Monetary Policy and Economic Reform

- Understanding zero interest rates

- What is wrong with Japanese banks?
  - The economics of financial disintermediation

- What went wrong with Japanese financial policy in the 90’s?
  - Comparison with the savings & loan bailout in US
  - The rise of the Japan premium

ISLM: The Liquidity Trap
The Cost of Capital when interest rates are zero

Suppose you buy a tool for 100 yen. In the course of one year it depreciates by 15%, you pay 0% interest, and prices rise by 5%.

The cost of having this tool for a year is:
\[ \text{Depreciation} + \text{Interest Expense} - \text{capital gain} \]
\[ 100 \times (0.15) + 100 \times (0.00) - 100 \times (0.05) \]
\[ = 10 \]

Now suppose prices fall by 5%.

The cost of having this tool for a year is:
\[ 100 \times (0.15) + 100 \times (0.00) - 100 \times (-0.05) \]
\[ = 20 \]

The real interest rate is the nominal rate (0) plus the inflation rate (-):
- If one expects deflation (i.e. negative inflation) the real interest rate will be positive even if the nominal rate is zero.
Deflation in Japan

- The real interest rate fell much more steeply in the U.S. than in Japan.
Solutions

- Inflation
  - Creating inflation alleviates the problem
    - Target money growth or money level (Previous Policy)
      - may not work if you don’t target future money growth
    - Target the inflation rate (commit to higher $p^*$)
      - October 10, 2003 BOJ Statement: “The Bank of Japan is currently committed to maintaining the quantitative easing policy until the consumer price index (excluding fresh food, on a nationwide basis) registers stably a zero percent or an increase year on year.”
    - Target the yen ($p^* = e(¥/$)) $p^{(3)}$
    - Commit to a price level target
      - If prices fall today, the BOJ can promise to offset these declines in the future
  - Run a bigger government deficit
    - Could be accomplished through fiscal expansion or tax cut
    - Has both Keynesian effect and monetary effect by raising inflationary expectations
  - BOJ is worried that it can’t control inflation down the line
What’s Wrong With Japanese Banks?

- Insufficient capitalization (capital to asset levels)
  - Forces banks to cut back on lending (reduce assets) or issue new equity (hard in a depressed stock market)
  - When bank share prices fall, bank lending falls to restore capital adequacy
- Asymmetric information problems reduce lending
  - Crash in land/stock prices made many borrowers insolvent
  - Banks cannot evaluate which borrowers are good and which are bad and so are unwilling to lend at any interest rate
- Moral hazard problem
  - Many banks are insolvent but can continue functioning as long as they have deposits
  - If they make a risky loan and it pays off they become insolvent
    - If it doesn’t, they are still insolvent
  - The longer the banks are kept open the greater the liabilities get!

What Went Wrong With Japanese Policy

- Objectives of banking regulation
  - Set restrictions on risky assets
  - Impose sufficiently high capital requirements
  - Close insolvent institutions
- Unfortunately regulators often like the quiet life and engage in forbearance (i.e. keeping open troubled banks)
  - That is not to close down insolvent institutions in hope situation will improve
- Regulators often fail to draw the crucial distinction between deposit insurance and “saving banks” (e.g. the convoy system)
  - Treatment of Ashikaga Bank was correct: Shareholders lost everything
The Japanese Case to 1998

- The perils of optimism: Japanese policy was characterized by far too much forbearance and poor disclosure
  - Tried to deal with failing institutions through mergers
  - Bad loans 64 trillion yen (13% of GNP), but some of this is recoverable
    - Around 5 times the amount allocated in the US S&L crisis
  - 1994 end of “no failure” policy in combination with poor disclosure led to creation of “Japan premium”
  - 12/97 30 trillion yen allocated for the deposit insurance corporation
    - Of this money 17 trill has gone for deposit insurance and 13 trillion into recapitalization of banks
      - Recapitalization is not done on the basis of solvency
      - 1.3 trillion flowed out in dividends of 23 largest banks while losses amounted to 2.2 trillion between 93 and 98

The Big Bang

- Motivation
  - Partial liberalization of financial/product markets undermined the regulatory system
  - This caused the cartel-like system to collapse
  - MOF recognition that perverse incentives in the midst of partial deregulation was untenable

