“Global financial crisis
– Japan’s experience and policy response”

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Introduction

Thank you. It is my pleasure to join this discussion.

I happen to have served Japan’s financial regulatory authority for more than ten years until I stepped down as head of the authority last July. This means that I experienced both the current global financial crisis and Japan’s last banking crisis in the late 1990s. I had the privilege of dealing with a big financial crisis, not only once but twice. “What a lucky person I am!” I sometimes feel like this somewhat cynically.

Anyway, the scale of the current crisis has often been characterized as “once-in-a-century” or “the most severe since the Great Depression.” Because I had such harsh experience, however, my feeling is that the current stress is rather a “second-in-a-decade" event.

Using this perspective, I would like to explain today the effects of the current global crisis on Japan's financial sector and the authorities' policy response. I will first describe the differences between the last crisis and the current turbulence in Japan in terms of their nature and magnitude. Secondly, I will touch upon the possible reasons why Japan's financial system has been less affected than the United States and Europe this time. Then I will move on to describe the measures taken in Japan in response to the current financial stress, which somewhat differs from that in the United States and Europe. Finally, I would like to raise a point with regard to the manner in which the world's regulators should advance their reform agenda.

1. Comparing the current stress in Japan with the last crisis

There are divergent views as to how the effects of the current financial stress in Japan can be compared with the country's last banking crisis in the 1990s. Some may argue that the magnitude of the last crisis was larger since many financial firms failed and the economy remained sluggish over an extended period. Yet others may say that the current stress is more severe as Japan's GDP and share prices have declined sharply.

These divergent views probably reflect the fact that the current stress differs significantly from the difficulties we faced in the 1990s. I think the following four can be pointed out as the main sources of the difference. The first two of them are encouraging to us but the latter two make us rather pessimistic:

- First, the market turbulence in Japan this time was triggered by an exogenous shock, whereas the root causes of the last crisis were located within the country. The current financial stress in Japan stems mainly from the collapse of the housing and securitization markets in the United States, among others. In contrast, the crisis in the 1990s was the result of an endogenous shock, since Japanese financial firms had been deeply involved in the creation of the bubble in the domestic property market. Accordingly, their exposure to problem loans was much greater in the 1990s.

- Second, the regulatory framework and financial safety net have now been improved significantly in Japan. In the early 1990s, we had in place neither sufficiently effective frameworks for disclosure or provisioning with respect to non-performing loans, nor sufficiently robust schemes for deposit protection and resolution of failed banks. The lack of these frameworks provided incentives for banks to postpone the disposal of their non-performing loans, and for the authorities to avoid bank resolution in fear of its side effects. Based on the bitter experience that the lack of a reliable framework prolonged financial distress and the economic slump, we have improved disclosure requirements, clarified the rules on write-downs and provisioning, put in place a prompt corrective action scheme, and established an early warning system that enables the supervisors to conduct intense monitoring of banks before they become undercapitalized. The deposit insurance and bank resolution schemes have also been strengthened, and a robust framework to deal with systemic risk has been put in place.

- Third, the impact of the market turmoil in one country spilled over quickly to other countries this time, including Japan. Since securitized products are traded on the markets, the current crisis has a strong cross-border character. Risks were scattered to a wide range of investors through the use of what is called the "originate-to-distribute" business model, and the losses were dispersed globally. The global turmoil also hit Japan's financial sector through a sharp decline of share prices worldwide. In comparison, the effect of Japan's banking crisis in the 1990s was largely contained within the border.

- The fourth point of difference is that the current market turmoil resulted in what is likely to become the deepest global recession since the Second World War. In the late 1990s, the world economy sustained positive growth as a whole even in spite of Japan's banking crisis, the Asian crisis, and the turbulence of the global markets that followed. However, in the World Economic Outlook published earlier this month, the International Monetary Fund forecasts the World's real GDP growth for 2009 as minus 1.1 percent. The global recession has led to a serious weakening of Japan's real economy through severe contraction of external demand. Japan's GDP recorded a negative growth of 12.4 percent on an annualized basis in the first quarter of 2009, and is projected to record an annual growth of minus 5.4 percent in 2009. The current global recession thus revealed vividly that Japan's economy is heavily dependent on the export sector.

2. Why was Japan's financial system less severely hit this time?

As I have just explained, Japan was not immune from the current global financial crisis. The financial system was severely affected by high volatility of the financial markets, including through a sharp decline in the prices of shares held by banks. Meanwhile, the deterioration of the real economy impacted banks' profitability in the form of increased credit costs, albeit on a limited scale.

