

# **“Growth and Crisis: What Can Developing Countries’ Learn from Experiences of Japan and Asia?”**

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April 20, 2009

# Outline

- **(1) Introduction**
- **(2) Growth and Crisis**
- **(3) Japan's Experience (main part)**
- **(4) Lessons from Asian Crisis**
- **(5) Lessons from Global Crisis of 2009**
- **(6) Concluding Remarks**

# (1) Introduction

- Many emerging economies fall into a **currency crisis and/or a banking crisis** as they develop and grow
  - Latin American countries in the 1980s; Mexico, Asian countries, Russia, Brazil, and Turkey, in 1990s
- Crisis seems to be a pitfall for many fast-growing economies?
  - Any common pattern (early warning) of a crisis?
  - Some have avoided a crisis: Any secret?
- Although rarer, advanced economies suffer from a **currency crisis and/or banking crisis**
  - Nordic countries in beginning of the 1990s; ERM crisis in 1992-93; Japanese banking crisis in the 1990s; Now the global financial crisis of 2008-09

# (1) Introduction, con'd

- Japanese lessons
- Positive
  - Japan grew from a low-income developing country status (1868) to a gold-standard, middle-income status (1897), to a devastated economy (1945), to a second largest economy with well developed financial and capital markets by 1990—without a currency crisis, so typical of emerging market economies today.
  - Gradual liberalization—trade to finance, domestic to external--worked
- Negative
  - Japan fell into prolonged stagnation following a burst of bubble in the 1990s. A series of policy mistakes not to stem the bud of banking problem in early stages
  - But, not unique to Japan. Nordic countries; US today.

# (2) Growth and Crisis

## (2.1) Growth and Finance

- Cross-border capital flows into emerging market economies are basically beneficial
  - Increase Capital (K)
  - Introduce Better Technology (A)
- However, developing countries often resist capital inflows
  - Nationalism
  - Sudden outflows throws a country into a crisis
- Two ways to introduce K
  - Foreign Direct Investment (FDI)
    - More technological transfers expected
    - Less danger of sudden reversal
  - Portfolio Investment: Equities and Bonds
    - Increase K by lowering interest rate
      - Huge benefits to the high interest rate counties
      - Could be counterproductive by (a) making possible to cause/sustain overheating and a bubble; (b) finance fiscal deficits which become unsustainable
      - Could lead to a currency crisis, if sudden stop/reversal occurs

# (2) Growth and Crisis

## (2.2) Type of Crises

- Balance of Payment Crisis (classic)
  - Fixed exchange rate regime;  $IMP > EXP$ , depleting forex reserves; devaluation
  - Many under Bretton-Woods regime; both advanced and developing countries; much less under flexible exchange rate regime and with capital flows
- Capital Account Crisis (21<sup>st</sup> century crisis)
  - With strong capital inflows (foreigners' optimism), current account deficits may continue for some years without depleting (sometime even increasing) foreign reserves
  - Crisis occurs when capital suddenly flows out (foreigners' pessimism)
    - Currency mismatch and maturity mismatch
    - Acute Dollar liquidity shortage
  - Mexico, Thailand, Indonesia, Korea, Russia, Brazil, Argentina

# (2) Growth and Crisis

## (2.2) Type of Crises, con'd

- Banking Crisis
  - Banks become insolvent (liabilities > assets) when (a) their loans go non-performing; (b) their securities suddenly lose value; (c) their foreign currency denominated assets suddenly lose value in appreciation; (d) their foreign currency denominated liabilities suddenly becomes large in depreciation
- Twin Crisis
  - Banking crisis → currency crisis
  - Currency crisis → Banking crisis
- Crisis and growth
  - Crisis → low growth
  - Low growth → Crisis
- Impossible Trinity

