Global economic crisis hits Japanese banks, exporters

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29 October 2008

Japan's stock market has been hit by extraordinary volatility over the past few days, hitting a 26-year low on Monday before recovering its losses yesterday after the government stepped in to announce a series of emergency measures. Despite claims that Japan was well positioned to weather the crisis, the world's second largest economy is rapidly being dragged into the financial and economic maelstrom sweeping the globe.

Amid growing signs of global recession, the Nikkei 225 Stock Average fell 6.4 percent on Monday to 7,163—its lowest level since October 1982. Up to the end of Monday, the stock market had lost half its value this year. The stocks of the major exporters all suffered after a series of company reports announcing falling profits.

Prime Minister Taro Aso warned on Monday: "Unless appropriate measures are adopted, the market's free fall will have a huge impact on the real economy." The Financial Services Agency has announced a ban from early next month on naked short-selling—a means of betting on a falling market. The government is also preparing to announce a second major stimulus package this week in a bid to boost economic growth. On Tuesday, the Nikkei rose by 6.4 percent.

Japan's deepening crisis is a product of the international financial storms and economic slowdown. As Shinichi Ichikawa, chief equity strategist at Credit Suisse in Tokyo, told the *Wall Street Journal*: "The factors hurting the market are beyond Japan's control." The Japanese government alone can't fix exporters' woes or the slowing global economy, he declared.

Last week Sony sharply cut back its profit outlook for the current fiscal year and Nissan announced plans to wind back production in the US, Japan, the UK and Spain. Yesterday Honda announced a 41 percent drop in its September quarter profits and warned of lower profits for the full fiscal year. Panasonic also reported a fall in profits.

Japan is heavily dependent on exports, particularly to the US and Europe, where the economies are slowing rapidly. In 2007, export earnings accounted for two thirds of Japan's economic growth. Falling exports have already led to a second quarter contraction in the economy and many analysts are predicting worse to come.

Hiromichi Shirakawa, an economist for Credit Suisse and UBS, predicted that the economy could shrink by as much as 1 percent next year—potentially the largest contraction among the major industrialised nations. The Royal Bank of Scotland stated last week that it did not expect the Japanese economy to regain its potential growth rate until at least the latter half of 2010.

A major factor hitting Japanese exports is the strength of the yen against all major currencies including the US dollar. Last Friday, the yen hit 90.89 to the US dollar—its highest value since August 1995. In the past three months, it has appreciated by 19 percent against the dollar, 32 percent against the euro and 33 percent against the British pound.

The G-7 financial ministers issued an emergency statement on Monday, partly in response to Japanese appeals for assistance. The G-7 warned that "recent excessive volatility in the exchange rate of the yen" had "possible adverse implications for economic and financial stability." The statement failed to halt a further appreciation of the yen on Tuesday.

A significant component in the rise of the yen is the unravelling of the so-called carry trade. Following the collapse of the share and property bubbles in Japan in the early 1990s, the country's central bank has maintained interest rates at record lows—at zero for five years—as part of efforts to end the economy's protracted stagnation.

The carry trade involves borrowing in Japan where the interest rate is currently 0.5 percent and investing in countries where the returns are far higher. One effect has been to depress the value of the yen against other currencies, which in turn benefitted Japanese exporters. Hedge funds in particular have invested heavily in the carry trade, which, according to the Stratfor website, involves massive investments—estimates range from $1.5 trillion to more than $6 trillion.

Now, amid global investor panic and uncertainties, investors are getting out of riskier countries, particularly the so-called emerging economies and looking for safe havens. As a result, the carry trade is "unwinding". As money floods back into the yen, it drives the currency higher. This in turn encourages investors to avoid even higher payments by paying off their yen debts, causing the yen to rise even further.

Many of the emerging economies that once offered high returns are in a state of economic turmoil, if not complete collapse. A growing number of countries have either agreed to a deal or are in talks with the IMF to avert bankruptcy, including Iceland, Hungary, Pakistan and the Ukraine.

The collapse of the carry trade is one of the main reasons behind the plunge of global currencies against the yen. The Australian dollar, for instance, which was a favourite among investors, has plummetted by nearly half against the yen since July.

As international credit markets have frozen up, countries heavily dependent on foreign borrowings have been caught out by the lack of finance, as well as having to make higher payments on existing loans due to falling currencies. In Latin America, Argentina is once again on the brink of default. In Eastern Europe, Romania, Hungary and Bulgaria are heavily exposed to foreign-denominated debt. On Monday, international ratings agency Standard & Poors lowered Romania's foreign currency debt rating to BB+ or "junk" status.

The steadily rising yen has been one of the indicators prompting a sell off of Japanese shares, particularly of the major exporters. The collapse of share values has opened up the first cracks in Japan's banking system, which previously appeared to be rock solid. Over the past two decades, Japan's major banks have purged their balance sheets of huge quantities of bad debt. They also had little exposure to the US subprime crisis.

Over the past month, Japanese banks have exploited the financial crisis in the US to make some major acquisitions. The largest—Mitsubishi UFJ Financial Group—paid $9 billion to purchase a 21 percent stake in Morgan Stanley and also bought a 35 percent stake in Union BanCal Corp for about $3.5 billion. Nomura Holdings bought up the Asian and European components of failed Lehman Brothers Holdings.

On Monday, however, Mitsubishi UFJ Financial Group announced plans to raise as much as $10.7 billion in new capital. Ms Li of KBC Securities told the *Wall Street Journal* that the decision was "a big blow for the confidence of investors in Japan and abroad. They previously assumed Japanese banks were relatively safe and didn't have the immediate need to raise capital."

Sumitomo Mitsui Financial Group and Mizuho Financial Group are expected to follow suit. Shares in Mitsubishi UFJ and Mizuho plunged by 15 percent on Monday and Sumitomo Mitsui fell by 11 percent. Economy Minister Kaoru Yosano indicated on Sunday that the government would increase its planned injection of funds to strengthen the country's financial institutions from two to ten trillion yen. While originally intended for smaller banks, it may now include Japan's top banks.

The major Japanese banks may not be vulnerable to American toxic debt, but their large share holdings have been badly hit by the downward plunge of the Nikkei 225. Mitsubishi UFJ held a portfolio of Japanese stocks valued at 6.1 trillion yen as of June. Since then the share market has collapsed by 40 percent wiping an estimated 2.4 trillion yen off the value of the bank's holdings. As a result, Mitsubishi UFJ has been forced to raise new capital to shore up its financial base.

The volatility on the Tokyo stock market and the rapid change in outlook for the Japanese banks makes clear that the international economic crisis is making itself felt in every corner of the globe.