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**Contemporary Monetary Policy and
Financial System Issues of Japan**

by
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ABSTRACT

It is well-known internationally that Japan has been experiencing serious economic and financial difficulties since the 1990s. This chapter aims to explain the current important issues regarding the Japanese monetary policy and financial system. Struggling with unprecedented deflation, the Bank of Japan has employed unusual policy tools, such as reducing target interest rates to zero and buying stocks. The financial system of Japan is having trouble with financial intermediation, risk sharing and liquidity services. It is notable that the Japanese financial system is quite different from that of a decade ago. In recent years, the Japanese household and business enterprise sectors as a whole are lenders, and the government and foreign sectors are borrowers. As a result, the business model of Japanese banks during the high growth period when banks collected money from households as deposits and lent it to large enterprises is no longer sustainable. In terms of households' portfolio investments, safe assets such as bank deposits and traditional insurance make up substantial shares and risky assets such as stocks are marginal. A bank-centered financial system like Japan's faces financial difficulties when the risk taking ability of financial institutions decreases, which actually occurred due to the huge non-performing loans of the 1990's. The government initiated the Japanese Big Bang to vitalize the financial market in Japan, but a satisfactory outcome has yet to be seen.

1. INTRODUCTION

This chapter discusses the current features of the Japanese monetary policy and financial system. The author believes that understanding the contemporary Japanese financial situation is of interest to international readers for the following reasons. First, although Japanese economy had experienced serious economic difficulties in the 1990s, it is still the second largest economy

in the world, preceded only by the United States¹. Therefore, the performance of the Japanese economy significantly affects the world economy, particularly Asian countries. Second, Japan is said to be the first country to struggle with prolonged deflation. With the end of Cold War, many countries are facing deflationary pressures nowadays. Therefore, how the Bank of Japan has conducted its monetary policy in the deflationary economy is an example for all central bankers and those interested in monetary policy. Third, Japan, as well as many countries, experienced financial crises in the 1990s. Unfortunately, Japan's non-performing loans were exceptionally large. For example, Posen (2000) pointed out that the costs assumed by U.S. taxpayers in the S&L crises were about 3% of the U.S. GDP, while the expenses incurred in connection with non-performing loans in Japanese banks are 15% of the Japanese GDP. Therefore, understanding what caused the disastrous financial situation in Japan and how Japan has tried to solve the financial crises is instructive for countries wishing to avoid these problems and those who suffer from similar problems².

This chapter is organized as follows. Section 2 explains the Japanese macro economic performance since the burst of the bubble (i.e., in the 1990s). Section 3 provides an explanation on how the Bank of Japan conducted its monetary policy to combat deflation. Section 4 gives an overview of the Japanese financial system and Section 5 explains the deregulation of Japanese financial markets, namely the "Japanese Big Bang". Section 6 discusses banking issues in detail. Finally, Section 7 concludes this chapter.

2. THE LOST DECADE

After the collapse of the economic bubble, the Japanese economy remained in a prolonged recession and the term "the lost decade" took root. Here, I would like to examine the macroeconomic condition in Japan during the 1990s, focusing on the slowdown in GDP growth, developments in deflation, and the decline in asset values.

¹ According to OECD (February 2005), Gross Domestic Product at current prices and exchange rates for 2004 of the United States is 11.7 trillion dollars. Japan's GDP for 2004 is 4.7 trillion dollars, followed by Germany (2.7 trillion dollars), United Kingdom (2.1 trillion dollars), France (2.0 trillion dollars), and Italy (1.7 trillion dollars).

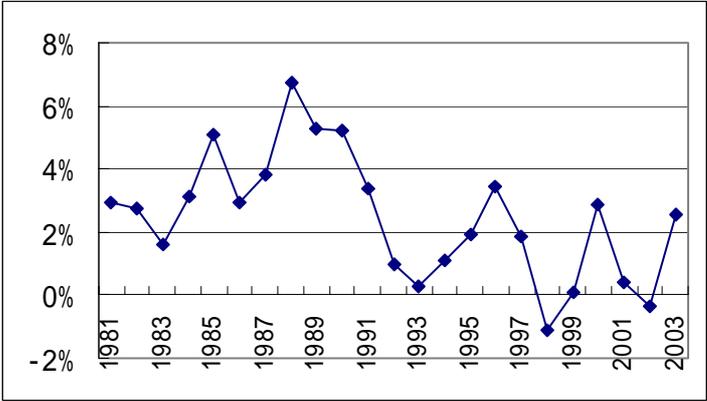
² Actually, the Japanese financial crisis has been examined by many authors, such as Hoshi and Kashyap (2000).

2.1 Stagnation of the Economy

GDP (gross domestic product) is the most basic indicator of economic activity. Figure 1 shows the real GDP growth over the last 20 years or so. The growth rate, which was approx. 3% in the early 1980s, reached a record high of 6.8% in 1988 during the economic bubble. But since 1990, the economic growth rate declined significantly, dwindling to almost nil in 1993. Though the economy showed a limited recovery tendency in 1995 and 1996, it lost momentum in 1997 and grew at a negative rate in 1998 (-1.1%). The fiscal tightening program implemented by the Hashimoto Cabinet that included raising of the consumption tax rate and increasing medical costs placed on the people is generally cited as a major factor of the economic slowdown in 1997.

Since then, although the growth rate perked up due to the “IT boom” in 2000, it fell into the negative territory again in 2002 with its rebound. As a result of such low-rate growth, when the real GDP in 1983, 1993 and 2003, is compared, it can be noted that it increased 1.43 times from 1983 to 1993, but increased only 1.13 times from 1993 to 2003.

Figure 1 Real GDP Growth Rate



Note: Real GDP based on the 1995 standards.

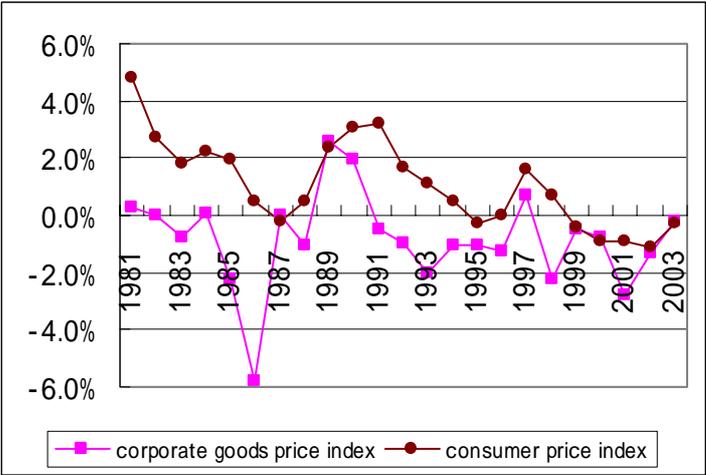
Source: Economic and Social Research Institute, Cabinet Office, Government of Japan

2.2 Trends in Price Levels

Standard price indices currently used in Japan include the Consumer Price Index (CPI), the Corporate Goods Price Index (CGPI; formerly known as “Wholesale Price Index”), and the GDP Deflator. Figure 2 shows recent trends in the CPI and CGPI. A considerable difference between

the movements of these two figures can be seen. However, by the beginning of the 1990s, a deflationary trend (in this figure, results with negative values) is evident by any indicator. For example, if we compare CGPI in 1990 and in 2003, we can see prices fell approx. 13%. Prices appear to have increased in 1989 and 1997 as the price of goods and services were increased to include the introduction of the consumption tax and the increase in the tax rate (from 3% to 5%).

