Japan’s Financial Crisis in 1992 and Unbalanced Incentives

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1. Inevitability of Financial Crises
   - Banks do not keep the deposit

   - two risks
     - Not being able to repay the deposit when people make a run on a bank - *Liquidity problem*
     - Money loaned can become uncollectable - *Bad loan problem*

   - *Liquidity problem*
     - the fractional reserve banking system
     - only purchasing short-term government bonds as banks’ assets (Litan 1987 and Kay 2009)

   - *Bad loan problem*
     - The bad loans will affect the total economy for long time if the magnitude is substantial.
Three possible reasons to make bad loans

- **Insufficient capital requirement**
  - how much capital is enough? How can we measure the capital?
  - The capital is invested in assets, the value of those assets would fluctuate according to business conditions. The capital requirement would induce optimistic behavior during prosperous periods and pessimistic behavior in periods of stagnation, causing wider economic swings.

- **Excessive monetary expansion**
  - Monetary expansion can create optimism, cause bubbles, and result in bursts, leading to massive bad assets and financial crises.
Three possible reasons to make bad loans (Continued)

- a monetary policy should not create bubbles so nothing could burst (BIS view, See White 2006)
  - How can we differentiate bubbles from asset price increases that reflect new technological opportunities.
  - Central banks should only respond to general prices and employment, not to asset prices (FRB view, See Mishkin 2007)

- Unbalanced risk sharing
  - Managing directors of banks are only fired when they amass huge bad assets. Bank capital is the equity owners’ money, not the general managers’.
  - Some argue that the greed of financial institutions created financial crises, but their greed can make them very deliberate if they are betting their own money.
2. Japan’s Financial Crisis in the 1990s

- **Japan’s peculiarity**

  Financial crises have been repeated, but not all crises have had a huge impact on the whole economy.

  Based on extensive data collection, Reinhart and Rogoff (2009, Chapter V) identified the “Big Five” financial crises and 13 milder financial crises among industrialized countries since World War II (the five are Spain in 1977, Norway in 1987, Finland in 1991, Sweden in 1991, and Japan in 1992), but not all the crises caused significant damage to the economy.
Among the Big Five countries, Japan’s prolonged stagnation is an exception.

The Big Five are divided into the average of the three Scandinavian countries, Spain, and Japan. In the case of Japan, the five-year average growth rates are shown as the rates after the crisis greatly fluctuated.
Why did it happen?
Monetary expansion and contraction

The monetary base, bank loans, and IIP are shown to have fluctuated in the same way around 1990.
The abrupt monetary expansion and contraction caused a typical pro-cyclical capital requirement problem.

The monetary policy made asset price fluctuate. Under Japanese regulations, capital includes a portion of the difference between the current price of stocks and their book value.

The stock price of a company reflects the value of real estate the company owns. Share prices increased due to an expansionary monetary policy, causing an increase in capital value and an expansion of bank loans, but then decreased when a tightening monetary policy caused the opposite phenomenon.
Two measures to be taken after bubble burst

- Expand the monetary base to avoid a decrease in land and stock prices
- Write off NPLs

Both policies are effective, but the Japanese government and the BOJ took neither.

It might be reasonable that the second was not taken because managing directors of banks have responsibility for the NPLs; if the NPLs are huge compared to the assets or profits of the banks, the managing directors will have to quit.

The supervising authority for the Japanese banking industry was the Ministry of Finance at that time. It had close ties with banks and securities companies, and many MOF officials retired into lucrative jobs at the banks.

What the MOF initially did was to deny the existence of NPLs, or at least to underestimate their value.
Two measures to be taken after bubble burst (Continued)

- In April 1992, the MOF for the first time published a report indicating that the bad loans of 21 major banks were 7 to 8 trillion yen.
- These amounts were severely underestimated, nobody believed the figure, and were bound to grow.
- And in 1997 and 1998, big financial companies such as Sanyo Securities, Hokkaido Takushoku Bank, and Yamaichi Securities, and the Nippon Credit Bank went bankruptcy.
- The MOF could not hide the truth any more. The Financial Reconstruction Law was enacted in October 1998, and the MOF and the Japanese government changed their policy to write off bad loans and to proceed with their disposal.
- At the beginning of the 2000s, the accumulated loss caused by the bad loans was found to be 100 trillion yen.
The accumulated loss caused by the bad loans was increasing.

