



A bank customer uses a high-tech ATM in Tokyo.

# The Road to Recovery

## A View from Japan

**Strategy for addressing both liquidity and solvency issues is needed**

*Kenneth Kang and Murtaza Syed*

**T**HROUGH most of the 1990s and early 2000s, Japan grappled with a financial crisis whose origins were in some ways similar to the turmoil afflicting the United States today. The storyline from a decade and a half ago in the world's second largest economy evokes an unmistakable sense of *déjà vu*: the bursting of a property bubble fueled by excess liquidity, lax financial regulation, and over-optimistic projections of asset prices precipitating a real estate and banking crisis.

Compared with the fallout and policy response over the past year, events were considerably more drawn out in Japan. Although the bursting of the bubble in Japan left the financial system saddled with large nonperforming loans (NPLs) and weakened the economy significantly, it took a while before the full scale of the problems became evident.

In 1997, six years into Japan's problems, mounting losses on failed real estate loans and falling share prices led to the interbank market freezing up and a wave of failures in the financial sector, featuring some of the country's largest banks. Faced with a financial system paralysis that threatened to undermine the entire economy, the Bank of Japan (BoJ) scrambled to unlock credit markets. The government also orchestrated large-scale interventions with public funds, struggling with a now-familiar dilemma: how to promote orderly deleveraging while minimizing costs to the taxpayer and limiting moral hazard. In Japan's case, the crisis was successfully resolved, but not before a "lost decade" of economic stagnation and a prolonged bout of deflation.

If anything, today's crisis appears more daunting, given its global scope, the complexity of the distressed instruments involved, and the much weaker international setting. Highly leveraged financial institutions have been joined by highly indebted households this time around, compounding

the weakness in domestic balance sheets. Nevertheless, both crises were grounded in broadly common ills, so that Japan's eventual success—and early difficulties—in overcoming its challenges are likely to provide useful insights.

Reflecting the breadth and gradual unfolding of the crisis, Japan's strategy evolved over a number of years, at first centering on innovative and exceptional measures by the BoJ to provide liquidity, including expanding the range of collateral, direct purchases of assets, and quantitative easing under a zero-interest-rate policy. While necessary, this liquidity provision proved insufficient for fixing the financial system. When the crisis intensified, the authorities turned to restructuring banks, pushing them to recognize problem loans and raise new capital, and in some cases seek out public funds or exit the sector. In the end, tighter supervision, judicious use of public funds, and a sound framework for restructuring distressed assets helped restore health to the financial system. At over ¥100 trillion (about \$1 trillion), bank losses were much larger than first envisioned, and about ¥47 trillion in public funds was eventually needed to dispose of NPLs and recapitalize banks. However, nearly three-fourths of these funds have since been recovered.

Encouragingly, the initial reaction to the current crisis has been swift and forceful, featuring several steps to address liquidity stresses in interbank markets and the passage of a publicly funded bailout package. All in all, the United States has so far moved with commendable alacrity: in Japan, it was not until 1999—eight years into the real estate bust—that a full-scale injection of taxpayer funds was committed to a comprehensive financial overhaul.

But where do we go from here? U.S. financial markets remain severely strained and fears of a grim recession loom. If Japanese history is any guide, some of the most difficult

steps may be yet to come. Although much energy has so far been devoted to bank liabilities (protecting deposits and supporting borrowing), a comprehensive strategy to address the broader challenges—restructuring troubled assets and facilitating consolidation—has yet to be fully fleshed out.

For a sustained recovery, nothing short of a systemic solution that addresses both sides of the balance sheet will do. In Japan's case, a comprehensive approach that addressed both solvency and liquidity issues in the banking system proved to be most effective in resolving the crisis. Measures included recapitalizing the banks and restructuring the debts of the corporate sector. Some potentially useful lessons are suggested by Japan's strategy.