Figure 2 The Rate of Price Fluctuation



Source: CGPI from Bank of Japan; CPI from Ministry of Internal Affairs and Communications

2.3 Depressed Asset Prices

Representative examples of asset prices are the price of land and the price of stocks. The price of these assets experienced a substantial decline in the 1990s.

Major stock price indices in Japan include the Tokyo Stock Exchange Stock Price Index (TOPIX) and the Nikkei Stock Average. TOPIX is calculated from all stocks listed on Section 1 of the Tokyo Stock Exchange weighted against the number of listed stocks. On the other hand, Nikkei Stock Average is the arithmetical stock price average of 225 stocks chosen and calculated by Nihon Keizai Shimbun Inc., from companies listed in the TSE Section 1 regardless of company size.

Figure 3 shows the historical movements of the Nikkei Stock Average. The stock prices started to rise steeply in or around 1986, and, at the end of 1989, almost reached JPY40,000.

Such ballooning in the price of stocks was a symbolic phenomenon of the bubble economy. By the start of the 1990s, the Nikkei Stock Average started to decline considerably, and in March 2003, it fell below JPY8000. This means the value of stocks bought at the end of 1989 dropped down to approx. one-fifth of the original value (on average).

Now, let us examine the land prices. Land transactions are not so frequently conducted as stock transactions, and no two pieces of land are under identical conditions, so it is difficult to demand an average land price. In Japan, major land price statistics include the official announcement of land prices (the Land, Infrastructure and Transportation Ministry announces the land price of surveyed areas on January 1st, each year), the prefectural land price survey (prefectures announce the land price of surveyed areas July 1st, each year) and the Japan Real Estate Institute's Urban Land Price Index.

Figure 4 shows fluctuations in the Urban Land Price Index. From 1987 to 1990, across the country, the commercial land price increased by more than 10% each year. However, in 1992, it began to recede and has remained stagnant. For example, the average commercial land price decreased approx. one-third nationwide from FY1990 to FY2003, and in FY2003, land price reached approx. the same level as 30 years ago (i.e., FY1972).

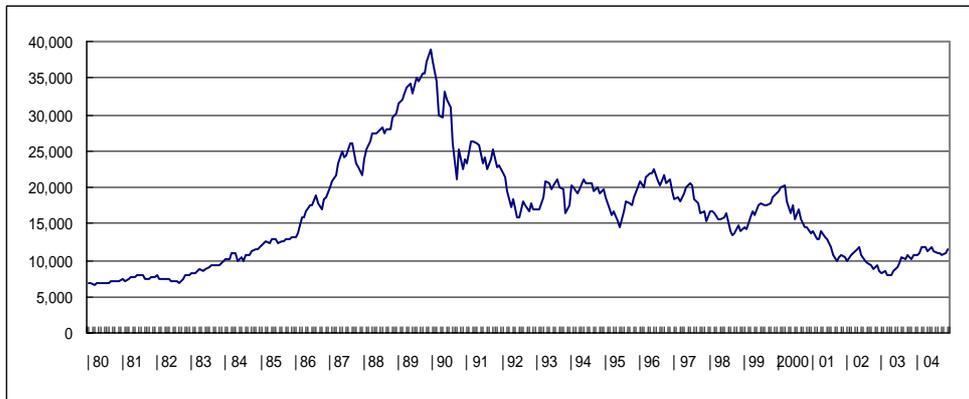
In Japan, prior to the 1990s, land prices never declined except for during the economic chaos caused by the first Oil Crisis (1974). Thus, many people acted on the premise that land prices would increase (“the myth of ever-higher land prices”) and the decline of land prices during the 1990s had a greater-than-expected negative impact on the economy. In particular, financial institutions which were overly dependent on land-collateral loans could not fully recover funds from the sale of land pledged as security, and suffered losses due to the disposal of bad debts³.

The price of these assets went largely unnoticed in the monetary policy until the 1990s. In particular, as seen in Figure 2, commodity prices were quite stable during the “economic bubble” in late 1980s, and monetary tightening was not considered necessary. However, since the prices of stocks and land rose steeply during this period, as shown in Figures 3 and 4, the dominant opinion today is that if the Bank of Japan paid sufficient attention to the escalating asset prices and implemented a monetary policy in late 1980s, the economic bubble would not have become so inflated, and damage from the burst of the economic bubble in the 1990s could have been

³ Krainer et al.(2004) examining Japanese land prices.

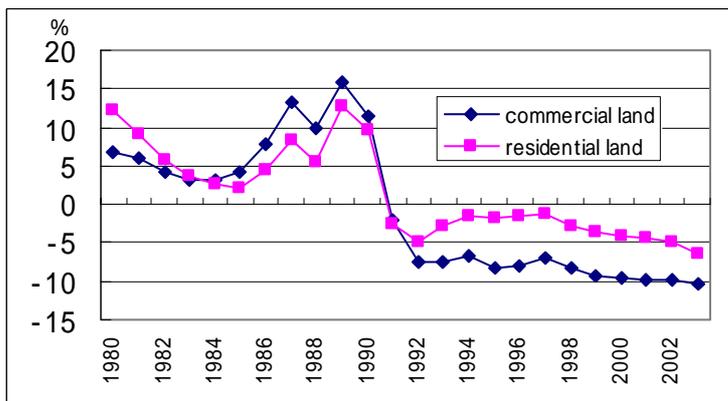
reduced⁴.

Figure 3 Stock Price Performance



Note: Nikkei Stock Average 225's Performance.

Figure 4 Fluctuation in Land Prices



(Source) Japan Real Estate Institute.

3. JAPANESE MONETARY POLICY SINCE THE 1990'S: HOW DID IT RESPOND TO DEFLATION?

3.1 Official Rate Policy

Table 1 shows changes in the official discount rate since 1987⁵. 1987 marked the then-current historical low of 2.5%. Then, in response to overheated asset prices, the official discount rate was raised from 2.5% to 6%, in the span of one year and three months, from May 1989 to

⁴ For example, Bernanke (2000) and Krugman (1999) criticized the Bank of Japan.

⁵ See Cargil et al. (1997) regarding the Japanese monetary policy before the mid 1990s.

August 1990. Since 1991, the official discount rate was reduced again in response to the slowing of the economy and dropped to 0.5% in 1995 without achieving economic recovery.