- Announced in 1996 by Prime Minister Ryutaro Hashimoto, the Big Bang is a series of reforms that began the reform of Japan’s financial system according to the following principles
  - Free Markets
  - Fair Trade secured by transparent and reliable rules
  - An institutional framework satisfying international rules
Japan’s June 1998 Package

- 60 trillion yen ($500 billion) bail-out package to
  - Underwrite the deposit insurance program (17 trill)
  - Nationalize bad banks (18 trill)
  - Buy equity in (inject capital into) undercapitalized banks (25 trill)
- Provided a bridge bank mechanism for handling insolvent smaller banks
- In addition the government provided 20 trillion yen ($167 billion) of liberal loan guarantees to small businesses
- Not enough money was spent!
  - Current estimates of bad loans are around 75 trillion!

Main Elements of Financial Reforms

- Legal elements
  - 1998 Laws for Financial System Reformation (LFSR)
    - Changed banking law, securities transactions law, insurance industry law
- Changes in asset management industry
  - Deregulation of commissions
  - Access to foreign funds (FX liberalization)
  - Securities brokerages to open without government licenses
  - Increased flexibility of asset management services offered by securities firms
  - Revision in investment trust market
    - Banks and trust banks can sell investment trusts since 1998
    - Rapid growth in this market
Sources of New Competition

- Deregulation of segmentation began in 1993 when financial firms were allowed to enter markets outside their territories through subsidiaries
  - Subsidiaries have not been allowed to offer the full range of services
    - Securities subsidiaries of banks cannot conduct stock brokerage because that is the most profitable for securities companies
    - Cannot do underwriting of securities because of potential conflict of interest
  - Lots of new entry in 1999
    - Orix trust bank formed from Orix corporation
      - People can make deposits using phone or internet
    - Mitsubishi trading entered securities investment and trading business
  - Allowing banks to issue strait bonds (currently only long term credit banks can do so now)
  - Allowing more institutions to offer defined contribution pension plans

Capital Market Reforms

- Improved transparency
  - Consolidated accounting rules went into place in 1998
    - Old rules allowed profit shifting because subsidiaries were defined only in terms of shares held not in terms of control
  - Breakdowns of cash flow will appear goes in 2000
- Improvements to corporate governance
  - Since 1993 the cost of filing derivate actions for shareholders has fallen to less than that in the US
  - After 2001, deposits will only be guaranteed up to first 10 million
    - Improved discipline on banks?
- Anti-trust law restricted firms from holding companies in unrelated sectors
  - Since 1997 companies have been allowed to be holding companies
Crossing the Rubicon

- Foreign exchange liberalization allows Japanese people to buy foreign securities freely and access foreign mutual funds.
  - If Japanese financial institutions can’t compete, they will not get funds.
  - Deregulation is going to be critical to competition
  - This will force further deregulation

Regulation and Keiretsu

- Prominence of banks and insurance companies exists because of pension restrictions
- Stable shareholding is a critical feature of keiretsu
  - Stable shareholding exists in part because Japanese financials do not need to maximize returns on their stock portfolios. Regulation plays a role through:
    - Absence of competition in banking and insurance
    - Regulation of brokerage fees
    - Lack of consolidate reporting and tax breaks for small enterprises. This encourages vertical groups
- The big bang is likely to dramatically change these relationships
  - For example the merger between Sakura and Sumitomo to form Mitui-Sumitomo
What are the implications

- Decline in Banking Sector
  - Initially seen for large firms
  - Likely to decline even more rapidly for small firms as stock exchange liberalization and venture capital emerges

- End of interlocking shares implies greater ease of FDI

- Greater productivity growth as corporate governance improves

Why have previous forecasts about Japan’s future erred?

- Confusion of macro and structural factors

- Underestimation of capacity for structural change
  - Labor markets
  - Trade regimes
  - Capital Markets

- *Are we witnessing a similar structural change today?*
Issues for the Future

- Many of the toughest reforms are postponed
  - Especially insurance and postal reforms

- Will this pull Japan out of the recession?
  - Probably not, but it may affect LR growth rates

- Japan is undergoing and will undergo substantial structural change in financial markets.
  - This is likely to dramatically change the character of Japanese finance in the future.

- What if it works?!