

## What Lessons Can Be Learned from Recent Financial Crises? The Japanese Experience

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*Yoshio Suzuki*

It is my pleasure, and indeed an honor, to be invited to join this panel. At the same time, however, I feel somewhat regretful to have to talk on financial crises in Japan and Southeast Asia, where until a few years ago we had taken pride in our record of financial development and stability as compared with the rest of the world. The common factors behind the recent financial instability in this area are, in my judgment, rapid economic development, the global integration of financial markets, and the failure of government policy to keep pace with these dramatic changes in the internal and external environments.

Let me start with the Japanese case. Japan's financial system and markets have been suffering from both instability and inefficiency since 1992 when the economy plunged into a long balance-sheet recession triggered by the bursting of asset price bubbles. These bubbles had emerged between 1987 and 1989, when a low interest rate policy designed to support the value of the U.S. dollar under the Louvre Accord remained in force too long. Japan's financial stability is still threatened by the resultant increase in bad loans, and by the failure of deposit banks—something that had never been observed in postwar Japan until 1994. To make matters worse, the efficiency of the system as a whole has been adversely affected by an increase in deposit insurance fees, and by government intervention to protect all depositors of failed banks at the cost of the relatively efficient

financial institutions. The world market share of the Japanese system has been declining since 1992 in terms of transactions in foreign exchange and stocks and bonds. The ratings of Japanese banks and securities houses have also declined internationally.

Thus, Japan today faces a dilemma between the stability and the efficiency of its financial system, in the sense that the cost of stabilizing the payment system undermines the efficiency of relatively good deposit banks, while deregulation, which is intended to enhance the efficiency of financial institutions, threatens the stability of the financial system. Further, a policy standstill cannot be the answer, since without some form of action, both stability and efficiency will continue to deteriorate under severe international competition and massive international capital movements.

In my view, the policy solution should be twofold. One step toward a solution would be the swift removal of remaining financial regulations to bring Japan up to the international level of deregulation, and to place Japanese financial institutions on an equal footing with world competition. The other would be the prompt resolution of the bad loan problem, the reinforcement of the safety net, and measures to bring Japan back to a sustained potential growth rate of 3 percent to 4 percent at the macroeconomic level. Needless to say, the former measures would enhance the efficiency of the system through competition among market players, while the latter would prevent instability resulting from severe competition and safeguard the system.

The Japanese government has resolved to adopt at least the former measures. The revision of the Foreign Exchange Law to abolish remaining restrictions on international financial transactions will take effect in April 1998. Under a program to be implemented between 1997 and the year 2000, the government will deregulate financial commissions, including stock brokerage fees, the scope of business activities in the banking, securities, trust, and insurance industries, and the provision of innovative financial instruments. This financial deregulation program, which has been dubbed the Japanese version of the "Big Bang," is more comprehensive than the

original “Big Bang” in Britain, but will take longer to finish. Some of you might be skeptical about the feasibility of such a wide-ranging deregulation plan in Japan, where past moves toward deregulation have tended to be both partial and gradual. This time, however, the Japanese government has already crossed the Rubicon, because the complete deregulation of international transactions will definitely be introduced in April 1998, and because Japan will inevitably face the hollowing out of its system and markets without international standardization of financial regulation.

My concern is not with this aspect of policy, but rather with the other category of policy responses relating to measures to improve financial stability. Deregulation to encourage competition inevitably results in more bankruptcies among financial institutions. This is particularly true in Japan, where the bad loan problem still exists. The reinforcement of the safety net remains to be discussed in the coming autumn session of the Diet.