In February 2001, the official discount rate was reduced to 0.35% and the “supplementary lending scheme (commonly known as Lombard-type lending)” was created and implemented in March 2001. In Lombard-type lending, any financial institution which can provide security (e.g., governmental bonds and quality corporate debentures) can borrow funds from the Bank of Japan at the official rate. Therefore, if the call rate is likely to exceed the official discount rate, it will be more favorable for banks to borrow funds from the Bank of Japan. In other words, as the official discount rate sets the upper limit of the call rate, banks are no longer concerned about a spike in interest rates.

In 1996, the Bank of Japan announced its decision not to use BOJ lending that applies the official discount rate as a monetary tool. Since the Lombard-type lending was introduced, traditional BOJ lending, where the timing and the amount of the loan is determined by the Bank of Japan, became unavailable.

Then in September 2001, in order to deter the negative impact of the terrorist attacks that occurred in the US, the official discount rate was reduced to 0.1%.

Table 1 Changes in the Official Discount Rate by Date

| | | | |
|------------|------|-----------|------|
| 2/23/1987 | 2.5% | 7/27/1992 | 3.25 |
| 5/31/1989 | 3.25 | 2/4/1993 | 2.5 |
| 10/11/1989 | 3.75 | 9/21/1993 | 1.75 |
| 12/25/1989 | 4.25 | 4/14/1995 | 1 |
| 3/20/1990 | 5.25 | 9/8/1995 | 0.5 |
| 8/30/1990 | 6 | 1/4/2001 | 0.5 |
| 7/1/1991 | 5.5 | 2/13/2001 | 0.35 |
| 11/14/1991 | 5 | 3/1/2001 | 0.25 |
| 12/30/1991 | 4.5 | 9/19/2001 | 0.1 |
| 4/1/1992 | 3.75 | | |

Note: Prior to January 2001, the rate for discount of commercial bills and the lending rate of the loans secured by government bonds or similar instruments; After January 2001, the basic discount rate and the basic lending rate.

3.2 Zero Interest-Rate Policy

As with other developed countries, the main instrument for monetary policy in present Japan is the open market operation. To achieve policy objectives, the Bank of Japan conducts daily monetary control, keeping a close watch on the short-term money rate shaped by the short-term financial market (specifically, the overnight call rate of the unsecured call market).

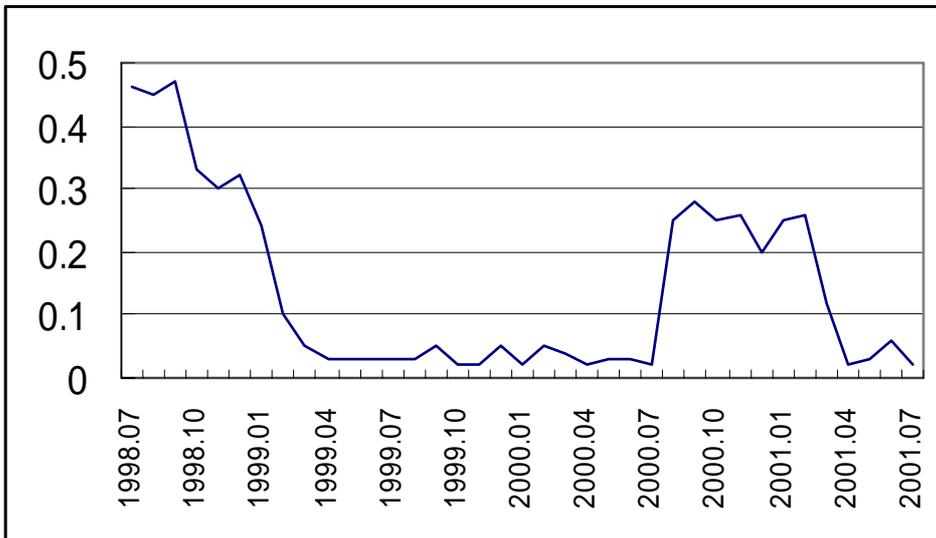
In September 1998, the Policy Board / Monetary Policy Meeting, the supreme decision-making body of the Bank of Japan, decided to “encourage the unsecured call rate to shift to an average of approx. 0.25%”. However, since goals for economic recovery had not been established, in February 1999, an “unsecured call rate around 0.15% was initially targeted and then, in line with market conditions, further decline would be steadily promoted”. This is called the zero interest-rate policy as a massive amount of funds were supplied (buying operation) and the call rate was reduced to virtually zero percent. At the same time, they also announced a plan to continue the zero interest-rate policy until “the situation allows for the prospect of the elimination of deflationary concern”.

A major turning point was reached in August 2000. Most of the Policy Board members thought “the prospect of the elimination of deflationary concern can be expected” and decided to “increase the unsecured call rate to an approx. average of 0.25%”. But then, the participants from the Ministry of Finance and the Economic Planning Agency insisted that “it is still too early to lift the zero interest-rate policy at this time”, and requested a postponement of the vote at the Policy Board until the next meeting under Article 19 of the Bank of Japan Law. However, the Policy Board turned down the government’s request to postpone the vote by a majority (1 vote in favor versus 8 against) and approved lifting of the zero interest-rate policy by a majority (7 votes in favor versus 2 against) .

However, after lifting of the zero interest-rate policy, the economy started to wane again. So, after only six months from the time of raising the rate (i.e., in February 2001), a plan was developed to “promote the unsecured call rate to shift to an approx. average of 0.15%” to return to the zero interest-rate policy.

Reflecting on such policy, the actual changes in the call rates are shown in Figure 5. As seen in the Figure, changes in the call rates were almost in line with the actions of Bank of Japan.

Figure 5 Zero Interest-Rate Policy and Changes in Call Rates



Note: Unsecured overnight rate, which is the policy target rate, is shown above (figures as of the end of the month).

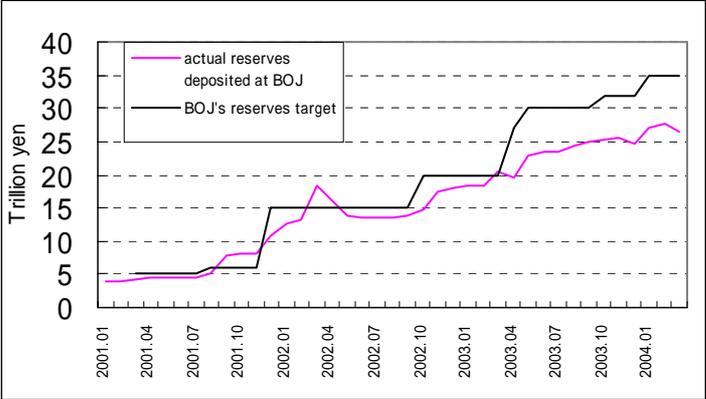
3.3 Quantitative Relaxation

Though the zero interest-rate policy was re-launched, there was a growing awareness that it lacked the strength to hold back deteriorating economic conditions, so the Bank of Japan decided to take further measures to boost the economy at the Policy Board's Monetary Policy Meeting in March 2001. More specifically, the main target of the money market control was changed from the conventional unsecured call rate (overnight) to the balance of current accounts held at the Bank of Japan, and it was decided to "increase the balance of the current accounts held at the Bank of Japan to approx. JPY 5 trillion for the time being (an increase from the previous balance of slightly over JPY 4 trillion by approx. JPY 1 trillion)". This is called quantitative relaxation, as the quantity of money is targeted instead of the interest rate. As deposits in BOJ current accounts carry no interest, it will be more profitable for banks to apply funds to other instruments (i.e., loans and investment in securities) and earn interest. If a large amount of "excess" funds is available, the banks' approach to lending is expected to be more aggressive. In addition, a plan to continue this new approach to control the money markets until CPI's year-on-year rate of increase stabilizes above zero percent was announced.