Figure 4 NPLs and its Loss


Note: End of March period of each year.
Why didn’t Japan write off bad loans and settle the problems?

- In case of the U. S., managers did not have incentives to delay the settlements of the NPLs, as long as it did not cause legal problems.

- Richard S. Fuld, Jr., chairman and CEO of Lehman Brothers, had been receiving 350 million dollars since 2000, and Stanley Onyle, CEO of Merrill Lynch, resigned because of the massive loss in October 2007 and got 160 million dollars as retirement allowance. Their pays were completely legal.

- Japanese CEOs recently have come to be paid better than in the past (around 1 million dollars or more a year), but they were only paid several hundred thousand dollars a year then, with a low taxed retirement allowance and a very low taxed private retirement pension.

- They therefore had an incentive to hide the NPLs, since their long-term payments would be lost when the NPLs were discovered.
Why didn’t Japan write off bad loans and settle the problems? (Continued)

- The Japanese government had not experienced a major bank bankruptcy, so financial officials wanted to think that NPLs would not be serious and that land prices would recover, but land prices did not recover, and the value of NPLs continued to increase.

- MOF could not supervise the financial institutions well, and it needed a new law, but in order to make a law, they explained to LDP why they failed, and they might to lose the privilege. It is reasonable for LDP to take the privilege from MOF because they have to make a new law that give tax money to banks with NPLs, which was not popular to the public.

- The new law, Financial Reconstruction Law was enacted in 1998, the supervision role was taken away from MOF, and Financial Supervisory Agency (Financial Services Agency after 2000) was created in the same year.
Delaying disposal is effective in clouding responsibilities

- To delay the writing off of NPLs is effective in clouding the responsibilities of policy failures. The CEOs of Japanese banks who had created the NPLs had retired with handsome allowances were not prosecuted by prescription, and their successors were prosecuted for trying to hide the NPLs.

- Former CEOs of the Nippon Credit Bank and Long-Term Credit Bank of Japan (both went bankrupt in 1998) were prosecuted on charges of accounting fraud. In the first and second trials, they were handed guilty verdicts but were acquitted by the Supreme Court in 2009 and 2011 on the grounds that the MOF had allowed, at that time, window-dressing of accounts and not including information on the subsidiary companies that had purchased the bad assets of parent banks at high prices.

- The initial prosecutions were as if the courts did not punish the thieves but those who bought the stolen goods.
Why didn’t BOJ expand money?

- In case of settling NPLs, it needs time to vague responsibilities, but time is not needed to expand money. Why was the BOJ reluctant to expand the money supply?
- At that time, the BOJ is under MOF, then, the question should be also asked to MOF. MOF might be only ignorant to the monetary policy, and they did not think that monetary policy can control price, exchange rate, and asset prices.
- Recently, the BOJ now admits that the reason it has not pursued monetary expansion is to restrain an increase of interest rates.
- BOJ officials have been arguing that reflation is dangerous because it increases interest rates and decreases bond prices. Such a possibility cannot be denied, but the problem was not serious in early 1990s. At that time, Japanese banks did not hold as many bonds as they do today.
Conclusions

- The lessons for corporate governance of Japan’s experiences in the Lost Decades are clear.
- Firstly, governance systems should be also applied to policy authorities. They need to be governed not to delay the disposal of bad loans and to not cause deflation and an asset price crash.
- A severe requirement for the accuracy of accounting data is a good policy, and it has been adopted in Japan since the early 2000s.
- Inflation targeting or nominal GDP targeting for central banks is a good policy, and an inflation target was in effect adopted in Japan in 2013.
Secondly, financial institutions have to seriously abide by the requirement for accurate accounting. Values of assets are known only after they are cashed. Values derived through calculation by mathematical models are only imaginary, not real. Bonuses of employees of financial institutions should be linked to revenues after assets are cashed.

Thirdly, unbalanced risk sharing is an important cause of financial crises. CEOs’ money should be incorporated into the capital of financial institutions. A bonus system linked to cash profits is helpful in lessening the degree of the unbalance.