

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

Japan's Bad Loan Problem Reaches Critical Point

by Yoshiaki Shikano, Doshisha University

To no one's surprise, the end-FY2001 (March 30) settlement of accounts by Japan's biggest banks was horrendous. Made public on May 24, all seven major banking groups showed accumulated losses of 4.2 trillion yen, their worst-ever showing.

The background to this banking crisis stems from two factors: 1) gigantic 7.8 trillion yen in new debt exacerbated the bad loan problem, and 2) Coupled with the swooning Nikkei, a revision of the method of stock valuation resulted in a massive decline of 1.8 trillion yen.

Major banks have made some progress in shedding bad loans, but at the end-FY2002, outstanding bad loans stood at 27.1 trillion yen. According to Finance Rehabilitation Law standards, bad

loans rose a staggering 47.4% over the end-FY2000.

How best should this 2001 settlement of accounts be interpreted? Minister Yanagisawa of the Financial Services Agency sounded a reassuring note, "In terms of bad loan disposal, the peak has been surmounted." But banking experts are not so sanguine, saying they will remain cautious because the volume of bad loans stand at an unprecedented level and are expected to mount still higher.

Counter-intuitively, as will be explained further in this article, the more progress major banks make in disposing of their bad loans, the higher the bad debt level rises. As a result, banking experts are on high-alert and overseas investors are suspicious that disclosure by Japanese banks is far from complete. Indeed, the International Monetary Fund (IMF) last fall expressed concern that the bad loans held by Japanese banks may far exceed the official tally. The IMF's interpretation is erroneous, however – Japan's systematic approach concerning bad loan disposal and troubled corporations is not accurately understood.

In a capitalist economy, a company's survival is determined

by how the capital market assesses it. As Enron's spectacular collapse proved, if a company's reputation in the market drops in conjunction with a rapid deterioration of the company's finances, it will fail.

But in Japan's case, despite the implementation of the 1998 "Big Bang" financial reforms, the system of cross-holding stock ownership remains in place and the market check system does not work. On the contrary – Japanese banks and the corporations that borrow from them typically form a unique and loyal "main banking relationship." Should a borrower be seized by a management crisis, banks are expected to rush to their rescue. Under such circumstances, even if a borrowing corporation runs into difficulties, it can escape bankruptcy by an infusion of emergency funding from its lending banks. Stated bluntly, Japan's bad loans problem lives on without the borrower being eliminated, although in a market economy, shaky borrowers are quickly weeded out.

According to a study of seven major banks conducted last year by the Nihon Keizai Shimbun(NIKKEI), fully 70 percent of companies that declared bankruptcy during the first half of 2000 had not been categorized as delinquent – the

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banks had determined their principal and interest repayments were satisfactory.

It is clear that the banks' loan assessment system is faulty. As indicated in the chart below, in Japan, borrowers are evaluated according to the standards of a repayment of principal and interest, financial conditions and the profit and loss. They are classified into five categories: Normal, Requires Attention, Requires Oversight, Risk of Failure, and Actual Failure.

