

Japanese Banking Reform: A New Hope

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Prime Minister Koizumi's appointment of a new cabinet represents an opportunity for definitive action to speed up the disposal of bad loans and alleviate public concerns about the banking sector. These steps, taken as part of a broader effort to promote structural and regulatory reform, are essential for a revitalization of the Japanese economy. Yet, some market participants have focused primarily on the potential for bank reform to result in short-term dislocations.

One reason is that investors want assurances that the policies will constitute a true reform of the banking sector. In 1999, the Japanese government agreed to a \$75 billion bank bailout, but without requiring action by banks to clear up non-performing loans. Three years later, many analysts suggest that banks are now worse off, not better. The appointment of Heizo Takenaka provides hope that definitive action will occur this time. Mr. Takenaka realizes the importance of not spending public money simply to subsidize banks, "Any policy to clear bad loans must come in concert with a more stringent evaluation of lending, fortification of shareholder equity and stricter corporate governance."

A good plan is one that encourages a realistic classification of non-performing loans (NPLs), better provisioning for NPLs, higher quality of capital, and a combination of carrots and sticks that provide the proper incentives for bank managers and shareholders. To the extent that Mr. Takenaka can combine these reforms with publicly funded capital injections, the result will not be a waste of taxpayer money. Instead, the policy will help to revive the Japanese economy, which has outperformed most industrialized economies over much of the past half century.

There are long-run benefits to ensuring that the banking reform is properly funded – a lesson learned during the U.S. savings and loan crisis of the 1980's. In 1987, the U.S. government passed the Competitive Equality Banking Act to deal with poorly managed thrifts. But this measure was woefully underfunded and as a result, restructuring was limited. Once the Resolution Trust Corporation was given the power needed to take definitive action in 1991, the result was decidedly different and the crisis abated by 1995 – one year ahead of schedule. Proper funding and definitive action lead to a healthier banking sector and can improve asset values.

Getting bad loans off the books and improving banks' balance sheets is not enough. Bank reform must involve changes in the way banks do business, with increased incentives for banks to allocate credit to productive sectors. An essential part of this is for shareholders to insist on improved bank management and monitoring of loan portfolios—the incentive for shareholders to insist on this should come from having them bear part of the cost of the clean up. Here it is useful to examine the 1990s Nordic banking crisis, where banks receiving government funds in Sweden and Norway were required to dismiss management, close branches, and write down equity values. As a result, the Nordic financial sector came back to profitability, though the crisis did not subside until 1 to 2 years after definitive action was taken.

Another reason that the markets have been bearish may be that investors want to be assured that the NPL problem will not be handled in isolation from other problems, such as deflation. This is because deflation harms consumer and business confidence, preventing productive lending and investment from taking place. Monetary policy can be a useful lever in preventing banking reform from having negative short-term effects by preventing the economy from contracting further. Unfortunately, in September, the monetary base actually decreased.

Banking reform will be much more difficult without a substantially more accommodative monetary policy.

The Bank of Japan can and should pursue bolder monetary easing to end deflation especially on the heels of banking reform. This would be consistent with the Bank's own framework, announced in March 2001, to target the quantity of money and achieve price stability. I am eager to hear the details of the government of Japan's "anti-deflation" package when it is unveiled later this month. If monetary policy works in concert with the new bank plan, the economy should rebound after the restructuring is underway.

It may be a difficult task to address the non-performing loan problem and improve corporate governance of banks. But we learned during the U.S. savings and loan crisis that once definitive action is taken, the benefits far outweigh the costs. A comprehensive economic policy package incorporating bank reform, pro-growth tax reform, structural and regulatory reform, and anti-deflationary measures will help to revive the Japanese economy.