

To its credit, however, the Japanese government has stated a commitment to applying the principle of self responsibility to the management of financial institutions and to establish a transparent supervision system based on market discipline.<sup>23</sup> This involves introducing a system of "Prompt Corrective Action" in which authorities would take actions based on objective criteria such as the Basle capital adequacy ratios. These actions are intended to promote a level of "good tension" between the banking industry and its supervisory authorities. This "tension" is hoped to alleviate past problems of an overly cosy relationship between regulators and financial institutions.

### **International Implications of the Japanese Financial Crisis**

Because of Japan's prominence, the crisis and subsequent restructuring of the financial system could impact on international financial markets and have spillover effects on foreign economies.

- The Japanese financial crisis has highlighted the relevance of systemic risk to the *international* financial system and the interdependence of financial markets and economies.
- The crisis has prompted reform of Japan's opaque regulatory system which should increase differentiation among the major Japanese banks and could provide increased opportunities for foreign banks in Japan.
- Mergers between Japanese banks could change the competitive dynamic of Japanese financial institutions, with attendant considerations for the international financial system.

The prominence of Japanese banks in international markets gives rise to international systemic risk associated with a large Japanese bank failure.<sup>24</sup> If a Japanese bank failed to meet its daily clearing obligations, this could damage foreign

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<sup>23</sup>D. Iwaasa, Canadian Embassy, Tokyo, "Japan: Improved Banking Inspection and Supervision", unclassified report, January 20, 1996.

<sup>24</sup>According to the Bank for International Settlements, Japanese banks had US \$723 billion in liabilities to foreign financial institutions in the BIS reporting area at the end of 1994. This represented 10 per cent of total international liabilities. On the asset side, Japanese banks' cross-border holdings totalled US \$1 trillion at the end of 1994, second only to the UK, twice as large as the U.S., and representing 14 per cent of the total stock. (Bank for International Settlements, *65th Annual Report: 1st April 1994-31 March 1995*, 12 June 1995, p. 170.)