The term "bad loan" is only applied to those companies whose

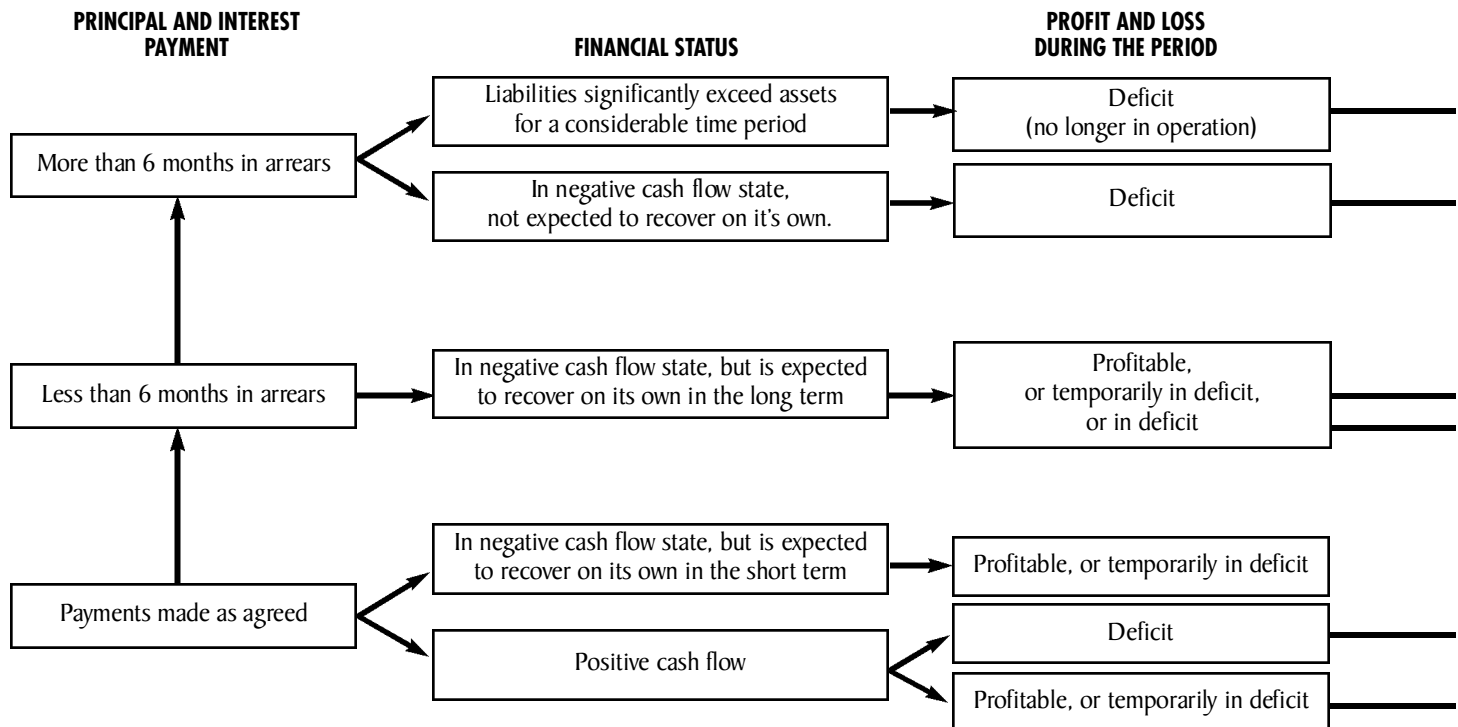
repayment is questionable, including those falling in the last three categories. Of the bad loans, the portion for which there is no security or collateral requires that a certain level of bad debt reserves be set aside. For example, a reserve ratio of 15 percent is applied for unsecured portion of loans to borrowers that "Requires Oversight," as shown in the chart.

These failures prompted the Koizumi government to carry out special inspections of the major banks' assessment of their borrowers during the second half of FY2001.

Specifically targeted were companies whose aggregated credit line totaled 12.9 trillion yen and whose share price had fallen rapidly. Using tougher measurements, these special inspections resulted in dramatic expansion of bad loans being characterized as "Requiring Oversight" or worse. Altogether, two and a half times as many companies were so down-graded – from 3.2 trillion yen to 7.9 trillion yen.

In addition, the government inspectors eliminated phrases in the inspection manual that had been subject to vague interpretation and

BANKS' LOAN EVALUATION PROCESS AS OF MARCH 2001



required banks to adopt more stringent standards for the lines of credit they extend. As a result, major banks' outstanding bad loans ballooned in March 2002. Moreover, because additional loan-loss reserves were required on the newly downgraded or reclassified bad loans, the costs involved in their disposal expanded correspondingly.

As I explained wrote in my January 2001 Japan Economic Current article (<http://www.kkc.or.jp/english/publications/economic->

currents4.pdf), bad loans stemming from collapse of the bubble economy are latent losses to Japan's economy itself. The liquidation of companies laden with excess capacity and debt is a prerequisite to the final disposition of the banks' bad loans.

At first Japan's industrial restructuring progressed slowly and haltingly. But some major corporations have recently begun to dispose of real estate latent losses in the fixed asset category. Those companies wishing to be classified as winners – ahead of

others in making changes – are pressed to apply a market price accounting system in harmony with international standards through the globalization of Tokyo's capital market.

