

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

Japanese Non-Performing Loans Represent The Latent Losses Due To The Collapse Of The Asset-Price Bubble

by Yoshiaki Shikano

The problem of non-performing loans at Japanese banks is attracting renewed attention. Many experts are concerned that the banks did not make sufficient progress in their efforts to dispose of bad loans. Since July 2000, several institutions—including Sogo, Chiyoda Life Insurance, and Kyoei Life Insurance—have failed, which has made a huge volume of bank loans. In addition, several construction and real estate companies have requested substantial debt cancellations from lending banks. Against this worrisome backdrop, Moody's Investor Services, Inc. concluded in an October 2000 report that "generic financial recovery is remote."

The financial results of 16 major banks for the September mid-term accounting period amply support that conclusion. These institutions built up loan-loss reserves by ¥1,664.5 billion (on a non-consolidated basis) to write off non-performing loans during this six-month period.

That figure exceeded the projected ¥893 billion by 80 percent.

Are Japanese banks still underreporting their outstanding non-performing loans? Certainly, no. Since April 1998, Japanese banks have been required by law to determine the broad-based volume of their non-performing assets and to maintain loan-loss reserves accordingly to cover bad loans. Moreover, the disclosure requirement has been expanded and improved in ways that enhance the reliability of the bad-loan figures.

What then has caused the problem? Some financial industry analysts have attributed it to "bank mismanagement." They say Japanese bank managers failed to accurately and appropriately avoid a concentration of risks during the expansionary phase of the asset-price bubble in the 1980s. I believe, however, that the bad-loan problem stems from the basic character of the Japanese economy over which individual banks have no control.

By the end of 1990, the loan portfolios of many Japanese banks were seriously distorted. The share of outstanding loans to construction companies, real estate companies, and non-banks had ballooned to 32 percent of the total portfolio of loans held by domestic financial institutions, including assets in trust accounts. As a consequence, the management and financial foundations of the banks became extremely vulnerable to movements in land prices. This was particularly the case for long-term credit banks and trust banks,

where real estate-related lending amounted to 51 percent and 54 percent of their respective loan portfolios. It was not surprising that many of these institutions eventually failed or were absorbed by other banks.

Shouldering Blame

Normally, shareholders bear the burden for a corporate failure according to their level of equity participation. In the United States, Britain, and Germany, the average percentage of shareholder equity for all industries ranges from 38 percent to 55 percent. Given this high level of public ownership, shareholders in these countries naturally feel strongly motivated to carefully monitor management. Shareholder oversight, in turn, creates an environment of discipline in which management strives to ensure business profitability. Most importantly, the high level of shareholder equity also serves as a buffer in the event of a corporate failure so that the banks rarely are forced to absorb the company's losses.

In Japan, however, while the portion of shareholder equity in non-financial companies has increased significantly in the past two decades, it still amounts to a comparatively low 20 percent, or half the level in the United States and Great Britain. This level implies that Japanese banks provide the lion's share of risk capital, which should be intrinsically taken by the stakeholders. It is the real essence of the "Japanese management" and gives these financial institutions the power of

Currently No. 4 January 2001

WTO Members Debate Tackling Competition Policy In A New Trade Round 4

Japan Business Dialogue 6

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life or death over a borrower whose business is faltering. But the down side of this arrangement is that banks incur very substantial losses when a borrower fails. For example, in the case of Sogo, which filed for protection under the Civil Rehabilitation Law, all lending banks were asked to accept an across-the-board, 95 percent cancellation of claims.

Three northern European countries, Sweden chief among them, experienced asset-price inflation in the second half of the 1980s that was much like Japan's experience. After the collapse of the bubble, many of the companies that had borrowed to invest in real estate failed. As loans became uncollectible, major banks were forced to rapidly increase their reserves to cover these losses. The Bank of International Settlement-based adequacy capital ratio remarkably declined to below 8 percent.

