

Restructuring Japan's Financial System: Looking Beyond the Storm

Although it is undeniable that the Japanese financial system is experiencing a crisis, there is no reason to predict that it will be a fatal one. The Japanese government has made a public commitment to stand behind the major banks and those engaged in international business activities. With the Bank of Japan's backing, systemic risk can be controlled, and the government's commitment assumed credible. This is not to say that there are no serious problems within financial institutions. The post-war financial system in Japan has proven to be inherently weak. Lack of transparency has allowed poor management practices to go unnoticed and uncorrected. Although reform will be necessary for the system to regain its health, steps are finally being taken by regulators and financial institutions to ensure that this takes place.

Restructuring of a system which is home to many of the world's largest banks will inevitably have some bearing on the international financial system. Just what the results will be depends upon how the realignment progresses and upon the final structure of the Japanese banks. One change that is already taking effect is the "unbundling" of the major Japanese banks in terms of quality. The major banks used to be considered equals in terms of credit-worthiness. The differing degrees to which banks are expected to be able to weather the financial crisis will leave them with differentiated credit ratings and financial health. In addition, the crisis, including some small bank failures and the exposure of alleged corruption among bank employees and government officials, has eroded confidence in Japanese financial institutions. Foreign (including Canadian) banks could use these changes as an opportunity to expand their business in Japan, subject to deregulation. Foreign banks could have a slight advantage over the next several years because they will not be burdened by the large write-downs plaguing the Japanese banks.

Bursting of the Bubble Economy

The 1980s in Japan was a period of rapid economic growth and asset price appreciation commonly referred to as the "bubble economy". During this period, financial agents acted as if the pace of expansion would continue forever and forced up asset prices, particularly real estate, by speculation. The current financial crisis was precipitated by the cessation of this growth at the start of the 1990s. The inevitable bursting of the bubble exposed underlying weaknesses in the management and lending practices of Japanese financial institutions (JFIs) and the system as a whole.

During the boom years, the Japanese economy grew more rapidly than those of the other G-7 countries. From 1980 to 1989, Japan's average annual real GDP