Analysis of japan's economic structure

The Japanese economic structure has always been perceived to be both stable and reliable. Despite periods of difficulty, the rules and regulation surrounding the Japanese banking industry have always attempted to deal with any potential problems and to manage them both on an international and national level. However, there is an argument that the stringent nature of the regulation in itself has caused some problems for the sector, with many banks finding themselves in distressed positions having followed the approaches advocated by the central Ministry of Finance.

Prior to the difficulties faced in the 1980s, which will be discussed in greater detail later, the Japanese banks largely followed the guidance of the Ministry and felt safe in the knowledge that there was a safety net in place should they fall into financial difficulties. Japanese banking, as a whole, was not particularly profitable and instead operated a cautious, yet extremely stable service. Despite this approach, the Japanese banking sector hit a substantial crisis in the 1980s, shocking not only those within the Japanese banking system, but also those involved in banking arond the globe.

By studying the events that caused this period of difficulty and looking more specifically at the activities of one banking group, in particular, it is hoped that lessons can be drawn from the scenario that will prevent similar events happening again.

Background to Japanese Banking

The bursting of the bubble in the 1980s did not just come from nowhere; in fact, when the banking system within Japan is studied, for many decades before the bubble burst, it is clear to see that the foundations for this difficult time had been laid some considerable time in advance of the events themselves.

Post war Japan took a very segmented and internal approach to banking. Very few transactions were conducted internationally, with almost all financing products being offered to Japanese corporations. This worked in the main due to the mentality of the Japanese people; they were keen savers, therefore, the banks in Japan had a steady flow of funds available to offer financing to Japanese corporations. As a general rule, city banks offered financing to larger corporations, whereas regional banks offered financing to smaller and more local businesses.

In fact, international trading was so low down on the agenda that the government used the Bank of Tokyo in the 1950s and 1960s to deal with the foreign exchange needs of the country and to act as the main foreign representative. Banks within Japan worked together, with the long term credit banks offering completely different services to the commercial banks. The banks were very customer orientated, offering financing at incredibly cheap rates to stimulate the economy, often at the expense of the banks' profitability.

All elements of the banking sector were managed closely by the Ministry of Finance which was largely responsible for all rate setting and banking relationships. Mergers between banks rarely happened and when they did they were often unsuccessful due to the segregated nature of the different banks, thus making it difficult for companies to merge successfully in terms of culture, administration and ethos.

Stability and low costs were the cornerstones of the Japanese banking sector and in this context Japan slowly became recognised on the international capital market radar due to the low cost of borrowing and the large amount of funds available. For example, when RJR Nabisco was taken over with a financing package of $25 billion, Japanese banks were central to providing the necessary funds. Increasing global involvement led to six out of the ten top banks in the world based on asset size being Japanese, in the early 1990s.

Bursting of the Bubble

Despite what seemed to be an extremely solid and stable banking system, the Japanese banking system suffered a terrible shock in the 1980s and 1990s, which resulted in a widespread financial crisis [1] .

Prior to the 1980s, the banking system in Japan was relatively insular with little international exposure. As the Japanese banks began to deal more and more with other countries, they became increasingly attracted to different financial innovations and instruments, many of which were higher risk than previously undertaken. Not only did the influx of international finance encourage new innovations, but it also led to the Ministry of Finance having to loosen its grip on the regulation of the Japanese banking sector. Deregulation became necessary so that foreign banks were able to enter the Japanese market. There was a large amount of pressure placed on the Japanese government to ensure that deregulation took place, as it had a substantial trade surplus with other countries (i. e. it was exporting more goods than it was importing, meaning that it relied on good relations with these countries to maintain its trade position).

The European banking system was also undergoing radical change and, as such, there was a growing need for other countries such as Japan to offer EU institutions equal treatment. The combination of these factors led to the Ministry of Finance finally accepting that both domestic and international banks had to undergo a period of deregulation [2] .

