Bank of Japan announces desperate measures to shore up banking system

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In an unprecedented move, Japan's central bank, the Bank of Japan (BOJ) announced late last week that it would purchase stocks held by the nation's largest and most troubled banks in order to bolster stability in the financial system. Although concrete details have not been finalised, the plan is to purchase some three trillion yen of shares ($US24.5 billion) held by at least 10 major financial institutions, and hold them for at least 10 years.

The decision represents the first time in history that a central bank has stepped in to buy stocks. Traditionally, such an act has been viewed as an unacceptable policy option. It directly ties the balance sheet of the institution responsible for establishing interest rates and overseeing the entire economy to the fortunes of particular corporations. It is also a dramatic shift by BOJ governor Masaru Hayami, who has been a consistent opponent of state actions to shore up failing companies and an advocate of large-scale economic restructuring.

But in the face of the government's refusal to implement major restructuring, the BOJ move is seen in some circles as an attempt to apply pressure to the cabinet of Prime Minister Junichiro Koizumi. "We thought some kind of high-risk taking action by the BOJ was necessary to send a meaningful wake-up call," a senior bank official told the *Financial Times*. "Action is needed at this critical moment".

Whatever the internal conflicts over policy between the government and the central bank, there is no doubt that the BOJ actions are being assessed in international financial circles as a sign of panic at the parlous state of the Japanese financial system. The announcement comes ahead of the end of the half-year financial period on September 30 when the banks must declare their real financial status.

Japan's banks hold shares as security on loans and declare them as assets, so the fall on world stock markets has undermined their balance sheets. Aggravating the crisis, government legislation is compelling the banks to reduce their holdings of shares by as much as six trillion yen or $US49 billion. The sell-off, however, has fuelled share price declines and raised fears that the assets of financial institutions could fall below the required capital adequacy ratios.

According to a recent report in the *Japan Times*, the largest 12 banks had 1.2 trillion yen ($US9.7 billion) in unrealised losses at the end of March 2002 on their equity portfolios. It is estimated that this figure could have grown to as much as four trillion yen ($US32.6 billion) as share prices have slumped further in recent weeks. The Tokyo Nikkei index hit a 19-year low on September 4, finishing below 9,000 points. In response, Hayami declared the stock market falls "threaten the stability of financial markets and the financial system."

Justifying its unprecedented actions, a BOJ official told the *Financial Times* on September 25: "We are well aware of the risks to our balance sheet. We never meant to do this. But unusual circumstances call for unusual measures."

At the heart of the crisis is the vast sum of non-performing loans on the books of Japan's banks—as high as $US428 billion—much of which dates back to the collapse of the stock and property market bubble in 1989-1990. According to one report cited by US economic advisor Glenn Hubbard, bad assets held by the Japanese financial system could be as high as 20 percent of Gross Domestic Product (GDP). "When I say this is a large problem, this is a very large problem," he said. By comparison, the Savings and Loan debacle in the US in the 1980s amounted to just one percent of GDP.

Bank profits are being channelled into shoring up their balance sheets, rather than new investments. Despite Japan having effectively zero interest rates, bank lending has fallen in Japan now for the 44th consecutive month and been a major factor in fuelling deflation.

The announcement that the BOJ intends to buy bank-held shares has produced mixed predictions about its potential impact on the world's second largest economy, which is experiencing its fourth recession in a decade.

Some analysts drew positive conclusions, hoping it would impel the cabinet of Prime Minister Junichiro Koizumi to defy opposition within the ruling Liberal Democratic Party (LDP) and press ahead with its long promised economic restructuring policies.

The *Washington Post* commented: "Many analysts saw an element of desperation in the move. But some also said it could provide the basis for a broader initiative to lift Japan out of the economic doldrums which it has been mired in for much of the past decade. So far, Japanese policymakers have balked at taking the two major steps that economists widely agree are essential for a lasting recovery: a painful disposal of the hundreds of billions of dollars in bad loans held by the banks and an extraordinarily powerful expansion of the money supply to combat deflation."