Well, if money is supplied in high volume through quantitative relaxation, the interest rate - the price of money - should decline rapidly. In fact, as a result of this quantitative relaxation, the unsecured call rate started to shift virtually to zero percent. When the interest rate reached zero, the zero interest-rate policy cannot provide further relaxation. So, at that point, it was no longer possible to adopt a policy which targeted the interest rate (to be exact, the nominal interest rate). However, quantitative relaxation could still continue even when the interest rate became zero.

Figure 6 shows changes in the actual balance of BOJ current deposits and the policy objective levels over time. As shown in the Figure, the objective levels were increased many times and reached JPY 30-35 trillion in January 2004. The actual balance of BOJ current deposits increased almost in line with the increase in the target figures. Furthermore, as the legal reserve required for the deposit requirement system was approx. JPY 4 trillion during this period, approx. JPY 20 trillion was held by banks on a voluntary basis (free reserves) in January 2004.

Figure 6 Quantitative Relaxation and BOJ Current Deposits



Note: Monthly average balance of BOJ current deposits. When the target level is within a certain range, the maximum value is shown in the graph. For example, the target in January 2004 was JPY30-35 trillion, so is shown as JPY35 trillion in the Figure. Prepared by the author based on the Bank of Japan’s materials.

3.4 Expanding the Range of Assets for Buying Operations

Open-market operations are conducted by trading government bonds and other securities. In this regard, the meaning of supply and absorption of funds varies depending on the type of asset chosen for purchase.

According to the traditional monetary policy standpoint, central banks should provide liquidity in the market without taking credit risk. Therefore, assets for operation were restricted to government bonds and best-rated corporate bonds (and bills). However, as it was not possible to fully address the economic conditions by only buying these types of assets, so buying operations that included financial assets with credit risk (e.g., CPs and asset-backed securities) were launched.

It is worth noting that purchasing asset-backed securities started in July 2003. Asset-backed securities are securities that are backed by one or more assets such as loan receivables. Even if one of those receivables becomes irrevocable, as it is not the only asset which backs the securities, its impact on the asset-backed securities is lessened. The Bank of Japan mainly bought asset-backed securities backed by credited loans from small and medium companies. This scheme is as follows; (1) a bank makes loans to a number of small and medium sized companies, (2) the bank combines these credited loans to issue asset-backed securities, and (3) the Bank of Japan purchases these securities. It is essentially the same as the Bank of Japan making loans to small and medium companies. The Bank of Japan itself admitted that “it is exceptional for a central bank to directly accept credit risk from the private sector”; however, as it was necessary to supplement the financial intermediary function to the dysfunctional financial institution, and this scheme was implemented as a temporary measure, effective until March 2006 . As of the end February 2005, the Bank of Japan holds JPY 241 billion in asset-backed securities.

Furthermore, in September 2002, the Bank of Japan decided to create a stock purchase program exclusively for stocks held by banks, implemented as of November. Specifically, the Bank of Japan purchased the stocks of quality companies with a certain level of credit rating (at least BBB-) at the market price from banks whose stockholding value exceeded core equity capital (Tier 1 of the Basel Accord). The stock purchase program ended in September 2004 and JPY 2,018 billion of stocks were purchased. The Bank of Japan will dispose of the purchased stocks over 10 years from October 2007 to avoid a negative impact on stock prices.

4. OVERVIEWS OF JAPANESE FINANCIAL SYSTEM

4.1 Japanese Financial System from the Corporate Financing Structure Standpoint

Before exploring characteristics of the Japanese financial system, I would like to discuss the situation of corporate financing. Table 2 shows the status of Japanese company funding in 5 years increments. First, a significant decrease can be noted in the amount of funds raised. During the “bubble economy” period (1987-1991), the corporate sector raised approx. JPY 120 trillion per year; but recently, it has dropped to approx. one-third. This reflects the weak state of corporate investments.

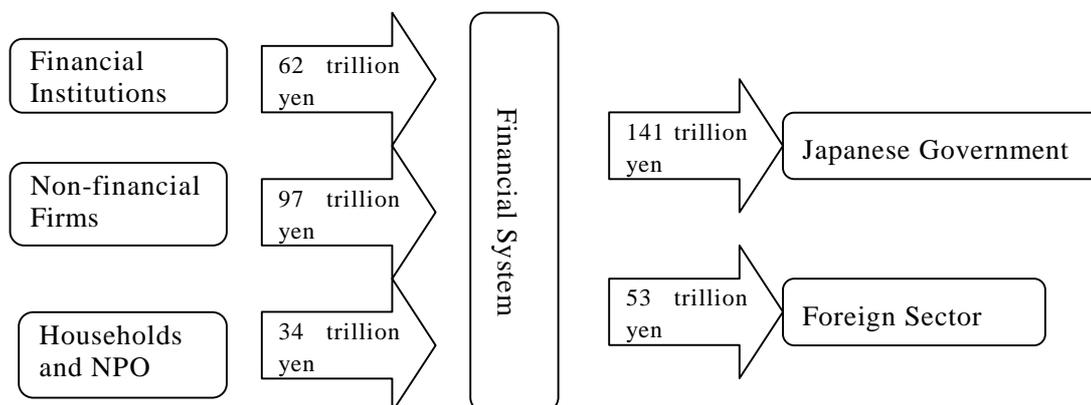
Second, funds for investment are fully financed through internal funds (i.e., retained earnings and depreciation allowances) and the remaining portion is applied to the repayment of loans and the redemption of corporate bonds. As a result, as seen from Figure 1, under the Japanese financial structure, funds flow from the household and corporate sectors to the government and overseas sectors.

Table 2 Status of the Financing Activities of Business Corporations (JPY in trillions)

| | 1987-1991 | 1992-1996 | 1997-2001 |
|-----------------------|-----------|-----------|-----------|
| Financing | 570 | 278 | 198 |
| Capital Increase | 32 | 11 | 11 |
| Corporate Debentures | 25 | -1 | -3 |
| Long-term Borrowings | 129 | 22 | -14 |
| Short-term Borrowings | 80 | 16 | -11 |
| Earned Surplus | 146 | 29 | 10 |
| Depreciation | 158 | 201 | 205 |

Note: Figures for all businesses are from the “Financial Statement Statistics of Corporations by Industry”, Ministry of Finance.

Figure 7 Recent Flow of Funds in Japan



Note: Prepared by the Author based on the Bank of Japan “Flow-of-Funds Accounts”. Figures in arrows represent the total financial surplus or deficit during 4 years from FY2000 to FY2003.