A combination of a loose financial policy and deregulation led to the increase in the supply of money and the decrease in the interest rate. Cheap lending rates and greater availability of credit led to many individuals and institutions taking speculative positions and making much riskier investment than had previously been undertaken.

Japan also found that property became a major issue, during the economic downturn. As Japan is a particularly mountainous country, land is at a premium and has always maintained a reasonably high value. For this reason, land was often used as collateral on debts and as a seemingly solid investment. Land and equity prices continued to escalate; however, in 1989, the Japanese government decided to try and control these spiralling prices by raising interest rates [3] .

These increases in the interest rates led to a massive financial crisis with huge falls in the stock market and many of the previously entered into debts turning bad. Many banks began to flounder and a series of governmental bail-outs and mergers took place as the country struggled to regain control over the economy. Credit became difficult to obtain which, in turn, brought capital investment to an abrupt halt, further slowing down the economic performance of the country [4] .

Zaitech Financing

One of the main innovations in terms of investing opportunities that entered the Japanese banking arena, during the 1980s period of deregulation, was that of the Zaitech. Quite simply a Zaitech is a form of financial engineering which allows the banking institution to invest its surplus funds for a return. At the safest end of the scale, the Zaitech involves taking any corporate excesses and investing them in bank deposits. At the other end of the scale, a Zaitech could involve borrowing in the Eurobond market and using the finance to conduct speculative investments in bonds or property. It is this latter approach that many of the Japanese banks took during the period immediately after deregulation. The combination of low interest rates and high values of land encouraged the banks to borrow at the low interest rate and invest in property, bringing in a healthy return.

Furthermore, many Japanese companies recognised that they could easily raise funds by issuing convertible bonds to the public. Between the years of 1984 and 1989, it was estimated that Japanese corporations issued a total of $720 million in securities, of which it was thought that around 80% were equities [5] .

Japan also had the principle that corporations were not required to state how they invested liquid assets. This made it difficult for analysts to make sensible judgments in relation to the risks that a certain company was undertaking in the form of financial investments. This led to greater speculations and difficulties and caused the stock market values to plummet further still when interest rates were increased and the value of property began to slide.

Background to the Sakura and Sumitomo Mitsui Financial Group Case

All of the turmoil above led to the eventual merger of Sakura with Sumitomo, in April 2002. Sakura bank really suffered, during the early 1990s, largely due to increasing costs, rising interests rates and falling profit margins. Its risk asset ratios, as required by the international body BASEL, were also substantially lower than is considered desirable and it continued to find it difficult to meet the capital adequacy rules.

As much of the difficulty was perceived to be down to higher costs, Sakura set about reducing its costs by integrating staff function and information system technology, where possible. Although this had a positive impact on the company, ultimately the main problem came from the increasing number of bad debts that the company had in its portfolio. The Ministry of Finance had traditionally been unwilling to allow banks to write off bad debt as this would not have given a positive view of the banking sector. Companies such as Sakura were not concerned about this as they simply followed the guidance of the Ministry of Finance, safe in the knowledge that it was protected by the government. However, as the financial climate worsened, there was growing concern that these bad debts would have to be written off. This took time, and during the early 1990s, the bad debt simply mounted as institutions (Sakura included) were reluctant to admit to the failings within their debt profile [6] .

Sakura’s segment in the banking sector was very much focussed on the retail banking end of things, with high numbers of mortgages being given to domestic lenders. As property prices fell and interest rates rose, this factor also led to a substantial increase in the amount of loans that were defaulted on and yet more bad debt was accumulated [7] .

Worse still, Sakura was competing largely against the Japanese Post Office with its retail banking offerings; the Post Office had the advantage of being hugely subsidised, of having certain tax relief advantages and not having to seek approval to make changes such as opening branches. These advantages have made it particularly difficult for Sakura to offer customers competitive options.