At present, adjustments to the balance sheet are being gradually implemented. Movement toward the early resolution of excess capacity and debt in the non-financial business community will be further enforced by revisions in the accounting/auditing system scheduled to follow the FY 2002 settlement of accounts. Until recently, Japan's accounting/auditing system placed major emphasis on profit calculation, which permitted the payment of dividends, ignoring information disclosure for investors.

But if the accounting/auditing system is revised in such a way as to properly disclose financial information, troubled companies will be instantly identifiable and Japan will finally enjoy a market-checking mechanism that forces the closure or drastic restructuring of companies that have experienced difficulty.

First, the auditing system to be introduced at end-FY 2002 will be vital in determining whether or not a company can continue to operate.

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*Based on percentage of unsecured portion of loans

Denotes Bad Loans

LOAN CLASSIFICATIONS	RESERVE RATES*	BALANCE HELD BY MAJOR BANKS (¥ TRILLIONS)
Failed	100 %	3.2
Risk of failure	70 %	8.4
Requires oversight	15 %	6.4
Requires close attention	2-5 %	42.6
In normal operation	0 %	274

Principal & interest payments more than 3 months in arrears
.....

Interest rate reduction
.....

Interest rate not worth the credit risk
.....

Principal payment deferred

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External auditors will assess whether a particular company will be able to continue to operate for a minimum of one year following the date of settlement of accounts. Should an external auditor have serious doubts as to whether such going concern is possible, a special note to that effect must be entered into the financial statement.

In major Western countries, because of the market's checking mechanism, self-governance works to ruthlessly force troubled corporations to boldly restructure or weed them out. As a result, special notes in financial statements are hardly needed. But if current practices in Japan continue, there is a high probability that corporations loaded with excessive debt/liabilities will be tarred with special notes. Drastic measures will be necessary to improve their financial postures by next March. Thus the weeding out or restructuring of problem corporations will be stepped up, further expediting bad loan disposal.

Second, there will be a compulsory adoption of loss reduction accounting concerning fixed assets in the March 2006 accounting period. Companies will also be allowed to introduce such reforms two years ahead of

schedule. There is a high probability that financially sound companies, seeking to be evaluated as excellent, will start early to employ loss reduction accounting for fixed assets. This trend will help to liquidate problem corporations.

If in the future the elimination of problem corporations goes into full force, together with the planned revision in the accounting/ auditing system, banks will be faced with a huge problem in shedding their bad loans. Japan's major banks' capital reserves have been significantly diminished due to the settlement of debt accounts. This, of course, has undermined banks' ability to continue to write off bad loans.

Furthermore, the allocation for future deferred tax credits will reach the level of almost half of the banks' capital. But because the deferred tax credits a company can take is directly related to its performance, the amount that can be listed diminishes if the deficit situation continues. For example, even if a significant loss is carried over, that amount is limited to less than the taxable income for the next period.

Therefore there is a danger that, if the amount calculated as deferred tax assets is limited due to a deficit during FY2002, some major banks may face a situation in which their

capital reserves will fall below 8 percent.

Clearly, Japan's economy faces a critical point this year. The question is whether or not the regeneration of industry and finance together can be accomplished. In order to underpin the foundation for future development and growth, it is time to restructure Japanese industry and to deal with the disposal of bad loans without fearing the burden on the public in the form of increased unemployment and the final disposition of losses through public funding. ■

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“Converging Interests: Japan, The US, and the WTO”

by R. K. Morris, The Global Business Dialogue

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For all of their differences – from geography to language, from handshakes to bows – the United States and Japan share a powerful common interest in seeing the World Trade Organization (WTO) succeed. Both will benefit if the WTO is reinforced and strengthened as the anchor and principal arbiter in the global trading system.

The “moving bicycle” has become trade policy’s most persistent metaphor. But instead of thinking about keeping a 10-speed bike moving ahead by continuous pedaling, we would be wise to imagine one having 36 speeds. Six elements – what I call “national factors” – are the forward gears. Another six “WTO issues” are the rear gears.

National Factors

Politics
The economy
Security
Trade patterns
Investment Patterns
Role in the Trading System

WTO Issues

Agriculture
Market Access, industrial tariffs
Intellectual Property
Antidumping
Investment
China

These factors should be examined, not systematically, as one might in a bicycle shop, but in different combinations, as one would on a hilly bike ride.

