43
1995	PNC / Midatlantic	33
	Average	36

Source: Gilson (1998, table TN.3).

capital infusion in the spring)! The tie-ups between Sakura and Sumitomo and between Asahi and Tokai were only slightly more ambitious. Unless these mergers result in significantly more downsizing, they will not help with the fundamental underlying problem.

Similarly, the capital injection that occurred in the spring of 1999 was also inefficient. Many of the banks that received support are destined to disappear or shrink massively, so it was probably unwise to spread public money so indiscriminately across the banks. I suggest that any policy proposal to address the continuing problems of the banks first be evaluated by checking whether it is consistent with the view that the Japanese banking sector needs to shrink.

Perspectives on Japanese Monetary Policy

The essays by Bernanke and by Jinushi, Kuroki, and Miyao each use very different approaches to arrive at the conclusion that Japanese monetary policy could have been used to foster growth during the 1990s. Because I also agree with this conclusion, I will not dwell on the details of these authors' arguments. Instead, I will pick up on three other observations that flow from their work.

First, I think it is important to recognize that the Jinushi, Kuroki, and Miyao essay stands out relative to the other contributions to this volume because it looks at what happened in the late 1980s as well as in the 1990s. Their assessment of the evidence from before the growth slowdown is very interesting: They conclude that during the period 1990-91 the BOJ's monetary policy was *too loose*! Their fitted rule for the call rate (shown in their table 4) clearly shows that one might have expected further monetary tightening during this period.

I find this observation intriguing in two respects. First, most textbook treatment of stock price determination would say that monetary policy would have a difficult time affecting any particular relative price in the economy (including the relative price of land or stocks). In a more recent context, Federal Reserve Chairman Alan Greenspan has been expressing his concerns over US stock prices for years, but stock prices have soared since his now famous quote about ''irrational exuberance.''

No doubt, if the United States does have a crash, there will be some who blame Greenspan, but to do so would ignore the impotence of his remarks for years. More important, in the Japanese context, why did the overall inflation rate in the late 1980s not explode, if monetary policy was so loose? Thus, there are good theoretical reasons to be cautious in asserting that the BOJ started or stopped an asset price bubble.

Furthermore, others who have looked for fundamentals-based explanations for the stock price movements have had some success in explaining this period. For instance, Ueda, in an essay published in *1990*, found that the land price increase in the 1980s can be fully explained by the growth in rental prices (Ueda 1990). In spite of the high rate of land price increases, the ratio of land price to rent hardly changed.

Because many Japanese firms hold substantial amounts of land, Ueda (1990) also found that the increase in corporate assets implied by the increase in land prices goes a long way toward explaining the stock price increase. If investors believed that the low interest rates and healthy growth in corporate earnings of the 1980s would continue forever, fundamental factors (including the land price increase) can fully explain the increase in stock prices. (See also Frankel 1993 for a similar account.) Thus, I believe we should add the Jinushi, Kuroki, and Miyao essay to the stack of evidence challenging the claim that the BOJ really triggered the collapse of the stock and land markets.

If the BOJ did not cause the collapse in asset prices that triggered this whole debacle, what did? As Jinushi, Kuroki, and Miyao note, there were also some direct credit controls on land and stock purchases that were put in place during this time, and these factors may well have been important. But I think this topic is still ripe for further study.

Bernanke's essay focuses more on recent events and argues strongly for two points. He first argues that part of the poor growth of the 1990s was due to insufficient aggregate demand. He then argues that a looser monetary policy focusing on depreciating the exchange rate would be a good first step toward stimulating spending; if that is tried and fails, he proposes a variety of other monetary actions.

I am a bit skeptical of the overall importance of the deflationist story of insufficient aggregate demand. To play devil's advocate, my concern comes from evidence on forward interest rates (e.g., published each month in BOJ's *Monthly Bulletin*). These rates suggest (at least since the fall of 1999) that the expected 1-year rate, 3 to 4 years ahead, has been about 2 percent; it is even higher going out a few years further. Taking Bernanke's estimate of a 1 percent real rate, this seems consistent with the view that the strong growth of narrow money is expected to slowly lead to a modest amount of inflation—not too far from the preferred level for many countries that are pursuing inflation targets.

Although this evidence gives me pause, I am equally puzzled by the movement in the exchange rate since the fall of 1998. It is hard to understand why the yen has appreciated so much—unless one gives some credence to the concerns over deflation. Moreover, I agree with Bernanke that a depreciation of the yen would improve growth in Japan in the near term. Given the low rate of inflation, it is hard to argue against this on the grounds of harming price stability; at the same time, a depreciation is almost certain to at least spur exports. So, despite my minor doubts about Bernanke's diagnosis, I am in full agreement with his policy prescription.

Unfortunately, this view is not shared by the BOJ. As Bernanke notes, the BOJ has argued that it cannot intervene on its own in the foreign exchange market. Like Bernanke, I am troubled by this argument. For one thing, it is quite possible that, even by stating its preference for a weaker yen, the depreciation would occur with little or no intervention. Moreover, even if the "open mouth" operations did not work, the BOJ could legitimately fight for the right to intervene to offset deflationary pressures. I think it is unfortunate that the turf battles between the Ministry of Finance and the BOJ over how to manage this issue have ruled out the depreciation strategy thus far.

What Next?