In order to stabilize the domestic financial system, Stockholm and the other two northern European governments developed a very bold rescue program. They injected public funds into the banking system so that major banks could maintain the capital ratio as high as 8 percent, but then nationalized these institutions.

Japanese borrowers acted very differently from their Swedish counterparts after the bursting of the 1980s bubble. Bank lending as a percentage of GDP remained at about 100 percent after 1990, which suggests that lending remained high even after the bubble burst.

Industry data also reveal that the real estate sector's liabilities continued to grow after the bursting of the bubble (see graph).

If the trend line in corporate assets and liabilities is placed over the one in bank lending, two important facts emerge. First, borrowers have not completed their post-bubble balance-sheet adjustments—which is the flip side of the banking industry's non-performing loan problem. And second, the financial and real estate assets that have been kept on the books at cost were acquired during the bubble period.

Problems with Bankruptcy Procedures

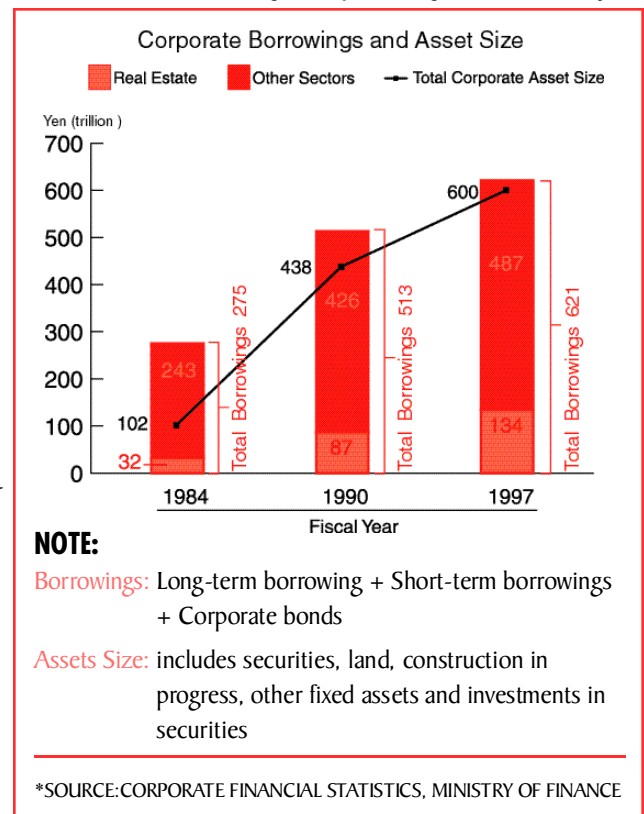
In Japan, corporate accounting principles have not included fully specified procedures for dealing with non-performing loans. A company's non-performing loans must satisfy the tax code's rigorous criteria in order to be declared tax-free write-offs. This gave rise to an environment where the banks could determine when a troubled borrower filed for bankruptcy. Borrowing companies are not considered bankrupt as long as they can duly settle their checks and notes by using emergency loans and interest-payment deferrals from the banks.

It is unilaterally advantageous for banks and other financial institutions to support a borrower in financial distress. Some experts propose that this system indeed has fostered the Japanese convention of

main bank-led rescue operations for distressed firms.

Moreover, the Japanese approach has effectively linked the fates of borrowers and their banks. Extensive cross-shareholding has further cemented these relationships. Major companies own large blocks of bank shares, but they rarely question the corporate rescue packages extended by banks because they, too, have a vital interest in maintaining a lender of last resort in event that they may need financial assistance at some future date.

Japan's bankruptcy system also has been flawed. Bankruptcy laws rigorously defined the procedures for corporate rehabilitation with a goal of preventing moral hazards by



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JAPAN
ECONOMIC
CURRENTS

corporate managers. Since restructuring could not proceed without the approval of the principal creditors, the banks exercised direct and substantial influence over the bankrupt company's application for reorganization or composition.