4.2 Characteristics of the Japanese Financial System from the Households’ Invested Assets Standpoint.

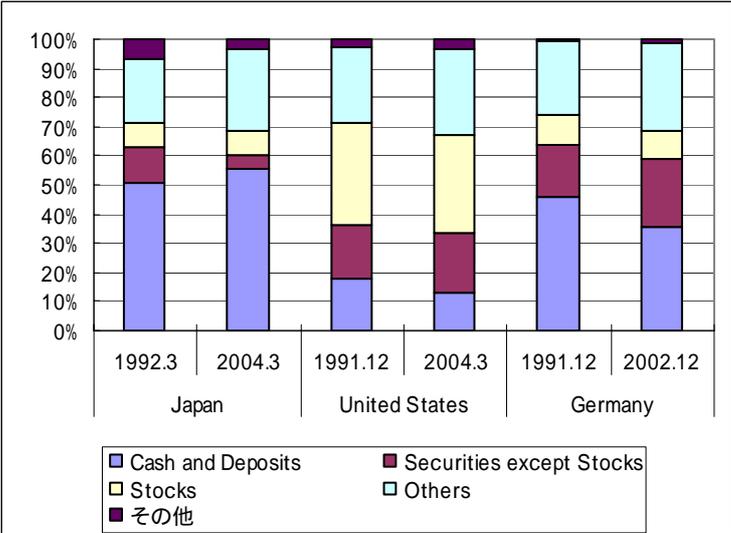
Next, to examine the characteristics of the financial system from the fund management perspective, the composition of the financial assets held by the household sectors in Japan, the US and Germany is outlined in Figure 8. The first characteristic of Japanese households is that the percentage of cash and deposits is quite high, and half of the household financial assets are deposited with banks (including the Post Office). In Germany, the percentage of cash and deposits was also relatively high, but the percentage dropped significantly during the 1990s. In contrast, the percentage increased in Japan.

Second, capital-safe financial instruments are dominant in Japan. In addition to deposits, since fixed-benefit type products are the core of insurance policies and pension plans, more than 80% of the household assets are defined-capital type financial instruments. In other words, the Japanese household sector bears almost no financial risk. On the contrary, in the US, not only is the percentage of cash and deposits low, but most of insurance policies and pension plans are products without defined benefits or capital safety, including variable policies and 401k plans (defined-contribution pension plans), and the household sector bears significant financial risk.

In Japan, instead of the household sector, financial institutions bear financial risk. Though such

exposure to risk worked effectively during the years of steep economic growth in Japan, when financial institutions lose strength and are unable to take risk, the risk-taking capacity of the society as a whole significantly declines. Japan’s weakness in this regard was exposed during the 1990s.

Figure 8 Household Financial Assets in Japan, the US and Germany



Note: Based on the flow of funds account of each country.

4.3 Overview of the Financial Market

The fact that banks are dominant in the Japanese financial system means the securities market is relatively small and weak. However, as evident from the fact NASDAQ and other securities markets supported IT companies, playing a central role in the growth of the US economy during the 1990s, it is necessary to enhance the capabilities of the securities market during times of rapid change (Allen and Gale, 1999; Royama, 2002). In fact, as discussed in Section 5, deregulation (the financial Big Bang) in Japan was promoted to activate the securities market. As a result, on the institutional front, Japanese markets are said to have reached a level comparable to the US and European markets; however, the function of the securities market has yet to be fully realized.

Table 3 outlines the major financial markets in Japan and their sizes. Short-term money markets are markets where funds for a year or less are traded, and are generally classified into interbank markets, which are limited to banks and other financial institutions and the open markets where

non-financial companies can participate.

The interbank market, where financial institutions manage their temporary financial surplus or deficit, is the main ground for the Bank of Japan to perform credit control. Among open markets, public and corporate bonds and the TB/FB market are relatively large. The bond loan market is the market where bonds (mainly government bonds) are loaned against cash collateral, and from the bond lender's view, he is a borrower of cash. It is also covered by the Bank of Japan's open market operations and has grown to become a key market for monetary adjustment. Both TBs and FBs, which mean "treasury bills" and "financing bills" respectively, are issued for up to one year for fund management by the government. In the US, the TB and FB markets constitute the core of the short-term financial market and these markets have begun to play a greater role in Japan as well.

In the long-term financial market, funds that mature after one year are traded and generally classified into the bond or stock market. For bonds, the government's budget deficit continues and the amount of outstanding government bonds is ballooning. The stock market includes traditional stock exchanges (e.g., Tokyo Stock Exchange, Osaka Stock Exchange, Nagoya Stock Exchange, etc) and the JASDAQ market operated by the Japan Securities Dealers' Association. Among traditional markets, the Tokyo Stock Exchange Section I maintains the dominant share. The JASDAQ market is a market where stocks of middle-standing companies are traded and had been placed as an OTC market in the past, but became a securities exchange market in 2004. As a result, the companies now can list their shares both on the traditional securities market and the JASDAQ market, and participants can place discretionary orders for trading.

In addition, as part of the financial Big-Bang, in order to provide stock markets for emerging companies, Tokyo Stock Exchange and Osaka Stock Exchange opened new markets called Mothers and NASDAQ Japan (the name was changed to Hercules due to NASDAQ's withdrawal from Japan), respectively. As the listing criteria of these securities markets for emerging companies are relatively flexible in comparison to those of traditional securities markets, these markets broadened the base for company listings. Furthermore, through the financial Big Bang, securities companies are now allowed to create private securities markets on the Internet.

Table 3 Major Financial Markets in Japan and Their Size

| | | Balance (Market Capitalization) | (JPY in hundred millions) |
|------------------------------------|---------------------|---|---------------------------------|
| Long-Term Financial Markets | Bond Market | Straight Corporate Bonds | 624,434 |
| | | Straight Government Bonds | 5,488,230 |
| | Stock Market | TSE (all companies listed) | 3,630,393 |
| | | JASDAQ | 113,922 |
| Short-Term Financial Markets | Interbank Market | Call | 186,529 |
| | | Bill | 297,900 |
| | Open Market | Public and Corporate Bonds Repurchase Market | 178,806 |
| | | Public and Corporate Bonds Loan Market | 575,097 |
| | | CD | 302,333 |
| | | CP | 155,753 |
| | | TB/FB | 1,267,672 |
| | | Tokyo Offshore | 398,461 |

Note: Balance as of the end March 2004. Figures of the balance of the public and corporate bond loan market are figures of bonds loaned.

Source: the Bank of Japan's website, except figures of the interbank market from Tokyo Tanshi's website.

5. FINANCIAL SYSTEM REFORMS

5.1 Too Many Regulations in the Financial System

In Japan, strict financial regulations have been implemented, and is sometimes described as including "even how to use chopsticks". Basic pricing rates within the financial system, including banks' deposit rates, securities companies' stock trading commissions, and insurers' premiums, were all controlled. The creation of a new bank, or a new insurance or securities company was rarely approved, except for foreign companies' entering Japan. Also, mutual entry among these 3 financial industries was prohibited. Furthermore, within the banking and insurance industries, the lines of business were regulated in detail. For banks, the regulations allowed long-term credit banks and trust banks to issue bank debentures and conduct the trust businesses exclusively. For insurance companies, mutual enrollment in life and non-life insurance companies was prohibited.