Having discussed most of the relevant economic issues already, I close by pointing to two concerns regarding the political economy of the banking and macroeconomic crises. Both these issues are related to the observation that, despite the size of these problems, the Japanese public does not seem to have decided who really is responsible for the mess. Furthermore, within the government there is likely to be further jockeying to attempt to get credit for resolving the crises.

Blame Shifting

By the end of the US savings and loan crisis, there was lots of blame to go around. Most important, many people went to jail, and in textbook descriptions of the crises certain figures such as Charles Keating became the poster boys of the crisis. In Japan, this has yet to happen. I believe it will need to occur before the public will be completely satisfied and prepared to support measures to fully resolve the crisis.

Against this backdrop, I found the essay by Sakakibara extremely incredible. In particular, he writes that "US ambivalence about the infusion of public money had been a big factor in making Japanese public opinion largely antagonistic toward such an infusion." This is a stunning attempt at historical revisionism! For instance, Thomas F. Cargill (2000), in his summary of why the public support was missing, makes no mention of the US position. Instead, he attributes the tepid support to the scandals inside the Ministry of Finance and the BOJ, the bungled handling of the *jusen* resolution, and the perception that in the first round of capital injections the banks seemed to receive very few sanctions. To assert now that the Japanese public's opposition to the bailout was driven by the United States is absurd. However, I believe this example proves my basic point that there is likely to be considerable posturing over who is responsible.

The other troubling thing about blaming foreigners is that it does not inspire confidence that foreign firms seeking to enter Japan will be treated fairly. I believe that the best chance for Japanese financial-services firms to become efficient and competitive is for them to learn from competing against foreign firms. This process may be hindered if the Japanese authorities are dickering with their international counterparts over these matters.

To move forward in determining who should be held accountable for the need to use public money, I believe it would be helpful to focus on the question posed by Friedman: What happened to the money? It is remarkable that the winners who managed to sell land at such high prices have not surfaced. I hope that there will be more work on this question, by both academics and journalists.

Who Will Get the Credit?

Although a macroeconomic recovery does seem to be under way, there is still quite a bit of controversy over whether further steps could be taken to make sure it will persist. Of the many potential debates, I will focus on the discussions of the mix between monetary and fiscal policy and the question of whether tax reform or bank recapitalization ought to come next.

Until the recovery is fully apparent, the BOJ likely will be under continued pressure to maintain a loose monetary policy. Part of this pressure will come from the Ministry of Finance, which is concerned with the impending social security obligations associated with the aging of the population and therefore is hesitant to keep running up budget deficits. I am sympathetic to these longer-term budget concerns. Accordingly, if stimulative policy is needed, I would prefer to see it come from the monetary side.

Ironically, Ueda (Kazuo Ueda, "Why the BOJ Won't Target Inflation," *Asian Wall Street Journal*, 6 March 2000) and others at the BOJ have argued that the BOJ's capital could be wiped out if it continues to expand its balance sheet when interest rates rise. Not surprisingly, BOJ officials are nervous about having to beg for capital from the Ministry of Finance. The Ministry ought to eliminate this concern by setting a framework to recapitalize the BOJ immediately.

If the BOJ is going to continue to aggressively expand its balance sheet, the question then is what securities should be purchased. Here, I would like to see the BOJ buying the bonds that will be issued to finish recapitalizing the banks and other financial institutions. It is clear that losses by the commercial banks are still not fully covered. Moreover, other financial institutions also may need assistance. I favor Friedman's prescription of shutting the insolvent institutions promptly; but doing so will require funding. Monetization is my preferred option.[1]

Furthermore, there is likely to be a debate over how aggressively to proceed on this front. As we saw during the time when Michio Ochi was the minister for financial reconstruction, there is considerable sentiment within the government for going slow and hoping that a recovery can occur without any tough steps. Even with Ochi's departure there is only so far that the Financial Supervisory Agency (FSA) can go without strong support throughout the government. A further advantage of agreeing that the BOJ is going to begin the refinancing operations is that it would provide cover for the FSA to take a tough line with the weaker institutions that need to be closed. As I said above, the sooner that happens, the better!

References

Cargill, Thomas F. 2000. What Caused Japan's Banking Crisis? In *Crisis and Change in the Japanese Financial System*, eds. Takeo Hoshi and Hugh Patrick. Boston, MA: Kluwer Academic Publishers.

Gilson, Stuart C. 1998. Chase Manhattan Corporation: The Making of America's Largest Bank (Teaching Note), May 12. Watertown, MA: Harvard Business School Publishing.

Hoshi, Takeo, and Anil Kashyap. 2000. The Japanese Banking Crisis: Where Did It Come From and How Will It End? In *NBER Macroeconomics Annual* 14, eds. B. Bernanke and J. Rotemberg. Cambridge, MA: National Bureau of Economic Research.

Frankel, Jeffrey A. 1993. The Japanese Financial System and the Cost of Capital. In *Japanese Capital Markets*, ed. Shinji Takagi. Cambridge, MA: Basil Blackwell.

Ueda, Kazuo. 1990. Are Japanese Stock Prices Too High? *Journal of the Japanese and International Economies* 3: 351-70.

1. In some respects, this may be inevitable, because the Deposit Insurance Funds that are being used for much of the restructuring activity come from a credit line from the BOJ. If the BOJ forgives (or cannot collect) on these loans, this would amount to monetizing the losses.