Once the courts accepted such an application, the burden of rehabilitating a failed company fell on the shoulders of shareholders, management, and creditors. But these three parties shared a common incentive to delay the financial pain of restructuring for as long as possible. The main banks, in particular, seemed more concerned about protecting their reputations as a good monitor. They tended to view the submission of an application for reorganization as a last resort.

Under the revised bankruptcy system that went into effect in April 2000, companies facing bankruptcy are now able to proceed with a rehabilitation plan after disposing of non-performing assets as they see fit. Patterned after Chapter 11 of the U.S. bankruptcy law, the Civil Rehabilitation Law was designed to promote the early and speedy rehabilitation of companies in crisis. Thus, the law does not require the replacement of current management.

It also allows a company to submit an application for reorganization before it realizes negative net worth or insolvency and recognizes a rehabilitation plan that has been approved by creditors holding 50 percent or more of the claims. In addition to facilitating corporate restructuring, these revisions to bankruptcy law over time will push the heretofore close relations between Japanese banks and their

borrowing companies in the direction of arm's-length transactions.

Accounting System Overhaul

The accounting system, which in the past supported the ascendancy of the banks in the event of corporate failure, also is being overhauled. In response to the growing call for the adoption of internationally agreed accounting principles, several significant changes went into effect in fiscal 1999. The standard of inclusion of subsidiaries in consolidated financial statements has been changed from an "equity position standard," where inclusion was based on majority ownership of voting shares, to an "effective control standard," meaning that inclusion is based on effective control of a subsidiary. Another revision obliges a company to register a valuation loss when the market value of real estate acquired for resale falls below 50 percent of the acquisition value.

Yet another change to be introduced in FY 2000 requires companies to adopt mark-to-market valuation of securities that were acquired for resale. In terms of bank accounting standards, since March 1999, financial institutions have been required to determine the soundness of their loan assets using standards and procedures set by the Financial Services Agency and to add to their reserves accordingly.

In sum, we are witnessing the disintegration of an accounting system that permitted and supported the postponement of loss disposal. A full decade after the bursting of the economic bubble, Japan finally has begun a wholehearted effort to push through balance-sheet adjustments. In the March 2000 settlement, it became

apparent that companies that were left holding very large non-performing assets when the bubble burst were willing to use loss accounting to dispose of latent losses in marketable real estate holdings and the latent losses in securities holdings. This explains why banks faced a growing number of requests for cancellation of claims.

From the perspective of the banks, this development represents a deterioration in the collectability of real estate-related loans. Thus, given the increase in major corporate bankruptcies, it is not so surprising that Japanese banks have been building up their reserves at a pace exceeding earlier projections.

As Moody's October 2000 report states, the 16 major Japanese banks will not be able to avoid writing off between ¥5 trillion and ¥11 trillion over the next three years. As borrowers mount full-fledged programs for balance-sheet adjustment, it is perfectly clear that the banks will be required to write-off increasing levels of non-performing assets.

In any case, those non-performing assets represent the latent losses suffered by the entire Japanese economy as a consequence of the collapse of the asset price bubbles. It is difficult to imagine that the old procedure of canceling claims can effectively address the bad-loan problem. In order to rebuild a solid foundation for the future growth and development of Japan, public funds must be used to finally resolve the bad-loan problem in the banking system.

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WTO Members Debate Tackling Competition Policy In A New Trade Round

by Edward M. Graham

At the 1997 World Trade Organization (WTO) Ministerial Meeting in Singapore, the European Union proposed adding competition policy to the future multilateral trade agenda. Not all WTO members embraced this proposal and, as a consequence, the global trade organization created the WTO Working Group on Trade and Competition Policy to further study this issue. However, at the November 1999 Ministerial in Seattle—the now-infamous meeting that was disrupted by rioting—member nations still could not agree whether to place competition policy on the negotiating agenda.

The following essay surveys both sides of the argument to include competition policy in a

future round of multilateral trade talks. In addition to explaining the term “competition policy,” this article also will consider the international dimensions of competition policy and examine why this issue has become contentious in the WTO.