These regulations decreased competition among financial institutions and proved quite effective in preventing financial institutions from failing due to competition and filing for bankruptcy. In other words, the result of these policies is that no financial institutions failed for approx. 50 years after the war.

5.2 Background of the Japanese Financial Big Bang

In or around 1980, side effects of overregulation became evident, and due to domestic and international pressures, financial deregulation made gradual progress. However, even in the mid-1990s, the following issues regarding the Japanese financial system remained.

First, the financial and capital markets were hollowing out. “Hollowing out” is where financial activities that should be carried out in Japan are diverted to other countries due to regulation or other factors. For example, the trading of Japanese equity derivatives flourish in the overseas markets, and a large number of foreign companies suspended listing on the Tokyo Stock Exchange. Second, institutional stress of the financial system became evident. Examples to illustrate this include the huge amount of nonperforming loans and the failure of many financial institutions. Third, the country is rapidly aging. For life-after-retirement security, attractive investments for personal financial assets were needed.

Prime Minister Ryutaro Hashimoto felt that gradual deregulation of finances could not solve these problems and that sweeping changes needed to be quickly made, and in November 1996, he directed “financial system reforms” to be made by the ministers concerned. The series of reforms implemented based on his directions are called the Japanese financial Big Bang. “Big Bang” is a scientific term used to describe the huge expansion when the universe began, and in the financial world, it refers to the essential reforms to the securities market conducted in the UK. Hashimoto wanted to carry out a “Japanese version” of these reforms.

5.3 Japanese Financial Big Bang

The Japanese financial Big Bang was aimed at establishing a new, free, fair and global financial system that would be competitive with the New York and London markets. For that purpose, the Financial System Reform Law was enacted in May 1998 and became effective in December of the same year.

Key revisions are summarized as follows: (1) Enhance asset management instruments (the introduction of new investment trust products including company-type mutual funds and privately placed investment trusts, the sale of over-the-counter investment trusts by banks, and the complete liberalization of securities derivatives) ; (2) deregulate price control (complete

liberalization of commissions and fees in stock brokerage and, for fire and automobile insurances premiums, the abolishment of the obligation to use premium rates established by insurance rating associations); (3) promote new entries (shifting from a licensing system to a registration system in principle for securities companies; promoting mutual entry among banking, securities and insurance businesses); (4) develop diversified markets (eliminating the obligation to concentrate transactions on securities exchanges, and introducing a private trading system); (5) enhance user protections (improving disclosure; enhancing user protection during failure).

By 2001, most of the planned reforms were completed (see Table 4). However, they do not go far enough to achieve the original goals of reform (i.e., the establishment of a financial system with international competitiveness).

Table 4 Deregulation in the Financial Markets

| | | |
|------|----------|---|
| 1993 | April | The Financial Institution Reform Act came into effect (establishment of securities and trust banking subsidiaries, regional financial institutions' entry into the trust business, etc) |
| | June | Complete liberalization of term deposit rates |
| 1994 | October | Liberalization of demand deposit rates |
| 1996 | November | Prime Minister Hashimoto directed financial system reforms (the financial Big-Bang) |
| 1997 | October | Introduction of multiple purpose securities accounts |
| | December | Banks were allowed to sell investment trusts (initially a shop lending method) |
| 1998 | April | Revisions to the foreign exchange law became effective (currency exchange at convenience stores became possible) |
| | April | Partial liberalization of commissions and fees in stock brokerage |
| | June | The Financial System Reform Law enacted |
| | July | Obligatory use of insurance rating organizations was abolished (insurance companies were allowed to individually establish premium rates.) |
| 1999 | December | The Financial System Reform Law comes into effect (core of the financial Big Bang) |
| | May | The nonblank bond issuance law becomes effective (financial service providers can issue bonds for the loan business) |
| 2000 | October | Complete liberalization of commission and fees in stock brokerage |
| | October | Banks' subsidiaries were allowed to enter into the insurance business |
| 2001 | January | Complete liberalization for mutual entry between life and nonlife insurers into the third sector |
| | April | Banks were allowed to sell life insurance products over the counter |

Note: Prepared by the author based on FSA's materials

6. CURRENT BANKING ISSUES IN JAPAN

6.1 A Series of Bank Failures

Following the burst of the economic bubble in Japan, a number of banks and corporative financial institutions failed. Beginning with the Hyogo Bank in August 1995 until Chubu Bank in March 2002, 16 banks went bankrupt. To dispose of the failed banks, large sums of money are required. For example, pecuniary donations of more than JPY 3 trillion were provided for the Long-Term Credit Bank of Japan and Nippon Credit Bank. Table 5 shows the list of failed banks and the amount of pecuniary donations from the Deposit Insurance Corporation; by the end of March 2003, pecuniary donations of JPY 17.9 trillion were provided to dispose of failed financial institutions. Essentially, such costs should be covered by the deposit insurance premiums; however, as deposit insurance premiums were far too short to cover the costs, JPY 9.9 trillion of government funds were contributed.

Table 5 Failed Banks and Disposal Costs

| Date of Failure | Failed Financial Institution | Pecuniary Donation from Deposit Insurance (JPY in hundred millions) | Date of Failure | Failed Financial Institution | Pecuniary Donation from Deposit Insurance (JPY in hundred millions) |
|------------------------|-------------------------------------|--|------------------------|-------------------------------------|--|
| 8-30-95 | Hyogo Bank | 4,730 | 12-14-98 | Nippon Credit Bank | 31,414 |
| 4-1-96 | Taiheiyo Bank | 1,170 | 4-12-99 | Kokumin Bank | 1,837 |
| 11-21-96 | Hanwa Bank | 806 | 5-24-99 | Kofuku Bank | 4,941 |
| 10-14-97 | Kyoto Kyoiei Bank | 438 | 6-14-99 | Tokyo Sowa Bank | 7,626 |
| 11-17-97 | Hokkaido Takushoku Bank | 17,732 | 8-9-99 | Namihaya Bank | 6,526 |
| 11-25-97 | Tokuyo City Bank | 1,238 | 10-4-99 | Niigata Chuo Bank | 3,817 |
| 5-15-98 | Midori Bank | 7,711 | 12-28-2001 | Ishikawa Bank | 1,809 |
| 10-23-98 | Long-Term Credit Bank of Japan | 32,350 | 3-8-2002 | Chubu Bank | 944 |

(Source) Deposit Insurance Corporation.

