COMMENT & ANALYSIS: Japan's route to safety: The country's financial institutions do not all share the same problems. The government should take note, argues Anil Kashyap:

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It has become fashionable to argue that Japan needs to resolve its financial crisis quickly. But its entire system is in crisis. What is more, banks, insurance companies and government financial agencies are suffering different problems that require different solutions. Failure to tackle these will doom any reform plan to failure.

The biggest problem facing Japanese banks is that they have no profit-making products, or services that define them as international leaders. They could become more profitable if they focused on the specific needs of Japanese customers, which are mostly small and medium-sized businesses. But the loan demand of these customers is much lower than the banking system's current assets. If they shifted in this direction, downsizing would occur.

Alternatively, they might maintain their size and try to compete by offering a full range of services, as Citigroup does. The danger here is that by offering new products in areas where they have no experience, they would incur more big losses. This could prompt the government to offer yet another capital injection, which the banks would squander by indiscriminately fishing for new profits.

Two questions should be asked when judging policy proposals. First, is a given proposal likely to facilitate the downsizing that is inevitable? Second, given that any money allotted to bailing out the banks would be limited, will any proposed refinancing happen in a focused way? For example, it would be poor policy to prop up banks that are about to go out of business.

Past recapitalisations do not meet these tests. And it is unclear whether the current proposals - to have the government's Resolution and Collection Corporation buy bad loans - will prove any better.

Furthermore, since the bad-loan problem merely reflects borrowers' asset quality problems, things will deteriorate as long as macroeconomic stagnation persists. In
the current deflationary environment a recovery is impossible: debt burdens continue to grow as prices fall. The Bank of Japan must buy assets until prices rise.

Insurance companies pose a different problem. Primarily, they have been crippled by their overly optimistic assessments of what their investment returns would be. As a result, they face a steady drain on resources because the promised level of repayments exceeds the income they can earn.

Unlike the banks, many insurers would be profitable if they had not made such aggressive pay-out promises. If these returns were negotiated downwards to more realistic levels, the companies could be sold at a positive price or could regain profitability in the future. Determining how to make this inevitable adjustment must be a policy priority. That would mean policyholders rather than the government bearing the losses. But these costs would also be reduced if the Bank of Japan reflated the economy.

Last, there is a tangled web of debts inside the government's financial institutions. Gauging their size is complicated because disclosure is poor and many of these institutions' assets are obligations of other government institutions. The most important issue, therefore, is to ascertain the asset quality underlying the transactions of these agencies.

The government has instructed the agencies to produce transparent accounting statements but the results so far are not encouraging. Indeed, conservative estimates indicate there are at least Y22,000bn (Dollars 170bn) in losses - more than 4 per cent of gross domestic product.

On top of this are the continuing distortions from allowing money-losing government-sponsored agencies to undercut private-sector competitors. How can banks make profits when the post office has 40 times the number of offices of the largest banking group, pays roughly the same rate on deposits as the banks and charges no maintenance fees?

Recently, Junichiro Koizumi, Japan's prime minister, and the ruling Liberal Democratic party agreed on reforms to some government agencies. But these appear to be incomplete. The government needs to withdraw wherever possible from its activities that compete with the private sector.

It is imperative that disclosure and the transparency of the government's net financial position are improved. A first step is to make a genuine effort to eliminate deceptive accounting practices. There should also be serious attempts to provide more realistic assessments of asset quality. In many government agencies,
there will certainly be many more losses than have so far been exposed.

After nearly seven months of talking about reform, more significant and tangible steps must be taken. Mr Koizumi's popularity will plummet once real reform is implemented and the associated painful adjustments begin. If bold steps are not taken soon, change will never come and Mr Koizumi could be gone within a year.

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