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Restructuring the Japanese banking system
Has Japan gone far enough?

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Abstract

The resolution of the Japanese banking crisis has been identified as a critical factor affecting the health of the global economy. Massive restructuring must be undertaken to improve the health of Japanese financial system. We provide evidence that the Japanese banking system has begun to restructure in light of recent financial deregulation. In particular, failures, mergers and other forms of restructuring are now underway. However, Japanese banks still must overcome serious obstacles to regain their place among the world's best financial institutions.

JEL classification: G30, G34, G38

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> . . . the health of Asia and indeed the world depends upon Japan—President Clinton in his opening address to the IMF/World Bank, November 1998.

> The IMF, on September 21, 1998, defined the largest risk to the health of the world economy as Japan refusing to "address its financial-sector problems while ensuring adequate domestic demand."

1. Introduction

Reviving the Japanese banking system is a key element in improving the health of the global economy. The extent of the bad loan problem for Japanese banks has been estimated at US$1.2 trillion, or about 7% of the GDP of Japan (Hoshi & Kashyap,

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1999). However, as recently as mid-1998, the Japanese government attempted to avoid the issue entirely. Keizo Obuchi replaced Ryutaro Hashimoto as prime minister of Japan in July 1998 and promptly vowed that none of the 19 largest Japanese banks would be allowed to fail, for example (*Economist*, September 12, 1998). The government even circulated rumors that the failure of just one top bank would lead to a global financial upheaval. Moreover, until quite recently the banks themselves were content to mask the extent of the bad-loan problem and hope that the economy reversed course. The Japanese government and banks have begun to change their ways, however, as failures, mergers, and other forms of restructuring have begun in apparent earnest.

This study describes the current state of the restructuring of Japanese banks, focusing on the largest Japanese banks per conventions in the business press. First, we discuss the extent of the banking crisis, the events that led to the present situation, and relevant research regarding the functioning of Japanese banks. Next, we examine current restructuring measures taken by the Japanese government and individual banks in response to the crisis. Specifically, financial deregulation and subsequent mergers and bank failures are analyzed in detail. Finally, we assess the remaining obstacles and future issues faced by the Japanese banking industry.

2. Extent of the problem

Deregulation of the Japanese banking system will be complete by 2001 and, ideally, unfettered competition will take place among banks, insurance companies and securities firms. Hoshi and Kashyap (1999) suggested that deregulation proceeded at difference paces for borrowers, savers and intermediaries. These differences exacerbated the Japanese banking crisis. Specifically, large Japanese firms greatly reduced their reliance on banks as bond markets became accessible in the 1980s (Anderson & Makhija, 1999). Japanese consumers, however, continued to invest most of their wealth in bank deposits rather than the capital markets. This created an asset/liability mismatch for the banks as their funding base remained relatively constant, but they had to search out new borrowers. These new loans were largely to smaller companies that relied heavily on real-estate collateral. These loans performed poorly due to the collapse of the real-estate market in the early 1990s.

The Banker allocated a significant portion of its July 1998 "Top 1000 Banks" special issue to Japanese banks. The Bank of Tokyo–Mitsubishi, thought to be one of the healthiest Japanese banks, reported a pre-tax loss of US$6.2 billion, the second largest pre-tax loss of any bank in the world for that year. In addition, although 118 Japanese banks made the list of 1000 largest banks, 38 reported losses. The article stated that if the banks revealed the extent of their bad loans very few would have reported a profit. This stands in stark contrast to 3 years earlier when Japanese banks dominated the top of the list. In fact, most banks currently carry real-estate–backed loans on their books at 70% of peak value. However, land prices have dropped for 6 straight years to about 50% of peak value in 1992 requiring at least a one-third increase in