# (2) Growth and Crisis

## (2.3) Sequencing

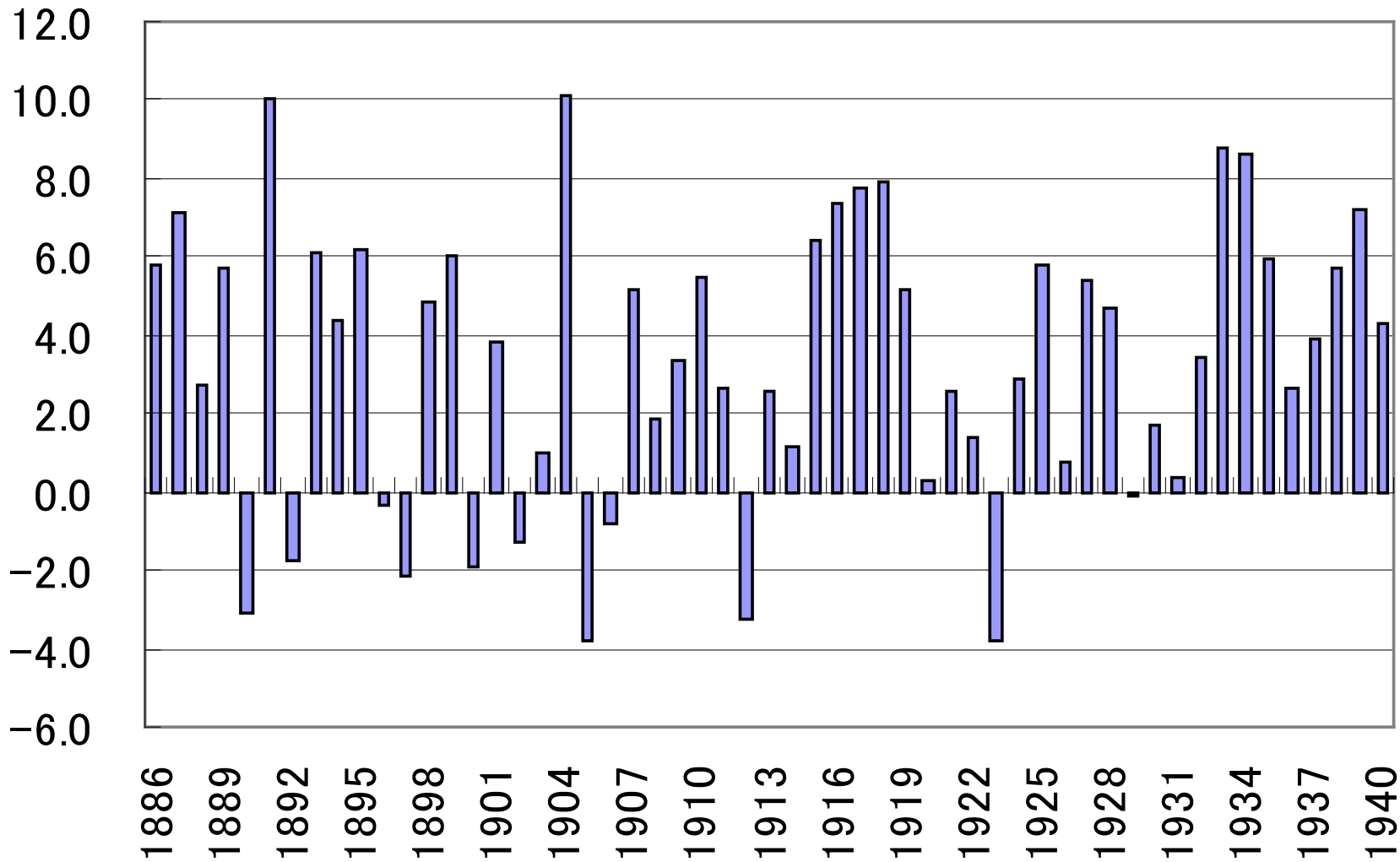
- Trade to Finance
  - Trade liberalization (lowering tariff) first
  - Financial liberalization (allowing capital inflows) next
- Domestic to External
  - Financial liberalization must take place in domestic regulation first,
  - External liberalization next
- FDI to Portfolio (Long to short)
  - Among capital controls, FDI should be liberalized first,
  - Portfolio flows (bonds, equities) next
  - It is good to make foreign investors aware of “risk”—not to encourage too much capital inflows
- Internationalization of the currency last
  - Liberalizing nondeliverable forward transactions would be the last step
  - Small countries may not be able to withstand large speculative flows (a whale in a pond problem)