Recognising the difficulties facing the banks, the Japanese government offered a substantial bail-out to several banks, Sakura included, which helped to raise the amount of capital available to these banks which, although it was successful, did little to assist the economy, as a whole, as banks were still reluctant to lend any funds to consumers, causing yet further economical difficulties [8] .

The Merger

Despite the difficult times, Sakura did have some positive movements during the 1990s. One of its most successful ventures was the 50% involvement in the consortium Japan Net Bank which successfully opened an internet and ATM based banking offering.

Sakura realised that it needed to form a strategic alliance with another bank, if it was to be able to compete with the other mega-bank structures that were being developed across Japan. It also needed to ensure that it had sufficient capital strength within the market. Discussions were entered into with several large banks and in April 2001 (a whole year ahead of schedule), an agreement was reached between Sakura and Sumitomo Mitsui Financial Group [9] .

This merger was interesting for several reasons. Firstly, the two companies did largely different things; Sakura was a commercial bank and Sumitomo was a money centre bank. Although Sumitomo was highly regarded amongst its peers, all money centre banks were generally underperforming. Prior to the merger, Sumitomo had established itself (through a joint venture with Daiwa Securities) as a bank that would substantially increase its offerings in relation to investment banking. In contrast to this, Sakura had particular power in relation to retail banking, particularly with the new area of internet banking that it had recently entered into.

Unlike other mergers, the one between Sakura and Sumitomo was done through traditional avenues with Sumitomo effectively taking over Sakura and renaming as Sumitomo Mitsui. In doing so, the merged company was then managed by a unified board of 30 directors.

Operations were largely merged, which resulted in a large amount of cost saving and economies of scale were enjoyed across the whole company. In completing the merger, the newly formed Sumitomo Mitsui became the third largest bank in the world. The merger was not all plain sailing and many staff left the company, some voluntarily and some through redundancy. There were also cultural clashes as two rival firms merged and had to accept external interference in their work, which had traditionally been kept very segmented [10] .

Over time, the merger has allowed the bank to become much more stable and to meet the Basel requirements, partly through diversification and partly through cost saving.

Current Financial Crisis

The situation facing Japanese banks in the 1990s is not entirely different from that currently facing the US, the UK and much of the rest of the world. The similarities are stark; the US, in particular, has been mounting up bad debts, backed on overpriced property in exactly the same way as Japan did in the 1980s and early 1990s. Despite the seemingly similar issues that have led to the crisis in the US, as happened in Japan, there have been some differences which may allow the countries affected by the widespread credit crunch to avoid such a prolonged period of recession as the one that was experienced in Japan [11] .

There are several reasons for this belief. Firstly, the US government reacted much more quickly and decisively when the emerging problems were first identified. In Japan, the Ministry of Finance attempted to maintain an approach of perceived stability for some time after a crisis became evident, allowing banks to store up bad debt for a considerable period of time.

Also, other countries (and in particular the US) have much higher consumer spending, traditionally. One of the main reasons that the Japanese economy took so long to recover was due to the reluctance of individuals to spend any money that they had; this is not likely to be such a large factor in the current crisis.

However; the health of the Japanese economy prior to its crisis should not be ignored. When Japan entered the period of decline in the 1980s, it was in a much more robust economic position than those countries being affected by the current credit crunch. It had a trade surplus, no borrowing and cash reserves. The US, on the other hand, had debts of around 190% of the gross domestic product when it entered the credit crunch period. Japanese individuals were also keen savers and could, therefore, reduce their saving ratio to mitigate the impact of the recession. This approach is not as readily available in the US and UK.

Conclusions

There are stark lessons to be learned from the situation that Japan faced in the 1980s and 1990s. Whilst, on the face of it, the parallels drawn between the current financial crisis and that faced by Japan are worryingly similar, it should be noted that a large part of Japan’s problem came from a reluctance to accept that there ever was a problem. With quick reactions from the government and strategic mergers, such as the one discussed above, the lessons learned from the Japanese crisis can truly be put to good use.

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Footnotes

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