I am also concerned about the weak trend in the Japanese economy, which might undermine financial stability. In my view, the start of the Big Bang is not a good time to carry out a hasty fiscal consolidation. Although the real growth rate in the last fiscal year reached 3 percent for the first time since 1991, the average forecasts of private research institutions suggest that it will decline to 1.5 percent again in the current fiscal year. This is because public works and housing construction will decrease due to the deflationary budget, while private consumption will be weak due to a nine trillion yen increase in income tax, consumption tax, and the social securities burden. The only items supporting the economy will be capital spending and net exports, which will benefit from the super-low interest rate policy and the resultant depreciation of the yen since 1995. I sincerely hope that a further increase in the current account surplus will not trigger speculative buying of the yen if the dollar weakens for some reason.

The lessons from the recent Japanese experience are multifold. The most important are as follows. First, the use of regulation that is stronger than the international standard to maintain domestic

financial stability will adversely affect the efficiency of the domestic system, markets, and players and will eventually lead the country into a serious dilemma between stability and efficiency. Second, in order to resolve this dilemma, it will be necessary not only to deregulate to international standards, but also to reinforce the safety net and expand the macroeconomy in order to mitigate the pain resulting from severe competition caused by deregulation. Third, the speed of the fiscal consolidation should be carefully monitored while the financial reforms are in progress, since otherwise a fragile domestic financial system and weak domestic economy may both provide incentives for international currency speculation.

These lessons cannot necessarily be applied directly to the financial market turbulence that has occurred recently in Thailand and other East Asian countries. However, they have some relevance to them. Thailand, Malaysia, and Indonesia are fast-growing economies with large current account deficits, so they need large capital inflows to sustain high domestic growth, and to finance their current account deficits. By the late 1980s, they had significantly deregulated international financial transactions in an effort to attract international capital.

However, they did not float their currency rates, but instead adopted the basket system with discretionary manipulation. For several years, their nominal exchange rates vis-à-vis the U.S. dollar remained quite stable, implying that their real exchange rates, taking into account inflation rate differentials, were tending to appreciate against the U.S. dollar. During those years, the Japanese yen had depreciated against the U.S. dollar, with the result that their exchange rates appreciated more against the yen than against the dollar.

This appreciation in real terms against the currencies of the two major capital-exporting countries, under systems that were nominally pegged against the dollar, attracted massive inflows of capital and caused domestic economic booms. The other consequences of this process were (1) the loss of aggregate demand control, (2) a further increase in current account deficits, and (3) real estate price

bubbles. These three factors, together with (4) overvalued currencies, and (5) the deregulation of international financial transactions, provided sufficient motive for international selling speculation against the currencies. These five conditions were most extreme in the case of Thailand. This is why the Thai baht was attacked first, followed by substantial declines in the value of the Malaysian ringgit and the Indonesian rupiah. The currency rates of other East Asian countries have also floated down, depending on the extent to which the aforementioned five conditions are present.

What lessons can we learn from these developments in Asia? The most significant source of weakness was the fact that the countries concerned did not float their currencies, but instead pegged them under manipulated basket systems. If they had floated their exchange rates, their currencies would not have been overvalued, and they would not have suffered (1) the loss of aggregate demand management, (2) increased current account deficits, and (3) the emergence of the asset price bubbles as a consequence of huge capital inflows. Of the five factors cited as causes of financial market turbulence, the first four could have been avoided by shifting to the floating exchange rate system. This would have left only the fifth factor: the deregulation of international financial transactions.

This implies that the deregulation of international financial transactions is not in itself the cause of financial market turbulence on such a large scale, provided that the exchange rate is market-determined. Here, we find a common lesson in Japan and Southeast Asia: that partial deregulation sometimes triggers instability in the domestic system and global market turbulence.

To cope with financial turmoil, some East Asian governments have strengthened regulation of domestic as well as international financial transactions. Judging from the Japanese experience, however, it is not regulation that needs to be strengthened, but rather the safety net of the payment system and control over aggregate demand.

We now have globally integrated markets in which financial innovation is occurring at an unprecedented pace. The best policy

approach in terms of preventing or responding to financial turbulence in this environment is to maintain financial deregulation in line with international standards in the domestic regime, so that sustained macroeconomic growth can be combined with proper safeguards for the payment system.