# (3) Japan's Experience

## (3.1) Modern Economic Growth

- Japan under isolation policy for more than 200 years; textbook “autarky”
  - Ban on foreign trade, going abroad or coming in, foreign communication, foreign exchange (gold shipment),
  - However, the economy was relatively advanced, but no steady growth
- Country “opened” by the Black Ship
- Japan's new government, 1868, beginning of growth
  - Economic infrastructure: railroad, telephone and telegraph, electricity,
  - New institutions: Constitution, various laws, central bank, commercial bank,
  - Industrial policy: promoting industries, eg. cotton spinning, steel, electric power,
- Lessons to modern-day very low-income countries

# PreWWII Growth Rate 1886-1940

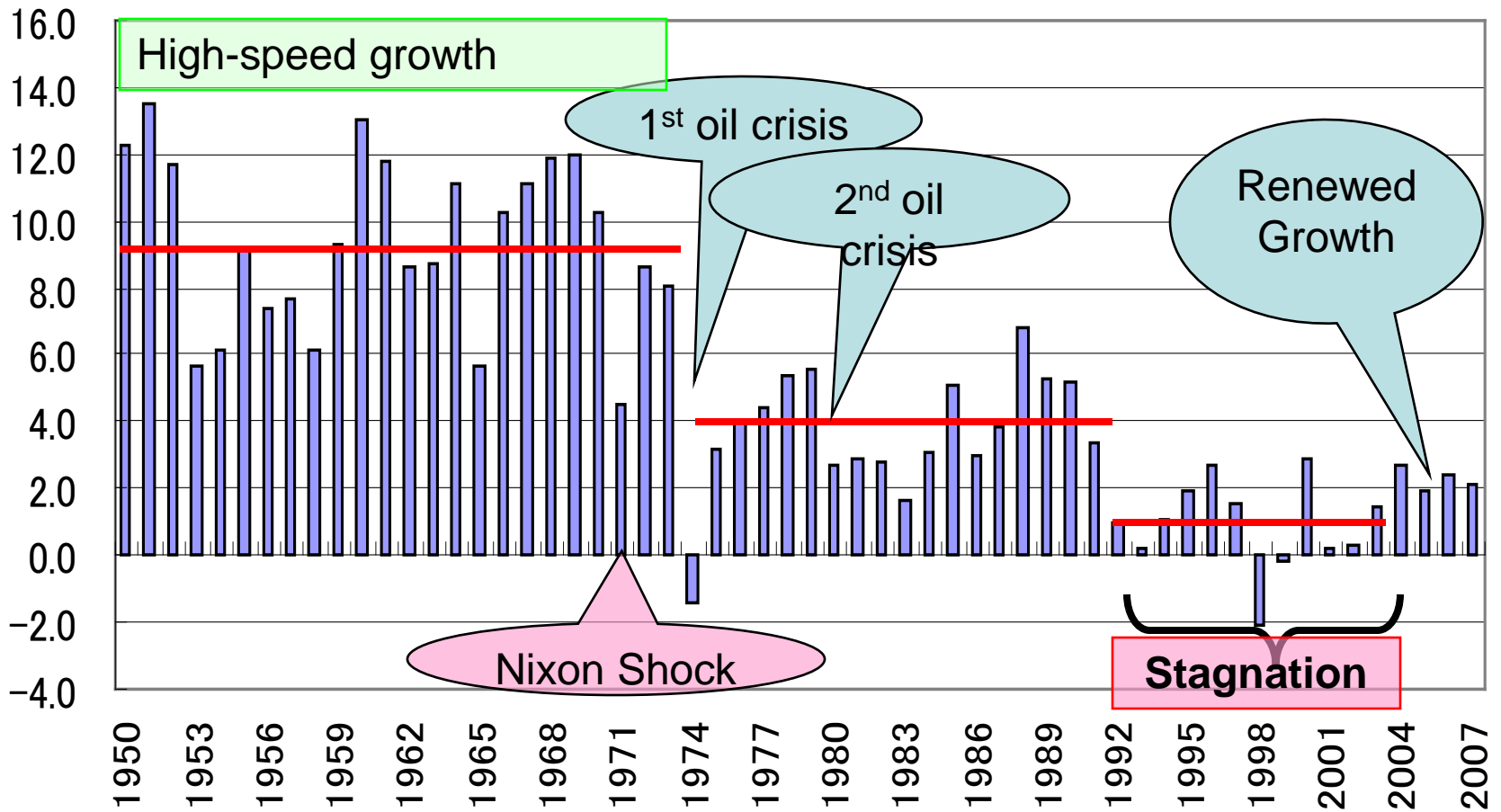


# (3) Japan's Experience

## (3.2) Original Miracle (1955-1971)

- High economic growth, av. 10% for about 20 years (=just like China now)
- Bretton-Woods with capital controls
  - Fixed exchange rate (360 yen/USD)
  - Slightly higher inflation than US (Balassa-Samuelson)
  - Strict capital controls
    - No portfolio investment inward or outward
    - Inward FDI resisted (Joint Venture encouraged)
  - No government bonds until 1965, remained small
  - Strong banking system, underdeveloped capital markets
- High saving, high investment
- Industrial policy (try to promote sunrise industries); mixed review

# Post WW II Growth Rate, 1950-2007



# **(3) Japan's Experience**

## **(3.3) Gradual Liberalization**

- Exchange rate Regime
  - 1971. Managed float. Large appreciation
  - 1973. Free float (but heavy intervention)
  - Large appreciation
- Trade Liberalization under GATT
- Domestic Financial Liberalization (1970s-1980s)
  - Deposit interest rate, window guidance, branch regulation, new entry, merger
  - Gradually, bond markets were introduced
- External Financial Liberalization (mid-1970s-mid-1990s)
  - Loans, portfolio investment in and out,
  - FDI almost no restriction