Politics, Agriculture and the Economies

As certain as autumn brings falling leaves, any acceleration in the WTO negotiations will bring cries of exasperation over the intransigence of the Japanese political system toward liberalizing agriculture. The clout yielded by Japanese rice producers and French farmers will be excoriated as a threat to the Doha Development Agenda, to economic recovery, and to the hopes of efficient agricultural producers, especially in poorer countries.

Precisely because this aspect of these negotiations is so predictable, it is worth considering how it relates to Japanese and American interests. Indeed, there is a difference, and a big one. From wheat, to rice, to pork and beef, the United States has major export interests that it will need to advance in the Doha round. Traditionally, U.S. agriculture has been a key driver of the WTO process, and it will have to play this role again.

Certainly agricultural interests are well represented in American politics. By my count, at least three-quarters of the 21 members of the Senate Finance Committee are from farm states. Wheat and beef from Montana (the state of Max Baucus, Chairman of the Senate Finance Committee) and corn from Iowa (the state of Senator Grassley, Ranking Member of the Senate Finance Committee) come to mind. Likewise, the producers of Louisiana sugar, Vermont dairy products, Florida citrus – some of America’s more import-sensitive food products – are also well represented, along with the fishing interests of Alaska and Maine.

That fact may not close the gap between U.S. and Japanese agricultural interests. It should narrow it, though, by underscoring that both countries have defensive agendas in agriculture, in addition to liberalizing ones.

But if the contentious issue of agriculture is put aside, the politics of both countries are essentially pro-trade. That commonality should enable U.S.-Japan cooperation in Geneva. But many reject this assumption. Politicians and the press in both countries tend to argue the reverse: that

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Japan is insular and import averse, and that the pro-trade coalition in the United States has crumbled.

This view has plenty of supporting evidence, from the continued low import penetration levels in Japan for certain products to the U.S. safeguard decision on steel. But the evidence is perversely selective, because it ignores the larger reality. Both countries are highly dependent on trade and the people in both understand this. Japan is the import dependent island that grew powerful and prosperous with the mantra “export or die.” For its part, the US is the continental power that, more than any other country, is the cauldron of the global economy.

However “globalization” is defined, America has been its chief inventor, and the future of the U.S. economy is tied to its success.

Remarkably, debate over the trade legislation that passed both the House and the Senate was not the forum for a battle about globalization or even about trade. Of course, there have been rearguard actions to defend long-protected sectors such as steel, textiles and sugar, but the battle over trade and globalization per se has been muted.

Market Access for Industrial Tariffs

Because Japan and the United States are industrial powerhouses, both would benefit greatly from an across-the-board cut in industrial tariffs. A prominent American trade association, the National Foreign Trade Council, has proposed making the elimination of industrial tariffs a centerpiece of the Doha agenda. Fully 55 percent of world trade is already duty free, but existing tariffs cost the global economy some \$190 billion each year. More to the point, Japanese and American companies pay much of that \$190 billion.

Neither government is blind to the benefits that would accrue from eliminating tariffs. It is just that they don't give each other credit for the recognition. In 1999, for example, Japanese negotiators had agreed to the APEC proposal for eliminating tariffs in nine politically sensitive sectors. Their American counterparts tended to discount the Japanese support, because the Japanese concessions were given grudgingly. What was missed is that Japan's position was real and it reflected its long-term interests.

Security and Trade

When the US announced its decision to raise its tariffs on steel by 30 percent, trading partners responded with anger,

disappointment, and in some cases with cries of betrayal. Some in the UK, for example, suggested that British support for the American effort in Afghanistan made it particularly inappropriate for the United States to levy protective tariffs on British made steel.

That episode served as a reminder that there are lessons that Japan and America have learned together. One lesson is that close partners should keep their security and trade interests separate. Each system has its tensions and its conflicts, but they have different cycles. One can provide ballast for the other. America's security relationship with Japan was a stabilizing factor in the mid-1980's when the trading relationship was so contentious. But in the early Cold War era of the 1950s and '60s, the reverse was true.

With some U.S. trading partners – China perhaps – it may be the case that the trade relationship provides a ballast when other areas flare up, as they did with the accidental bombing of the Chinese embassy in Belgrade and the later detention of the American pilots on Hainan Island.