6.2 Management Integration in Progress

Reorganization among banks that have not gone bankrupt is now underway. In particular, reorganization has been accelerated among city banks that play a central role in the Japanese banking system. City banks are banks based in Tokyo, Osaka and other major cities with nationwide branch networks which mainly trade with large companies. In March 1990, there were 13 city banks, but in March 2003, they were integrated into 5 banking groups. These are called banking groups because they adopted a bank holding company system and have multiple banks as subsidiaries. Mitsubishi Tokyo Financial Group, Mizuho Financial Group, Sumitomo Mitsui Financial Group and UFJ Holdings are called four major banking groups (megabanks). Furthermore, in February 2005, the merger between Mitsubishi Tokyo Financial Group and UFJ Holdings was officially agreed and a banking group with a market capital exceeding JPY 10 trillion will be created (see Figure 9). This new group aspires to become one of the global top 5 by market capitalization by FY2008.

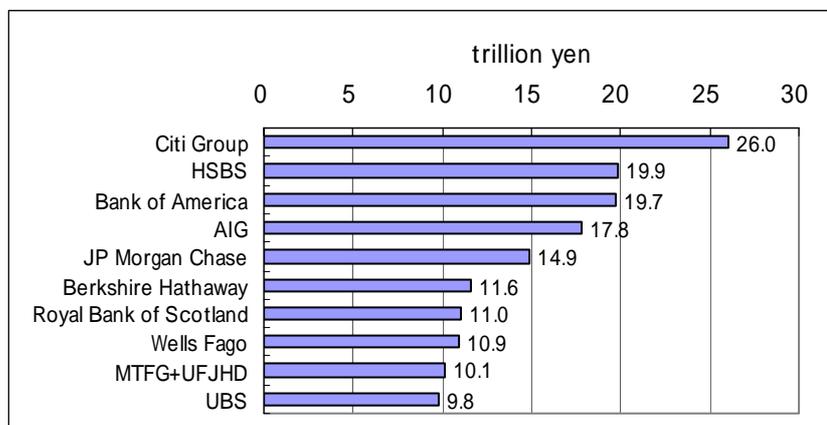
On the other hand, regional financial institutions which are said to have fallen behind major banks in reorganization, have become actively engaged in business consolidation in recent years. Table 6 shows changes in the number of Japanese private-sector financial institutions including major banks, over time. In 10 years, from 1980 to 1990, the number of credit cooperatives decreased considerably, but the number of other financial institutions remained almost unchanged. In the following 10 years from 1990 to 2000, the decrease was most significant for city banks, showing a decline from 13 to 9 (31%). Credit cooperatives decreased by 123 or 30%. Credit associations (or Shinkin Banks), though the reduction rate was not as high, also decreased by 15%. In contrast, the number of regional banks remained unchanged.

Even during the approx. 5 years from March 2000 to January 2005, financial institutions have continued to decrease. The number of city banks further decreased by 2, to almost half of the original number. The second-tier regional banks also decreased by 6 to less than 50. However, a notable feature since 2000 is the significant decrease in the number of credit associations/credit cooperatives. Credit associations decreased by 85 in just 5 years.

The decrease in the number of Japanese financial institutions has been considerable within such a brief period. Furthermore, unlike the US, except for foreign banks and subsidiary banks of financial institutions, there were less than 10 new entrants such as online banks during this

period⁶.

Figure 9 Market Capitalization of Major Financial Institutions Worldwide



(Source) Nihon Keizai Shinbun, February 19, 2005.

Table 6 Changes in the Number of Private-Sector Financial Institutions by Business Type over Time

| | 3/1980 | 3/1990 | 3/2000 | 1/2005 |
|-----------------------|--------|--------|--------|--------|
| City Banks | 13 | 13 | 9 | 7 |
| Regional Banks | 63 | 64 | 64 | 64 |
| Second Regional Banks | 71 | 68 | 54 | 48 |
| Credit Associations | 462 | 454 | 386 | 301 |
| Credit Cooperatives | 483 | 414 | 291 | 179 |

Note: source: Inoue (2003) and materials on Nikkin's website

6.3 Problems with Non-performing Loans

The biggest problem faced by Japanese banks is non-performing loans. Non-performing loans are monetary loans and valuable securities for which interest or the principal is not paid as promised. Japanese banks usually take land as a collateral when processing loans, but as the land prices dropped significantly, they cannot recover credited loans by selling the land in lieu.

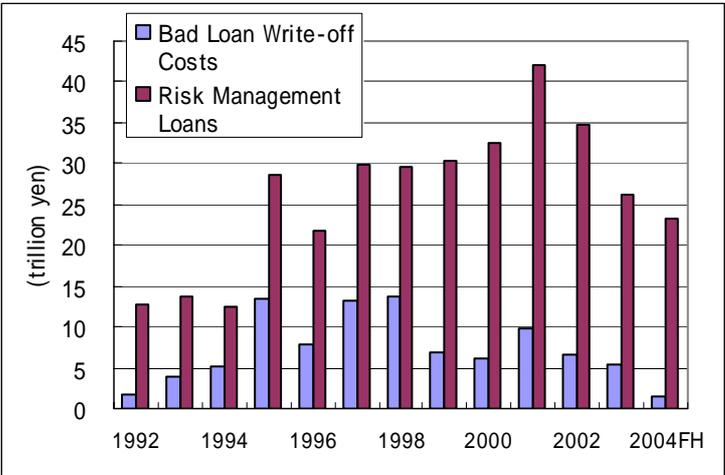
Figure 10 shows the amount of non-performing loans held by Japanese banks (in the Figure, non-performing loans are called Risk Management Loans according to the definition under the

⁶ See Yamori et al. (2005) for a detailed analysis of the current situation of new types of banks such as online banks.

Banking Law) and the amount of loss incurred to dispose of non-performing loans (loss from the disposal of bad debts). During the peak year, a loss of approx. JPY 15 trillion was incurred, causing continued account deficits (in FY2001, 58 out of 133 banks were in red). Moreover, even though such a huge amount of non-performing loans were written off, it was still hard to decrease the amount of bad debts.

Fortunately, since 2002, supported by the government’s financial revitalization program which encouraged major banks to quickly dispose of nonperforming loans, and economic conditions and stock prices heading towards recovery, the balance of non-performing loans decreased significantly. However, the level is still much higher than that of the 1990s, and if economic slowdown occurs again, non-performing loans may increase, so it is still too early to say that the problem of non-performing loans has been solved.

Figure 10. Non-performing Loans and Write-off Costs by Japanese Banks



(Note) Figures from FY 1992 to FY1994 cover only major banks (i.e., city bank, long-term credit banks, and trust banks). Figures since FY 1995 cover all banks (i.e., major banks and primary and secondary regional banks). Figures for FY 2004 are until the end of the first half of FY2004.

(source) Financial Services Agency.