# (3) Japan's Experience

## (3.4) Lost Decade

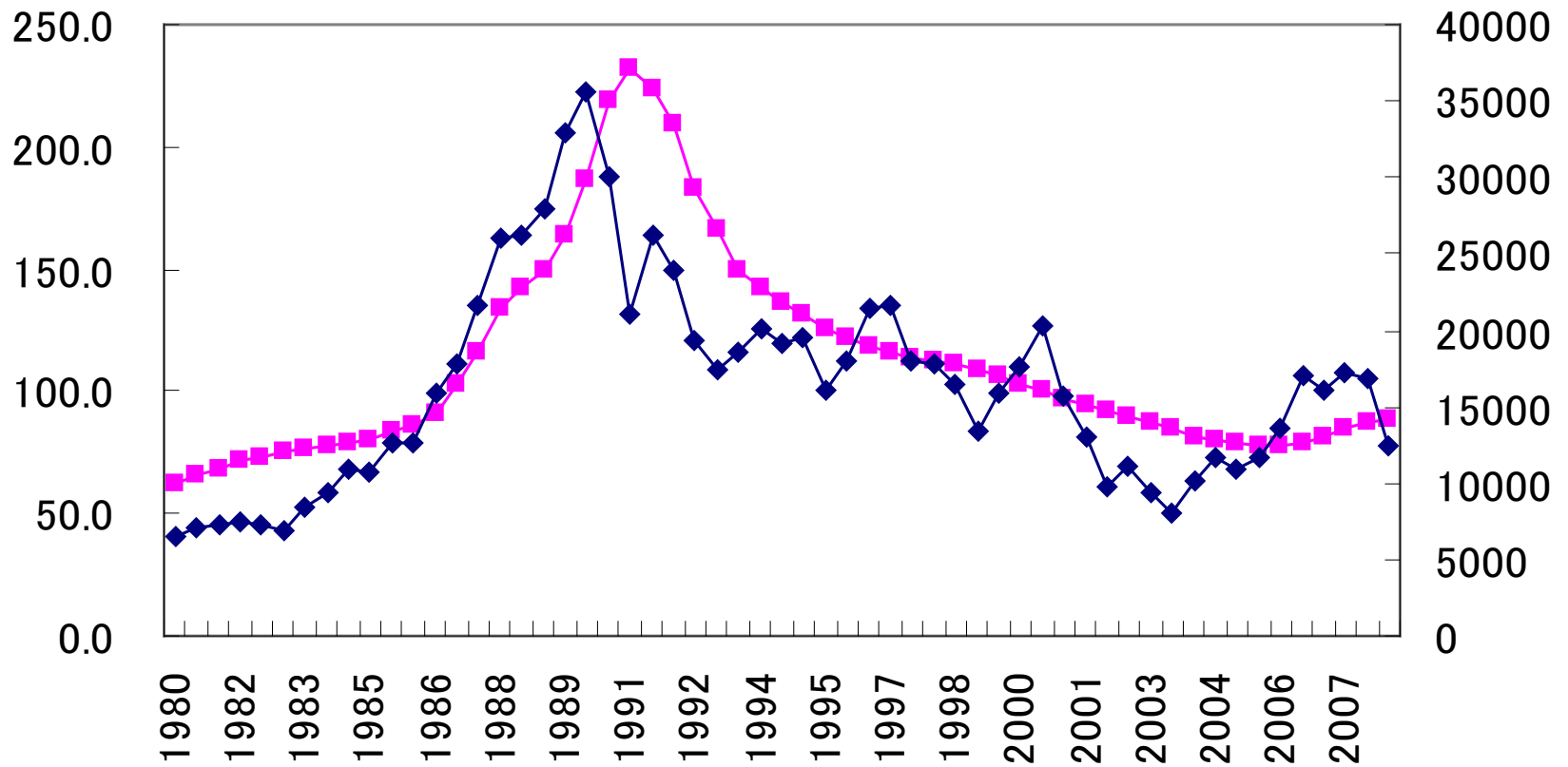
- Huge asset price bubble (1985-1990) and burst (1990-2003)
  - Slow build up of non-performing loans (NPL), but forbearance
  - Housing Loan Companies
  - Smaller banks
  - Full-fledged banking crisis (1997-98)
  - Second wave of banking crisis (2002-03)
- Slow growth
  - Yen appreciation (despite bad news), Banking crisis, credit crunch, high unemployment,
- Deflation
  - Conventional Monetary policy became ineffective at zero interest rate
  - Real interest rate remained high for a depressed economy

# Boom and Bust: summary

- Japan,
  - Boom, 1985-1990
    - Stock prices tripled in 4 years: Dec 1985-Dec 1990
    - Commercial Land Prices quadrupled in 5 years: 1985-2000
    - Housing Land prices triples in 6 years: 1984- 2000
  - Bust, 1990-2003
    - Stock prices peaked at 38,915.87 yen in Dec 1989
      - Lost about a half in 9 months, 20,000 by Sept 1990
      - In the height of banking crisis 1998, 14,000 Aug 1998
      - Post-bubble LOW, 7607.88 yen, April 2003
    - Commercial Land price peaked in Sept 1990
      - Became half of the peak in 4 years, Sept 1994
      - Became one-quarter in 8 years
      - Post-bubble LOW, one-sixth of the peak, 2004
    - Housing land prices peaked in Sept 1990
      - Became half of the peak by 1996
      - Became one-third by 2005

