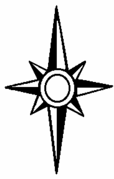

PacNet

Number 5

Pacific Forum CSIS
Honolulu, Hawaii

January 30, 1998

The Asian Contagion: Will it get to Tokyo?
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Many economists and political figures in Washington are expressing concern is that the Treasury Department is exacerbating the "moral hazard" problem, which is seen as endemic in global banking. From the perspective of regional analysts, however, the debate over international intervention to contain the spread of the Asian contagion leads to very different line of inquiry. The question most on the minds of Asia-watchers is where is the region's largest economic power – Japan – in this moment of great financial crisis?

Why Japan failed to take a more prominent leadership role – first with Bangkok and now with Seoul – is an important question. In the wake of the slide of the Thai baht and subsequent assaults on the currencies of other "Tigers" such as Indonesia and Malaysia, Japan's Ministry of Finance (MOF) toyed with the notion of creating an Asia currency fund to circumvent the tough austerity measures likely to be attached to IMF intervention. The idea was floated in late October of last year to a warm reception in Southeast Asia, but fell flat with the Western banking community much to the chagrin of Japanese manufacturers and lenders. In November, the prospect of a separate Asia fund was put to rest; then came the meltdown in South Korea. Japanese banks now hold the largest share (roughly $20 billion) of the $100 billion in short-term debt that is owed by Korean banks in 1998. It has since been reported that the total Japanese bank exposure in Southeast Asia is about $123 billion.

At the same time, the Japanese government recently went public with its latest estimate that its banking sector carried 76.7 trillion yen in domestic bad or questionable loans ($580 billion). The announcement was received as good news. Although it was more than double the amount of previous official estimates, it was well below the figures bandied about in international financial circles. Nevertheless, Japan's weak response remains the greatest concern to Wall Street elites in their discussions about Asia's monetary mess. The moribund Japanese financial system, backbone of the second largest economy and top lender to the world, is now a source of serious concern in Washington.

In various cases over several years, Japanese supervisory authorities failed to recognize both the severity of each failure and the connection to the health of the financial system as a whole. In fact the MOF did not require banks to report non-performing loans until 1993. In 1995 after the totality of the bad loan problem was becoming very apparent, the conventional wisdom in Japan remained that the problem would solve itself once the economy began to recover and stock prices rose. The economy did not recover and the situation worsened. Unlike the U.S. response to the savings and loan crisis, there was neither a widespread liquidation of the collateral to the bad assets nor was there any injection of new capital to offset losses.

In September 1995, the MOF faced an international financial scandal damaging its credibility worldwide. U.S. prosecutors charged a trader in Daiwa Bank's New York branch with fraud as a result of an eleven year cover-up of over $1 billion worth losses in illegal bond trading. It was soon revealed that the director general of MOF's banking bureau learned of the trading losses much earlier, but failed to reveal this information to both his counterpart in the international finance bureau at MOF and to American regulators in New York. A culture of denial now appeared pervasive in both the private and public sectors.

This and other MOF failures increased public and international awareness -- and criticism -- of its immense regulatory portfolio. The MOF, with its proud history dating back to 1869 and second only in institutional seniority to the Bank of Japan, was unaccustomed to such widespread condemnation. In addition to setting tax rates and establishing budget goals, the MOF also functions as the equivalent of the American Treasury Department, Office of the Comptroller, Securities and Exchange Commission and Federal Deposit Insurance Corporation. Moreover under Japanese law, the MOF enjoys significant control over the Bank of Japan. The bankruptcies, moreover, undermined the election base of the ruling conservatives, the Liberal Democratic Party (LDP). Political leaders increased their criticism of the MOF although many balked at proposing a new framework with which to protect depositors from further fraud and mismanagement. Faced with overwhelming evidence of poor bank supervision, a consensus nevertheless emerged among politicians, bureaucrats, academics, and media pundits that the MOF should split off its supervisory and investigative functions into a separate and independent agency. In typical Japanese style, MOF bureaucrats were then tasked with reorganizing their very own ministry and staffing the new agency. In response, the MOF proposed to Prime Minister Hashimoto that he sponsor an even larger financial reform package.

Hashimoto and the MOF modeled their new reform plan on Margaret Thatcher's major overhaul of the British securities industry in 1986 – the so-called London "Big Bang." Adding to the sense of urgent reform was growing concern over Japan's increasing pension and budget obligations which loomed large as a result of rapidly changing demographics. By 2025, one third of Japanese would be over the age of sixty. In 1997 the number of Japanese over the age of sixty outnumbered those under the age of fifteen. The prospect of having to rely on a shrinking pool of workers to finance a growing number of pensioners made the MOF nervous about Japan's economic and social future. Making up for lost time, the Tokyo Big Bang aimed to not only reform the securities business but also to liberalize other aspects of the financial

system. Areas of reform included (1) liberalizing foreign exchange, (2) lifting the postwar ban on financial and other holding companies, (3) eliminating barriers between the banking, insurance, and securities industries, (4) reforming the corporate accounting system, and (5) deregulating insurance premiums, (6) strengthening financial and bank supervision, and (7) revising the Bank of Japan Law to create greater central bank autonomy. Hashimoto's goal was to have the entire reform package implemented by 2001.