Defining Competition Policy

“Competition policy” encompasses any law or governmental policy that affects the conditions of competition in any market. These conditions would include the number of sellers in a market, the ability of new sellers to enter a market, and the ability of incumbent firms to acquire or divest other companies, including competing firms as well as suppliers, distributors, or retailers that service the market.

Economists generally believe that under most circumstances, greater competition (meaning numerous sellers in the marketplace) produces a more favorable outcome for consumers. According to this view, monopolization of a market by a single seller or small group of sellers is not good since it usually drives up costs. However, there are circumstances—for example, if strong scale economies are extant—in which a reduced number of competitors may be preferable. Also, most economists would argue that inefficient companies should not be protected to preserve the number of competitors who sell in the market.

“Proponents of WTO coverage of competition policy point out that for most member nations, the relevant market is the global market, whereas national laws cover only a portion of the market.”

In principle, the private actions of firms as well as governmental regulations can affect the conditions of competition. However, formal competition policy, as embodied in relevant national laws, is aimed principally at private practices. For example, in the United States, antitrust laws, which are enforced primarily by the Department of Justice, almost exclusively seek to prevent private sector actions that impede market competition. In Japan, the Antimonopoly Law, enforced by the Fair Trade Commission, is also aimed at preventing corporate anticompetitive behavior.

By contrast, in the EU, the relevant competition law covers some government actions as well as private practices, but the former applies mostly to state subsidi-

dization. Thus, the fact that WTO rules (and the predecessor rules of the General Agreement on Tariffs and Trade) historically have focused on governmental actions has complicated the consideration of global negotiations on competition policy because the domestic laws of so many member nations focus on private sector practices.

Competition and WTO Rules

In fact, some experts argue that the focus of WTO rules on government practices is very much geared toward fostering competition, as were the terms of the original GATT. These rules generally require

governments to maintain markets that are open to foreign competition. They also establish limits on the extent

to which a national entity may limit trade through the use of tariffs and quantitative import restrictions, require national treatment for imports of goods and some services, and oblige governments to grant most-favored nation treatment to imports from other WTO signatories.

WTO Consideration of Competition Policy

Proponents of WTO coverage of competition policy point out that for most member nations, the relevant market is the global market, whereas national laws cover only the portion of the market that lies within the jurisdiction of a sovereign entity. For example, if an American company's international practices adversely affect, say, Japanese consumers, Tokyo may be unable to seek redress because these activities fall

WTO Members Debate Tackling Competition Policy In A New Trade Round

by Edward M. Graham, Continued

JAPAN
ECONOMIC
CURRENTS

outside of the jurisdiction of domestic enforcement agencies.

Opponents of a globalized regime governing competition make two points. First, they argue that while there are domestic laws aimed at fostering competition, neither the substantive nor the procedural standards embodied in these laws are the same in any two jurisdictions. Moreover, individual governments strongly disagree about which standards should be adopted internationally. Thus, the anti-global competition policy camp argues that it would make little sense to develop a multilateral regime if a consensus cannot first be reached on what standards should be adopted and national laws are not modified to be consistent with those standards.

The second argument against a WTO role is that this organization does not have the requisite expertise to administer highly nuanced rules pertaining to competition. Of course, an organization can acquire or build such expertise. But neither the arguments for or against the development of WTO rules governing competition address the undeniable reality that some sort of multilateral approach is necessary in an era when markets themselves are becoming increasingly "borderless."

For these reasons, competition agencies around the world are currently engaged in new efforts to build cooperative relationships. They apparently believe that cooperation among enforcement agencies provides a more effective means of addressing the international dimension of competitive policy than a new set of WTO rules.