# Land Prices and Stock Prices, Japan 1980-2003

—■— Land Price Index (Left scale) —◆— Stock Price Nikkei index (right scale)



# What went wrong in Japan, **creating bubble**

- Bubble: euphoria and weak supervision
  - Fundamentals until 1987-88
    - Financial deregulation and liberalization
  - Transformed into a bubble somewhere
    - Yen appreciation and capital inflows
    - The interest rate kept too low (2.5%), too long
  - False belief of land price ever increasing
    - Banks were lending for collateral values; borrowers' ability to service debt was not important in banks' decision
    - Supervisor was cozy with the supervised; no expertise and no serious supervision—no precaution

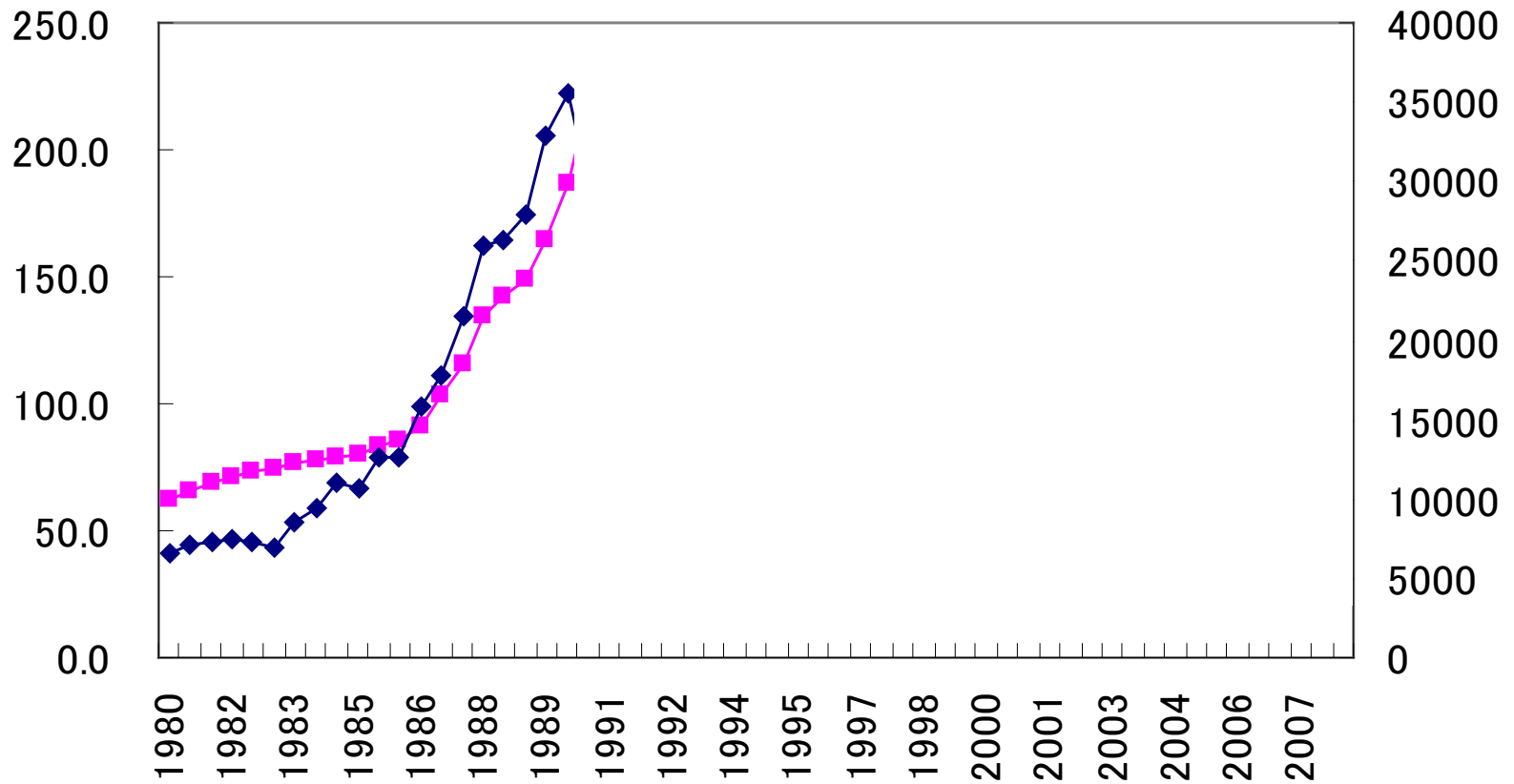
# Lost Decade, Prelude

- Stock and land prices soared in 1985-89
  - The stock price (Nikkei 225) and land prices soared from 1985 to 1989. The stock prices peaked at the last business day of 1989,
  - During the last phase,
    - Lending decision of banks was more influenced by collateral than borrower's ability to pay
    - Loan/value ratio rose to 100%, with expectation of ever-increasing land prices
  - Delayed policy response to curb asset price increases
    - Fundamentals were good; doubt about a “bubble” hypothesis
    - Low interest rate because of low CPI inflation rate and yen appreciation of 1985-87; interest rate hike May 1989
    - Direct control on real estate lending came in March 1990

# Japan as number one

Land Prices and Stock Prices, Japan 1980-2003

—■— Land Price Index (Left scale) —◆— Stock Price Nikkei index (right scale)



# Then bursting a bubble came

- Stock Prices decreased almost 50% in the first 9 months of 1990.
- Land prices started to decline in 1991.
- Policies were directed to contain the assets prices, belatedly
  - Interest increases from mid-1989 to 1990
  - Quantitative control on banks not to increase the lending to real estate projects: March 1990

# Lost Decade, Sign of weakness

- Jusen (housing loan companies), a failed business model
