PacNet
Number 2

Pacific Forum CSIS
Honolulu, Hawaii

January 15, 1999

'Muddle Through' Strategy Won't Work by Peter Ennis

The more things change in Japan, the more they seem to stay the same. It's undeniable that 1998 was a time of vast turbulence and institutional upheaval in a country that greatly values stability. The financial system wobbled, a credit crunch blanketed the economy, unemployment hit record levels, two huge banks were nationalized, the Ministry of Finance's (MOF) infamous 'convoy system' lost all credibility, and the beginnings of a real bank regulatory system began to take shape in the form of the Financial Supervisory Agency (FSA).

The political system was equally unsettled. The ruling Liberal Democratic Party (LDP) suffered a humiliating loss in July's Upper House elections. A rambunctious group of opposition parties suddenly emerged on center stage, led by the Democratic Party (DP) of Naoto Kan. And both the LDP and the DP saw the emergence within their ranks of Young Turk reformers, determined to shake up the old-guard's way of doing things. All of these signs of change notwithstanding, the harsh reality is that Japan today is not much closer to ending its economic problems than it was at the beginning of 1998.

There is no consensus to allow the kind of painful, widespread shake-out in the private sector – foreclosures and bankruptcies for sizable firms – required to truly clean up the bad-debt mess plaguing the banking industry and starving the rest of the economy. Without that, the economy is unlikely to show many signs of life. And there is no consensus to undertake the longer-term structural reforms needed to raise productivity and efficiency and return the economy to a decent rate of growth. The hesitation in both cases is understandable: a reluctance to go through a difficult transition period, during which many people would lose their jobs. But delay only makes matters worse, in the form of lagging growth, more bad debts for banks, and rising government red ink. By default, Japan has settled into a 'muddle through' mode, based on little more than the hope that the nation's economic troubles will somehow just go away.

Through some clever maneuvers, the LDP has managed to regain its grip on power. Together with the bureaucracy, the LDP is throwing vast sums of money at the economic problems, hoping to keep its political pals in construction and other industries alive and prevent a potentially explosive rise in unemployment. Meanwhile, the Democratic Party has been unable to present a credible policy alternative to LDP rule, and is thus suffering a decline in public opinion polls.

So Japan remains stuck between a dying economic system and the prospect of painful-but-inevitable reforms that many are just not ready to undertake. Sooner or later, financial instability will return, and give another jolt to the political system. The 'muddle through' approach won't work. For now, though, it's the only game in town.

The recent nationalization of Nippon Credit Bank (NCB) shed much light on this eerie change-but-no-change situation. The FSA, formed last year, moved against NCB with a degree of speed and toughness that has been sorely laking in the country's bank regulatory system. The bank had been verging on insolvency for almost two year, and with MOF help had received infusions of government funds twice in the past. But based on the results of recent inspection, FSA concluded NCB was in such a sorry state that it should be taken over. NCB officials resisted, but to no avail.

LDP diet members stayed on the sidelines, unwilling to risk public embarrassment by intervening to help the bank. The MOF was out of the picture as well.But FSA's toughness toward NCB has merely intensified the government's dilemma. How will the vast pool of loans now under government control be dealt with?

Loans deemed by FSA to be hopelessly in default (so-called Category III and IV loans) will be taken over the Resolution and Collection Bank. The RCB is supposed to foreclose on the deadbeat borrowers, sell the collateral that had been put up by borrowers, and recoup the government's losses. The problem, however, is that the RCB is buying bad debts at government expense, but is not disposing of them. Bankrupt firms stay open.

Secondly, the newly-appointed managers of Japan's two nationalized banks – NCB and Long-Term Credit Bank – will have to decide how to treat the mountain of so-called Category II assets on their books. These are loans to companies that have not missed loan payments but whose business viability is in doubt. The great danger is that politicians will intervene and press the bank managers to maintain lending to firms that don't deserve new loans.

Consider, for example, the different fates of two huge construction companies. Kokudo Kaihatsu went bankrupt last November, after Mitsui Trust and Tokai Bank refused to extend new loans. By contrast, Aoki construction was recently the beneficiary of extraordinary largesse from Industrial Bank of Japan and Asahi Bank, which decided to free the company from any need to repay its considerable debts. Why? Aoki is one of the best connected of Japan's powerful construction firms, with close ties to former prime minister Noboru Takeshita. Many firms are receiving this nice treatment.

Some U.S. equity strategists, mistakenly believing that Japan is finally tackling its bad debt problem, have begun sending money into Japanese stocks again. They are likely to be hurt. Bank stocks have indeed rebounded, at least until the very recent yen appreciation caused a broad sell off. But strength in bank stocks is mostly because of the political decision by the LDP to bail out current bank stockholders, which are mainly other banks, life insurance firms, and corporate allies.

Banks appear to be writing off large amounts of bad loans. In reality, they have been doing so for years. But there are three problems with the way this so-called cleanup of the system is being gone about.

First, the banks are still behind the curve of mounting new bad debts. With the economy still lagging, Category II loans easily become Category III, even if the banks are loathe to admit it.

Secondly, as mentioned, the LDP and the bureaucracy have found a host of ways to funnel credit to companies even while banks are reluctant or unable to lend. In some cases, such as Aoki construction, banks use capital infusions received from the government to forgive loans to favored firms. In other cases, government loan guarantee programs allow deadbeat borrowers to continue to receive new credit. Many bad loans sold to the RCB sit on the government books. Finally, the Finance Ministry's Trust Fund Bureau extends vast amounts of credit to suspect firms, with the result that it now holds 26% of all financial assets held by financial intermediaries (itself, banks, and life insurance firms). The figure will go mich higher in the coming years.

The bottom line is that a cleanup of the system is not really taking place. Companies that don't deserve credit are kept alive, even if private banks are reluctant to lend to them. Unproductive real physical capital is not pared down or put into the hands of people who can manage it better. This hinders efficiency and discourages new investment. The government faces the very real danger that the credibility crisis that has surrounded Japan's private banking system for several years will be transformed into a credibility crisis for government finances.

Until Japan begins genuine adjustment, recovery and financial stability will remain elusive. But there remains no consensus to allow an inevitable shake-out in the private sector to occur. A 'muddling through' strategy can postpone the day of reckoning, but it can't prevent it.

Peter Ennis is Editor-in-Chief of The Oriental Economist [tka@pipeline.com], from which this article was drawn (January, 1999). For more information on this insightful monthly publication, contact 800-772-3701 (U.S.) or 03-3246-5621 (Tokyo, Japan).