Adam Posen, a Japanese analyst at the Institute for International Economics, told the *Post*: "This is the BOJ panicking. But it could be good news, because it could be part of a deal where the BOJ finally ends deflation and the government finally forces the banks to deal with loans. So far, though, there's no explicit deal and the stock purchase could well end up being a stop gap measure."

But the overriding sentiment is one of scepticism and pessimism. The *New York Times* criticised Koizumi's support for the BOJ's move, stating "in backing his (LDP) party's efforts to prop up stock prices and the banks, he has again contradicted his promises to let market forces determine winners and losers".

The credit rating agency Fitch declared: "Such an unconditional bailout scheme would, by itself, do little to improve the fundamental health of the economy or the financial sector. In the absence of follow-up policy action aimed at resolving the banks' bad loan problems, the stock purchase scheme will act as little more that a short term palliative for the economy."

These sentiments were echoed by an editorial in Japan's *Asahi Shimbun*, which was scathing in its criticism of Koizumi and the inaction of his administration in the midst of the deepening crisis of the banks and the economy:

"The BOJ's resolve to embark on a course of action it fully realises is forbidden can be seen as a message to the government to adopt more daring policies to get Japan out of its long period of deflation... Koizumi's most important task at the moment is to make clear he has the political will to dispose of non-performing loans...

"The Bank of Japan is taking a gamble. To support the gamble and to avoid letting it die for lack of support, the government must be determined to come up with the necessary policies. Particularly now that this point has been reached, unless the government takes drastic measures, Japan will end up sinking into a quagmire of deflation and non-performing loans."

The Koizumi administration is in the midst of drawing up plans for what will be the Japanese government's eighth stimulus package in 18 months, which will be announced in October. Few details have been released as yet but it has been suggested that it will include a cut in corporate taxes of around two trillion yen ($US16.2 billion) to assist business, combined with tax increases on Japanese working people—most likely in the consumption tax. Koizumi has also announced that his government would devise measures to speed up the disposal of non-performing loans held by the country's financial institutions, but given no details.

Economic indicators released over the past week, however, highlight the intractable crisis of the Japanese economy, the inadequacy of the stopgap measures of the central bank and the government and growing nervousness in corporate circles.

Last week, for the first time since introducing an auction system for selling 10-year Japanese bonds in 1988, the Ministry of Finance failed to sell all $US14.6 billion worth of 10-year bonds on offer. Japan's Cabinet Office also issued a bleak assessment of the country's prospects, stating that the growth targets for 2003/2004 would be difficult to achieve. Although it had earlier stated that exports to the US would return Japan to steady growth, it now predicts that factors such as an US war on Iraq and a rise in oil prices, coupled with the stock market weakness, will further undermine domestic demand. The Cabinet Office has predicted that deflation will continue for another two years.

Although the number of corporate bankruptcies fell 3.1 percent in August from a year earlier, the liabilities of the bankrupt firms rose 44 percent to 1.059 trillion yen ($US8.6 billion), topping the one trillion yen level for the second straight month, according to figures released by Teikoku Databank Ltd. The size of the liabilities was the second largest for August since World War II. The number of bankruptcies in the January-August period reached 13,248, the third highest level in post-war Japan. Teikokou Databank has predicted the number of corporate failures will pass the 20,000 mark this year.

Land prices in Japan also fell in the 12-month period to July 1, for the 11th consecutive year. The *Japan Times* commented: "The slide reflects a prolonged economic slump that is undermining the property market with lower demand. If asset values continue to decline and economic deterioration continues, unrealised losses on property assets may swell further in the corporate sector."

The prescription that has been consistently been offered in order to salvage Japanese capitalism's economic fortunes is the wholesale bankruptcy of indebted companies and the removal of their non-performing loans from bank balance sheets. The dilemma confronting the Koizumi cabinet and previous LDP administrations is that this will involve sending to the wall thousands of firms with intimate ties to the ruling party, particularly in the construction, real estate and retail sectors. The International Monetary Fund estimates that dealing with the bad loan crisis will cause between 800,000 to 1.8 million job losses directly and slash one to two percent off Japan's already declining GDP. Such policies, carried out in the interests of the financial oligarchy, would aggravate the sharp political and social tensions produced by a decade of unemployment and falling living standards to breaking point.