Nevertheless, one can fairly say that Japan's financial system itself remains relatively sound compared with those in the United States and Europe. This recognition derives from the fact that the losses Japan's financial banking sector incurred from complex securitized products have been limited; as of end-June 2009, the cumulative realized losses since April 2007 are about 25 billion US dollars, and the valuation losses are about 5 billion dollars. These figures are one digit smaller than those of the American and European financial sectors. The exposure of Japan's financial sector to opaque, toxic assets is also significantly smaller. This implies that future additional losses from these assets will be limited as well.

Then, why was Japan's financial system less exposed to the market turmoil and less severely affected in the current global crisis? There are a few anecdotes that indicate some possible reasons for this relative soundness.

- First, it is alleged that the soundness is simply a result of the fact that Japan's financial firms were not strongly innovation-oriented.
- Second, it is probably because of a historical coincidence that the firms were giving priority to improving their financial soundness rather than enhancing their profitability in the last several years. When the "originate-to-distribute" business model became widespread, it happened that Japan's financial firms were at the final stage of resolving the non-performing loan problems.
- Third and finally, some observers point out that the risk

management practices of Japan's financial firms were improving in the course of the period I just mentioned.　Firms became more cautious than before about investing in financial products with uncertainty on their underlying assets or associated risks. Early implementation of the Basel II framework in Japan has also contributed to ensuring these practices.

I think there is some truth in every anecdote but, being a former financial regulator, I am naturally most attracted to the third possible reason.

3.　Stabilization measures taken in Japan

Let me now move on to describe the short-term stabilization measures taken in Japan in response to the current market turmoil. As I mentioned earlier, the features of these measures seem to differ considerably between Japan on the one hand, and the U.S. and Europe on the other.

The U.S. and European authorities have taken a number of extraordinary actions to stabilize the financial system.　They include large-scale capital injection with public funds, temporary bank nationalization, and bank debt guarantees by governments, as well as massive liquidity provisioning by central banks.　Meanwhile, few of these extreme actions have been taken in Japan in response to the current turmoil.

This difference reflects the fact that the shock Japan has suffered in the current turmoil is exogenous. In other words, Japan's financial system suffered from external injury but not from a disease of internal organs. Therefore, most of the short-term policies in Japan are aimed at preventing the external injury from turning into a serious internal disease. More specifically, the measures we took can be classified into three types.

- The first type is the measures to *preserve the soundness of the financial sector*. For instance,
  - We conducted stress tests with financial firms on a regular basis to make sure that the financial sector maintains its soundness as a whole.
  - We also did our best to identify as soon as possible the potential spillover effects of overseas events, such as the collapse of Lehman Brothers and the public intervention into AIG (American International Group).
  - Based on these efforts, we expressed concerns to the financial firms that could be impacted significantly, and urged them to take remedial actions as necessary.

- The second type of measures is aimed at *maintaining the functioning of the financial markets*. For example,
  - We banned naked short selling of shares and enhanced disclosure on short selling. The objectives of these measures were not to keep a specific level of share prices, but to avoid extreme price volatility and to support the pricing function of the markets.
  - Also, in response to the market turmoil that followed the Lehman's collapse, we, the Financial Services Agency, coordinated with the Bank of Japan and relevant government agencies with respect to government or central bank purchases of qualified commercial paper and bonds in an effort to provide liquidity.

- The third type of measures is focused on *sustaining bank lending* in order to support activities in the real economy. They include:
  - Providing the capital injection scheme, which can be used by banks on their own business judgment to maintain a sufficient capital base and sustain their lending; and
  - Intensive supervisory review of banks' lending practices to ensure that their financial intermediary functions work properly.

4. Right balance between crisis management and reform

In parallel with these short-term measures, the world's financial regulators are advancing medium-term reforms to strengthen financial regulation. Discussions are underway globally regarding the capital adequacy of banks, procyclicality in the financial system, market integrity and transparency, and international cooperation among regulators. Here, I would like to emphasize that the right balance needs to be struck in implementing short-term stabilization measures and medium-term regulatory reforms.

On the one hand, crisis management measures should not remain in place over a prolonged period as some of them include exceptional actions with large-scale public support. Such a situation could cause moral hazard in the marketplace or distort the system in the longer run. On the other hand, too hasty implementation of medium-term measures could rather exacerbate the situation and impede economic recovery. This is the reason why the Pittsburgh G20 Statement has made it clear that the rules to improve bank capital "will be phased in as financial conditions improve and economic recovery is assured."

The implementation of regulatory reform needs to be well timed and carefully sequenced. Financial regulators should be reminded that tightening regulation is not a goal in itself: it is rather a means to ensure that the financial system plays its indispensable role of supporting the broader economy.

Thank you.