Introduction

macroeconomic troubles
sector-specific factors
two-way links between the real economy and the financial system

- the depressed state of the economy
  - the banking system
- the poor health of the banking system
  - the economic recovery
Output and Price development

Output (Fig. 1)
- the decline of trend growth rate around the early 1990s
- Kuttner and Posen (2001): Japan’s “great recession”

Price (Fig. 2)
- aggregate price: GDP deflator, CPI
- asset prices: Japan’s Nikkei 225 stock average, land price (collateral for loans)

Most recent banking crisis - poor macroeconomic performance
unusual japan case

- severe financial problem (relative to macro stagnation)
- Japanese taxpayers’ cost of the Japanese banking crisis: about 4% of GDP
- U.S.: 2.2% of avg. GDP of 1933 - 1935
output and price development con’t

deflation: inflation < 0

▶ when?
feedback from the financial system to the real economy

hayashi & prescott (2002)
textbook view: banking problem $\rightarrow$ credit crunch
authors’ view: lending behavior of japanese banks
  - zombie firm
  - zombie banks
  - govt policy
Japan’s policy reaction to the great recession

monetary policy: quite expansionary
fiscal policy: quite expansionary
zombie firm explanation
  ▶ low interest rate → bank
  ▶ deficit spending → zombie firm (by increasing ad)

policy actions: ↓ restructuring
  ▶ deposit insurance
  ▶ capital adequacy ratio
  ▶ govt agency
  ▶ IRCJ - troubled borrowers, successful?
financial system overview

bank-centered financial system
75% of the total assets in the financial system
▶ banks
▶ life insurance
▶ govt financial institution

Too big?
Bank Crisis

Japna’s Financial Crisis and Economic Stagnation

Banking sector problems

banking sector problem

Fukao: a net operationg profit - negative(loss)
cause of the profitability problem

lack of profitability of bank lending operations
heavy dependence on revenue from lending (less fee or commissions)

- movement away from bank financing
- fee and commision ↓: alternative high-margin products
- difficult competition situation: competition form the govt (Japna Post, GHLC...)
- low profitability of many of the banks’ customers: evergreening
evergreening

implicit or explicit pressure from govt
hide the (would-be) serious capital shortage on the banks’ balance sheets
Immediate capital shortage problem

Banking system - severely undercapitalized
- bad loans: underreserve against ??? bad loans
- accounting treatment of deferred tax assets

Double gearing: p. 16
implication for banking reform

Zombie bank - Zombie firm
Health bank - new and health firm (efficient) firm
selective rehabilitation by market signals
8 lessons

1. banks may refuse public funds
2. Programs of asset purchase and recapitalization must be big enough
3. buying troubled assets alone is not likely to solve the capital shortage
4. Recapitalization programs must be preceded by rigorous inspection to determine the size of the problem
5. Troubled assets purchased by AMCs need to be put back into the private sector or restructured swiftly in order to prevent further deterioration of the value of those assets
6. Nationalization can be useful to wind down systemically important banks
7. Targeting total lending or lending to specific sectors can be counter-productive
8. Recapitalization was ultimately driven by macroeconomic recovery
Lessons not Learned

See 5.1. Lessons Not Learned
The ambiguous cases
toxic assets on the b/s of banks

- effort and capital to monitoring the risks associated w/ holding these assets
- incentive to gamble for reclamation
- incentive of other healthy institutions
different from those pursued by Japanese officials
moral hazard

Conclusion

- optimistic scenario
- pessimistic scenario

undo the moral hazard that has been created via the myriad of govt interventions
..would have created even more distortions in the financial system