Japan's Big Bang Starts to Whimper
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With a general election due by October, Japanese politicians are backtracking on much-needed financial liberalization. This could spell trouble for the next tranche of so-called Big Bang reforms, which would further open the long-coddled financial industry to market forces. Without a commitment to continued liberalization, the chances of a sustained economic recovery in Japan are doubtful.

Late last year, Japan's ruling coalition, headed by the Liberal Democratic Party, reneged on the government's commitment to end the full protection of bank deposits by April 2001, instead extending the protection until April 2002. The April 2001 deadline put strong pressure on both banks and regulators to clean up the nation's lingering bad loan problem and to prepare for the post-Big Bang market-oriented financial system. Sadly, now that pressure is gone.

Worse still, the Ministry of Finance plans to continue the full protection of settlement accounts for one more year, essentially extending the initial deadline by two full years. Moreover, prominent LDP leaders appear willing to slow down or even reverse the overall reform of the financial system. "We will readjust what should be readjusted," LDP policy chief Shizuka Kamei recently told the press. He then suggested that the bank recapitalization plan using public funds that is scheduled to end by April 2001 should also be extended by another year. His proposal has been included in the bill to reform the Deposit Insurance Act, which was submitted to the Diet last Friday. This bill also provides public funds that can be used for bailouts of small banks, such as credit unions and shinkin banks.

Besides repudiating earlier commitments, there have also been signs of a resistance to permitting the forces of competition to take hold. For instance, after the sale of Long-Term Credit Bank to a foreign buyer, Michio Ochi, the head of Japan's Financial Reconstruction Commission, suggested that the next buyer of a failed bank would be Japanese. The FRC subsequently announced that Kokumin Bank, one of the failed banks, would indeed be taken over by a Japanese bank.

Now, the FRC has decided that the failed Nippon Credit Bank should also remain in domestic hands. This week the commission is expected to announce that NCB will be sold to a group of Japanese bidders, led by Internet financier Softbank, despite a potentially stronger bid by Cerberus Capital Management of the U.S. Ironically, Japan's new financial watchdog, the Financial Supervisory Agency, has been holding up other innovative Japanese firms such as Sony and Ito-Yokado from entering the banking business, citing the lack of proper licensing standards as the reason for the delay.

These events are alarming in three respects. First, the regulatory delay aims to protect the smaller banks by insuring them a supply of cheap funds. This focuses attention on the viability of smaller institutions which, although politically important, is of minor economic significance. The time and energy spent on these issues distract from the more significant problems. Second, many of these actions can be interpreted as a return to the "convoy" system of regulation in which stronger institutions are held back to help protect weaker firms. Obviously, a rebirth of the convoy system would be a huge mistake, as it greatly contributed to the country's current problems.

Finally, these statements and decisions raise doubts about the government's commitment to the remaining Big Bang financial reforms, such as the full integration of banking, securities dealing and insurance. These reforms are essential for the recovery of the Japanese financial system and its economy. Japanese banks are still hampered by regulation that prevents them from reaching the levels of profitability and efficiency of their main global competitors.

For instance, with the passage of the Financial Services Modernization Act of 1999, U.S. financial institutions will be able to further expand their reach by entering new lines of business and new alliances. In part because of past
regulatory barriers, Japanese banks already lag far behind in their product offerings and their institutional competence. One stunning reflection of this gap is the fact that large Japanese banks at the end of 1998 made about the same fraction of income from fee-based activities as they did in 1978. Over the comparable time period U.S. banks more than doubled this type of business. Delaying the full deregulation of the Japanese markets will only serve to widen this problem and leave the Japanese banks less able to compete.

The argument that banks need to begin earning more revenues by offering products besides loans is strengthened by the recognition that borrowing needs from the banks' traditional customers will likely continue to fall. Many of the banks' current losses are due to the high degree of real estate related lending done at the end of the 1980s and in the early 1990s. A driver behind these loans was an attempt to find new lending opportunities after the large firms that the banks had long counted on began migrating to the cheaper financing available through capital markets. The deregulation of bond and equity markets in Japan is now essentially complete, making it even easier for more firms to finance themselves through the markets. As a result, Japanese banks can be expected to lose still more customers and should be encouraged to downsize their lending rather than make loans purely to stay large or to protect their de facto bankrupt customers.

Fundamental to the necessary adjustments is the pressure of competition. Given the lack of competitiveness of the Japanese banks, further shelter from competition would encourage at best gambling recovery strategies. Banks may find it tempting to enter new lines of business in which they have no hope of becoming efficient. The fallacy of such attempts will only be exposed when competition is permitted, and the ultimate losses incurred will be increased by delaying the competition.

A better alternative is to fully open the markets now, most importantly to foreign financial institutions. Opening up would have three salutary effects. First, the experienced and efficient foreign competitors would help provide good signals about where the best profit opportunities exist in Japan. This could help push some Japanese firms that are capable of surviving towards making better decisions.

Second, the foreigners might opt to acquire some of the least efficient incumbents, potentially saving the taxpayers from paying more in the future to close down such firms. At the very least their presence will probably highlight for the regulators the Japanese firms that are pursuing the most reckless strategies. Finally, Japanese savers and borrowers will get better service. Given that they are going to get stuck with the bill for cleaning up the past mistakes, this seems like the least that they deserve.

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