In the meantime, the debate in the WTO continues over whether the organization should develop a set of rules governing competition. Some experts have suggested that, at minimum, the WTO

“Several Asian countries, led by Japan, have argued that reform (or even abolition) of antidumping statutes should be on the WTO agenda.”

should investigate the anti-competitive impact of certain trade measures. At the top of this list are the antidumping measures that more than 40 nations employ, the United States and the EU chief among them.

Antidumping laws are designed to protect domestic firms from the "unfair" trading practices of importers of like products. However, most analysts believe that in actual practice the protection itself is "unfair," since it suppresses legitimate competition.

Several Asian countries, led by Japan, have argued that reform (or even abolition) of antidumping statutes should be on the

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WTO agenda. However, both the United States and the EU have refused to even discuss such reforms. This distresses a number of prominent trade specialists who have suggested that further liberalization of the multilateral trading system might be

impossible if antidumping reform is not part of the agenda.

In sum, it remains uncertain whether the WTO will undertake the development of a set of rules regulating private business practices, revise antidumping statutes, or create a new regime governing international investment. Since the resolution of these issues will have a major impact on the conduct of business worldwide, the wise multinational corporate executive should closely watch this evolving debate. ■

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"U.S.-Japan Relation After The Election-What's Ahead"

Toshinori Shigeie, Minister Plenipotentiary, and Deputy Chief of Mission, Embassy of Japan

Japanese watched the U.S. presidential and congressional elections intensely, according to Toshinori Shigeie, Minister Plenipotentiary and Deputy Chief of Mission of the Embassy of Japan in Washington, D.C. Many were as riveted as Americans because they recognized that the outcome would have important implications for future U.S. policies toward Japan. Mr. Shigeie told attendees of the November 20 Japan Business Dialogue that no matter who is finally declared the winner of the presidential race—be it Texas Governor George W. Bush or Vice President Al Gore—the world needs strong, interested and cooperative leadership from the United States.

Mr. Shigeie suggested that the advent of a new administration presents an important opportunity for a "fresh beginning to U.S.-Japan relations." He noted that various informal groups and think tanks have prepared reports of U.S.-Japan policy recommendations for the new American government. Although the Japanese may disagree with some of the proposals, Tokyo has generally regarded these reports positively since they reflect serious interest in U.S.-Japan relations.

Mr. Shigeie discussed four main elements of the U.S.-Japan policy agenda: security relations, economic relations, Asian Pacific security issues, and international trade. In the security area, the U.S.-Japan Mutual Security Treaty continues to

serve as the cornerstone for the security of Japan and Asia. It is important to keep the Japanese public engaged in the security debate, he said, particularly in view of continued uncertainties on the Korean peninsula.

In terms of specific issues, officials in Tokyo and Washington should give priority to the relocation of the U.S. Marines Corps heliport currently at Futenma Air Station in Okinawa. They should also devote greater time and attention to discussing broader security issues.

U.S.-Japan economic relations are unlike any other bilateral economic ties, Mr. Shigeie said. Tokyo welcomes the increase in foreign direct investment in Japan, particularly from U.S. companies. Private sector-driven development will help to ensure a sustainable recovery of the Japanese economy. While the bilateral deregulation talks are a major vehicle for ongoing discussion of U.S.-Japan economic issues, the two governments should review the specific issues on the agenda. A more general framework for these negotiations might be preferable, Mr. Shigeie proposed. However, the number-one priority for both countries should be to put the Japanese economy back on track.

North Korea is at the forefront of Tokyo's consideration of Asian Pacific security issues. Mr. Shigeie said Japan pursues its own negotiations with North Korea aimed at normalizing relations at its own pace, regardless of developments in U.S.-North Korean relations. However, Tokyo and Washington should continue to work closely in coordinating their policies toward Pyongyang.

On the international trade front, Mr. Shigeie said that while the global trading system needs a new round of multilateral trade negotiations, further efforts are needed to build support for these talks. There still are too many unresolved issues, including trade in agriculture and services, he pointed out. An active agenda of discussions at WTO headquarters in Geneva would help to set the stage for a new WTO round.

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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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