- **Liquidity provision helped forestall an immediate systemic crisis, but did not adequately address the fundamental problem of an undercapitalized banking system.** Ample liquidity is part of the solution, but without steps to fully recognize losses and address the capital shortage, the functioning of the markets can be distorted and delay needed restructuring. Weak accounting practices and regulatory forbearance masked the NPL problem for many years and limited incentives for action, such as seeking out new capital or merging with other institutions. The delay in recognizing the losses proved extremely costly, allowing insolvent “zombie” companies to linger. Today, global losses on securitized debt originating in the United States are estimated by the IMF at about \$1.4 trillion. Only about half have so far been written down. More transparent regulatory structures based on fair market valuation that encourage banks to repair their balance sheets could assist. At a minimum, early action to recognize losses and raise adequate provisioning could help nail down capital shortages and kickstart the process of restructuring.

- **Public funds to recapitalize banks were conditional on equity write-downs and strict performance criteria to limit moral hazard.** Injecting capital into viable institutions, together with the orderly resolution of nonviable ones, helped support credit and bolster capital ratios in Japan. In exchange for public funds, however, banks were required to write down the capital of existing shareholders, replace senior management, and submit a reorganization plan that would be reviewed regularly by the Financial Services Agency. After less stringent approaches failed, public funds were also strategically aimed at promoting financial sector consolidation, with several large banks and many smaller institutions either closed or merged. In order to strengthen market discipline and minimize the risk of moral hazard, governments should also consider an appropriate exit strategy for divesting their shares in the banking system after stability is restored.

- **Restructuring of distressed assets was needed to clean up bank balance sheets.** Japan's strategy called for major banks to accelerate the disposal of NPLs from their balance sheets within two to three years by selling them directly to the market, pursuing bankruptcy procedures, or rehabilitating borrowers through out-of-court workouts. Remaining loans were sold to the Resolution and Collection

Corporation, which was charged with disposing of failed banks' bad assets, and to the Industrial Revitalization Corporation of Japan (IRCJ), established in 2003 to purchase distressed loans from banks and work with creditors in restructuring. Government purchases through such asset management companies (AMCs) helped provide legal clarity and accountability. If asset prices recover, such interventions could end up costing taxpayers far less than their original price tag—in Japan, the IRCJ even managed to generate a small profit before it shut down in 2007.

- **A sound private-sector-led framework can help in such restructuring.** Although a public AMC can quickly remove distressed assets from banks, recovery values are likely to depend on the private sector taking a lead in restructuring. In Japan, the private sector played an important role, including foreign funds that were allowed to take over two troubled banks and help restructure distressed companies. Getting the incentives right hinged on proper valuation of distressed assets and a sound framework for restructuring.

- **Debtor balance sheets also had to be adjusted.** In Japan, large NPL write-offs and debt restructuring helped facilitate necessary deleveraging of the corporate sector. More important, the insolvency system was overhauled, with the 2000 Civil Rehabilitation Law allowing faster and more diverse bankruptcy disposal methods and the establishment of the IRCJ. Cleaning up housing mortgage debt in the United States would likely require somewhat different methods, but it would keep people in their homes and stem the precipitous decline in property prices at the root of today's crisis.

- **Supportive macroeconomic policies, although not a panacea, complemented financial sector measures.** In response to the crisis, Japan's policymakers slashed interest rates and boosted fiscal spending. Between mid-1991 and end-1993, the BoJ cut the discount rate from 6 percent to 1¾ percent. However, this ultimately failed to revive the economy as the crisis disrupted the normal transmission channels of monetary policy, requiring a deep and comprehensive fix of the banking system. Overall, Japan's experience suggests that macroeconomic policies can support the adjustment process and provide some breathing room, but they are no substitute for direct steps to address underlying financial sector weaknesses that led to the crisis.

Finally, there is a comforting lesson: despite the initial enormous dislocation, there is nothing like a crisis to bring to light—and build popular support for—much-needed reforms. In Japan, measures to develop capital markets and banking capital adequacy rules under the Basel II framework helped establish a more competitive financial system, one that has fared relatively well amid the current global turmoil. With a more strategic focus, today's crisis could also herald positive reforms that enhance the efficiency, but also the resilience and transparency, of the global financial architecture. ■

*Kenneth Kang is a Deputy Division Chief and Murtaza Syed is an Economist in the IMF's Asia and Pacific Department.*