6.4 Changes in Main Bank Relationships

One characteristic of the Japanese banking system is the stable long-term relationship between banks and companies (the main bank system). A “main bank” is a bank that fulfills the following

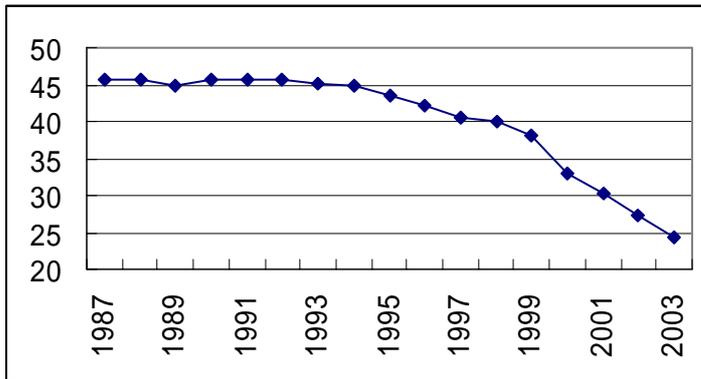
conditions: (1) the bank has the largest loan share, (2) the bank is a major shareholder, and (3) directors are dispatched from the bank. Main banks are said to have the following functions (e.g., Horiuchi et al. 1988; Sheard 1990; Hoshi et al. 1990). First, it provides other lenders with information as a key monitor. As corporate financial activities are carried out through the bank account held at the main bank, the main bank can monitor the company on a daily basis. Therefore, other financial institutions can rely on the main bank for monitoring the company. In this way, monitoring costs of the society as a whole can be reduced. Second, it can provide rescue and reorganization assistance. For example, at the outset of a crisis, the main bank develops measures to avoid bankruptcy as the representative of the creditors. From the viewpoint of companies, it serves as a kind of insurance.

However, as the needs of corporate funding changed (in particular, major companies are increasingly less dependent on bank loans for financing) and the soundness of banks deteriorated, so too the relationship with the main bank changed. This is succinctly expressed in the ongoing dissolution of cross stockholdings which served as the symbol of the main bank relationship. Figure 11 shows the changes in the percentage of equity held by stable shareholders over time, and it can be seen that the percentage started to decline rapidly from around 2000. Main factors include the downturn in stocks in the 1990s causing huge losses from equity holdings, and banks and companies developing a strong awareness of stockholding risks, and the enactment of the law limiting bank stockholdings⁷.

Some positive aspects are expected from the dissolution of cross stockholding, such as more effective investment of assets held and the stabilization of bank and corporate management; however, if there are no buyers of the stocks sold through the dissolution of cross stockholding, a depression in stock prices is a concern. Therefore, the government established the Bank Equity Purchasing Corporation in January 2002 to take over stocks held by banks, and the Bank of Japan started to purchase stocks held by banks in November 2002.

⁷ The law limiting bank stockholdings enacted in 2001, limited the bank stockholdings to up to the amount of their equity capital from the term ending September 2004. As of the end March 2001, the stockholdings of major banks (14 banks) were JPY 32.6 trillion (book value), exceeding their equity capital (JPY 21.8 trillion) by approx. JPY 11 trillion. So, major banks had to sell JPY 10 trillion or more of stocks if equity capital was not increased. For reference, the law was revised in August 2003 and the date of compliance to the regulation was extended from September 2004 to September 2006.

Figure 11 Changes in the Stable Stockholding Ratio over time.



Note: “stable stockholding” means cross stockholdings, stocks held by financial institutions, stocks of financial institutions held by business corporations, and stocks held by affiliate companies.

Source: “Survey on the Status of Cross Stockholding” NLI Research Institute

6.5 Need for a New Business Model

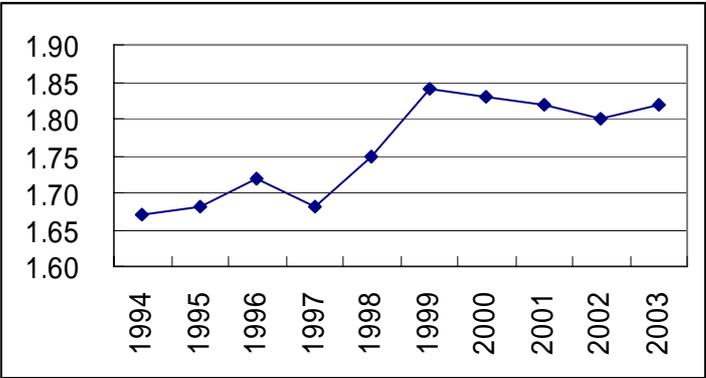
Many critics think that the low profitability of Japanese banks is a problem. The major source of profit-making for Japanese banks is the difference between the loan and the deposit rates (deposit-loan interest rate spread). However, the spread is very thin. For example, as shown in Figure 12, the deposit-loan interest rate spread of Japanese banks is slightly less than 2%. In contrast, the US bank spread is nearly 4%. Moreover, since loss incurred by nonperforming loans should be regarded as costs for lending, if the amount is taken into consideration, the deposit-loan interest rate spread remains negative for some years.

In addition, Japanese banks do not earn much income from commissions other than interest rate spreads. Thus, they are not apt to earn profits if they do not increase the amount of loans. However, as seen in Table 2, companies do not only borrow money but also make repayments, so bank profits will dwindle if they rely too heavily on these companies (especially large companies). A new banking business model must be developed.

In this regard, the March-2003 report of the Council on Financial Services, the advisory council at the Financial Services Agency, is suggestive. In this report, titled as “In preparation of the reinforcement of relationship banking”, the council recommended that financial institutions, particularly *regional* institutions such as regional banks, Shinkin banks, and credit unions, develop the capability to create loans for regional customers. In other words, the report suggests

that regional financial institutions have no choice but to engage in relationship banking; a banking business model that banks provide financial services such as loans to customers using soft information accumulated through its long-term, close relationship with its customers. Of course, the importance of relationships in regional banking services has been well-recognized even before the council’s report was published, but the Council on Financial Services emphasized the weak ability of many regional institutions and that financial institutions need to take immediate action to develop their ability for relationship banking.

Figure 12 Deposit-Loan Interest Rate Spread for Japanese Banks



(Source) Japanese Bankers Association, *Analysis of Financial Statements of All Banks*, various issues.

7. CONCLUSION

This chapter aims to explain the current characteristics and important issues regarding the monetary policy and financial system of Japan. Struggling with the unprecedented deflation, the Bank of Japan has employed unusual policy tools, such as reducing target interest rates to zero and buying stocks.

The financial system of Japan is having trouble with financial intermediation, risk sharing and liquidity services. Regarding the financial system issues, it is notable that the Japanese financial system is quite different from that a decade ago. In recent years, the Japanese household and business enterprise sectors have become lenders, and the government and foreign sectors have become borrowers. As a result, the business model of Japanese banks during the high growth period when banks collected money from households as deposits and lent it to large enterprises is

no longer sustainable. In terms of households' portfolio investments, safe assets such as bank deposits and traditional insurance make up substantial shares and risky assets such as stocks are marginal, in spite that the deregulation of financial markets has been well advanced. A bank-centered financial system like Japan's faces financial difficulties when the risk taking ability of financial institutions decreases, which actually occurred due to the huge non-performing loans of the 1990's. The government initiated the Japanese Big Bang to vitalize the financial market in Japan, but a satisfactory outcome has yet to be seen. Japanese banks must change their business model. The author believes that relationship banking is a key concept for most regional financial institutions.

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