Investment and Antidumping

With respect to investment and antidumping issues, on the other

hand, the US and Japan do not yet appreciate how much they have in common. In both areas, Japan has straightforwardly and aggressively urged negotiations in the WTO. And in both cases, America has resisted this demand. With regard to antidumping, US reluctance to engage is the subject of high drama, as can be seen in the contentious debate over the so-called Dayton-Craig amendment to pending Trade Promotion Authority legislation (TPA). The amendment would effectively bar the US from even talking about dumping in the Doha round, if not prohibit the US from participating in the round altogether.

Yet with American companies themselves targeted by antidumping suits in export markets, and adverse WTO rulings about the effects of US antidumping actions on the US economy, some review of the WTO disciplines seems both inevitable and potentially beneficial.

There is less drama in the WTO investment discussions, but the pattern is the same. Japan wants a WTO agreement on investment and it is preparing the groundwork. But in an odd case of role reversal, the US is less certain. In the Uruguay round, intellectual property rights (IPR) was the critical new issue,

and the U.S. took the lead. This time it is investment and Japan and Europe are taking the lead.

In a global economy, trade and investment are inseparable and belong together in the principal instrument of global commercial law, namely the WTO. What is needed now is for the US to match Japan's engagement with its own. As with IPR, both countries have a critical stake in solid rules that protect investors, whether they be investors in the generation of new knowledge or investors in new plant and equipment.

Finally, Japan and the US – perhaps for different reasons – are both actively pursuing a range of bilateral agreements. In the end, however, both countries are the linchpins of the global economy. As such, both are absolutely dependent upon an effective global system. They depend upon it to regulate their dealings with one another and to assure levels of cooperation with others (China for example), that cannot be achieved through any other means. Bilateral agreements can be welcome supplements, but they cannot substitute for the WTO.

On this question, as with most others relating to the WTO, the building blocks of U.S. and

Japanese interests may differ in their details, as do their government's positions, but the fundamental interests are convergent, if not identical. ■

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"Koizumi Reforms"

Tsuneo Watanabe, CSIS

June 18, 2002

Although Prime Minister Koizumi is unlikely to make any drastic policy changes in the immediate term, he will have to address Japan's deep economic problems soon, said Tsuneo Watanabe of the Center for Strategic and International Studies (CSIS).

Speaking at the June 18 Japan Business Dialogue, Watanabe argued that if "bold action is taken in the next few years to truly reform the system," Japan might be able to prevent its economic doldrums from dragging down the regional and global economy.

But this action is impossible as long as the Liberal Democratic Party (LDP) old guard is in control because "reform means destroying the vested interests that constitute the core of the party's support."

Watanabe said that Koizumi has three options. The first – and the most likely path for Koizumi to follow – is to keep in step with the LDP platform and to encourage gradual change from within the party.

The second "very difficult" option would be to enact drastic internal reform of the LDP. But these efforts would be blocked, by the *zokugiin*

(Diet members who dominate a particular policy area because of their seniority and expertise in a particular area). The *zokugiin* and the three *zoku*, (policy "tribes" that largely determine Japan's policies on agriculture, construction, and commerce) enable the LDP old guard to protect their special interests, which are at odds with public interests, explained Watanabe.

Moreover, because LDP's internal rules are adopted unanimously, rather than by majority vote, the old guard maintains an effective veto power against the cabinet. Finally, the LDP's policy making division, coupled with well-established boundaries of responsibility according to government Ministry, discourages political initiative beyond bureaucratic sectionalism.

And the third option, widely debated in the wake of an April 6, 2002 Asian Wall Street Journal editorial by Ed Lincoln of the Brookings Institution and Clyde Prestowitz of the Economic Strategy Institute, would be to force a dramatic realignment by resigning from the LDP, dissolving the Japanese parliament (the Diet), and precipitating new elections that would focus on the need for political and economic restructuring.

Considering declining public support for Koizumi, however, he has lost the golden opportunity for election and political realignment. We will have to wait for the Japanese judgement on continuing stagnation with the LDP rule and the lame duck Koizumi in the next election, which may not come soon. ■

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KKC fosters a deeper understanding of Japan's basic social structure. Furthermore, it conducts public affairs activities to improve the Japanese people's recognition of Japan's global role.

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