The need to conform to global standards helped win the case for foreign exchange deregulation. Many would argue, however, that Japan remains far behind international norms in its corporate accounting and financial reporting. Although these new changes will apply to the larger city banks and credit and trust institutions, larger challenges remain. Until Japan abandons the practice of valuing securities at their acquisition cost instead of their market price, the benefits of reform will be obscure. The MOF's strong bias favoring the interests of shareholders over depositors remains another significant impediment to financial recovery. The same predilection exists within Japan's political leadership. The ruling Liberal Democratic Party (LDP) was rumored to be pushing a plan to spend some 13 trillion yen in government money by having an arm of the Deposit Insurance Corporation, the Resolution & Collections Bank, to buy preferred shares of stock in various financial institution. The oft-repeated rationale from both the LDP and the MOF for their respective approaches has been "to ensure stability in the banking system." Yet it is far from a coincidence that the government guaranteed postal savings system – administered separately by Japan's Ministry of Post and Telecommunications – reported its biggest monthly deposit gain ($25 billion) in the last month of 1997. The closely related issues of corporate governance, accounting reform, and deposit guarantees require the most immediate attention if Japan is going to turn the corner in 1998.

There are some signs of progress. The November 1997 collapse of Hokkaido Takushoku Bank, one of Japan's eleven city banks, signaled the end of the MOF's successful run at merging troubled banks with a stronger institutions. In mid-November 1997, Fuji Bank, with 1.78 trillion yen in its own publicly disclosed bad loans, refused to loan more money let Yamaichi, the smallest of Japan's big four brokerages, and let Yamaichi go under. Yamaichi was part of the same *keiretsu* as Fuji Bank. The influence of cross-shareholding and the importance of relationship banking in Japan have evidently greatly diminished.

The failures of both Takugin and Yamaichi in the same month may be the start of a much needed shake-up of corporate Japan, but the overall economy remains in recession as a result of flat consumption. In one of its greatest financial missteps, the government in spring of 1997 raised the sales tax from 3 to 5 percent and the economy promptly fell to a twenty-five year low. It was, therefore, much welcomed but surprising news when the Hashimoto government broke its own promise of fiscal austerity and announced a new stimulus package on December 17, 1997. The estimated $38 billion stimulus included $16 billion cut in Japanese income taxes, roughly the same amount in public works spending, and large tax cuts for corporations, landowners, and investors. A fiscal hawk within his own party, Hashimoto shocked many with his announcement; he had earlier encountered intense criticism for his decision to commit $77 billion of public money to shore up the financial system.

Faced with a growing crisis in South Korea, Wall Street and the White House immediately applauded the initiative. However the yen gained only briefly against the dollar after the stimulus package was announced, and the financial crisis in Asia and Japan's economic malaise continue to take their toll.

With a strong dollar policy now in play, there is great incentive for Asian economies, as well as other developing countries, to devalue their currencies and in effect export deflation. Asia's excess capacity has the potential to create enormous deflationary fallout in the region. In the words of one analyst, "the problem is that trying to export deflation within the region, say to Japan, is not viable because Japan itself needs to export deflation," and "Asian currencies, including the yen, will have to depreciate further against the dollar and the deutsche mark." The net result of course would be a significant rise in the current account deficit of the United States. Many would argue that the trade deficit should not be an object of government policy, but the political reality in Washington may prove otherwise. With American interest rates falling, others now warn that Japan may begin to sell-off its vast U.S. Treasury holdings at what appears to be the top of the market. An added incentive to sell is the weakened yen.

It is therefore critical that Japan, with over forty percent of its trade with Asian economies, abandon its traditional policy practice of exporting its way out of a recession. With the guarded condition of Japan's financial system, the recent American setback in the WTO with the Kodak-Fuji Film case, and Treasury's policy reversal on Korea's bailout, the U.S. policy approach toward Japan in the new year will require greater finesse. Japan's enlightened self-interest in permitting increased American participation in financial services will not be enough to ameliorate the trade hawks in Congress and in the Clinton administration. Congressional criticism of a Clinton administration plan to make available an additional $3.5 billion to the IMF for emergency lending and $15 billion to replenish depleted fund coffers is growing as both parties hear from taxpayers who question any kind of foreign bailout. Congress is sure to ask what is Japan doing about Asia's financial mess. The United States, therefore, must maintain a delicate balance between pressing Japan to do its share in the region's economic recovery by absorbing Asia's output and encouraging the country to stay the course with difficult domestic financial reform. In Japan, public anxiety about the economy is at its worst level in 15 years according to a recently released survey. The great dilemma is that a rejuvenated Japanese financial system is a prerequisite for regional economic stability, but such a prospect must preclude Japan from solely exporting its way to back to health. In short, Japan's efforts to increase domestic consumption must factor in both significant increases in regional imports and foreign participation in the financial services sector if the Asian contagion is truly going to be put to rest. If not, the

trade problem will again exacerbate tensions regarding American foreign economic policy in the region.

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