Global Financial Crisis: Japan's Experience and Policy Response

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I happen to have served Japan's financial regulatory authority for more than 10 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. Somewhat cynically, I sometimes consider, "What a lucky person I am!"

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 instead a "second-in-a-decade" event.

Using this perspective, today I would like to explain 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. Second, 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 differ somewhat from those in the United States and Europe. Finally, I would like to raise a point regarding the manner in which the world's regulators should advance their reform agenda.

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 compare with the country's last banking crisis in the 1990s. Some argue that the magnitude of the last crisis was larger, as many financial firms failed and the economy remained sluggish over an extended period. However, others say that the current crisis 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 would concentrate

on following four main sources of differences between the events. The first two are encouraging, but the latter two leave us 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. As a result, their exposure to problem loans was much greater in the 1990s.
- Second, the regulatory framework and financial safety net have been improved significantly in Japan. In the early 1990s, we lacked both sufficiently effective frameworks for disclosure or provisioning with respect to nonperforming loans and sufficiently robust schemes for deposit protection and resolution of failed banks. The lack of these frameworks induced banks to postpone the disposal of their nonperforming loans, and led the authorities to avoid timely bank resolution in fear of its side effects. Based on the bitter experience that this lack of a reliable framework prolonged both 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 into 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 international 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 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 its borders.
- The fourth point of difference is that the current market turmoil has 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, 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 –1.1 percent. The global recession has led to a serious weakening of Japan's real economy through severe contraction of its 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 –5.4 percent in 2009. The current global recession thus revealed vividly that Japan's economy is heavily dependent on its export sector.

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 the high volatility of financial markets, including the sharp decline in the prices of equity shares held by banks. Meanwhile, the deterioration of the real economy affected 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 the end of June 2009, the cumulative realized losses since April 2007 are about US$25 billion, and the valuation losses are about US$5 billion. 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.

Why was Japan's financial system less exposed to the market turmoil and less severely affected in the current global crisis? There are some possible reasons for this relative soundness.

- First, it has been alleged that the soundness is simply a result of the fact that Japan's financial firms were not strongly innovation-oriented, and therefore not as exposed to the exotic financial instruments that experienced the greatest declines in value.
- Second, it is probably attributable to historical coincidence that Japanese financial firms were concentrating on 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 their nonperforming loan problems.
- Third and finally, some observers point out that the risk management practices of Japan's financial firms were improving during the pre-crisis

period. Firms became more cautious than before about investing in financial products with uncertainty in their underlying assets or associated risks. Early implementation of the Basel II framework in Japan has also contributed to improving financial 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.

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 United States and Europe on the other.

The U.S. and European authorities have taken a number of extraordinary actions to stabilize their financial systems. They include large-scale capital injections with public funds, temporary bank nationalizations, and government bank debt guarantees, 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, 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 ensure the maintenance of financial sector soundness.
  - We also did our best to identify the potential spillover effects of overseas events, such as the collapse of Lehman Brothers and the public intervention into AIG (American International Group) as quickly as possible.
  - Based on these efforts, we expressed our concerns to financial firms that could be significantly affected by these external shocks, 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 objective of these measures was 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 collapse, we at 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 papers 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 capital injections, which can be used by banks voluntarily to maintain a sufficient capital base and sustain their lending.
  - Intensive supervisory review of banks' lending practices to ensure that their financial intermediary functions work properly.

The 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 under way 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. Leaving these in place too long 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 G-20 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.