  - 1992-93, Regulatory forbearance
  - Rehabilitation plan of Jusen, flawed
    - Supervision failure and the convoy system
  - 1994-95
    - Big political debate what to do
    - Refusal to make them go bankrupt
    - Shift burdens to banks beyond their equity stakes=>save agricultural cooperatives
    - Failure of tax injection to clean up=> tax injection became a taboo
- Tried to fail two credit cooperatives in December 1994 also became a political issue
  - MOF officials were wining and dining with executives of the credit cooperatives
- Set unfortunate precedent of political intervention without principles (whoever has strong political connection get better treatment)

## Missed chance 1995

- Undercapitalization due to nonperforming loans and lower stock prices
  - More financial institutions became vulnerable
  - Failures of Kizu Credit Cooperative and Hyogo Bank, August 1995
  - Daiwa Bank, losses in NY branch due to a rogue trader, resulting in ousting from the US operations
- No capital injection (Jusen trauma)
- More forbearance
- More rescue mergers arranged by MOF → gift from deposit insurance corp for a rescuing institution
- Finance minister assured in 1995
  - **Blanket guarantee**; All deposits are protected
  - **Too big to fail**. No failure of large banks

# Big collapses, November 1997

- Spectacular fall of big institutions, Sanyo, Yamaichi, Takugin, November 1997: mistake in losing systemic stability
  - Sanyo Securities: First default of interbank call market
    - → interbank market froze up
  - Hokkaido Takushoku, could not obtain funds in the call market
    - large NPL. Not clear it was solvent
    - → failed, and assets were to be assumed by other financial institutions
  - Yamaichi Securities failed due to lack of liquidity,
    - Large losses hidden in subsidiaries
    - → failed, and to be liquidated
  - “Japan premium” shot up
  - Political shift toward capital injection, first proposed to be 20 trillion yen

# Capital injection of March 1998

- Feb 1998, capital injection (purchase of preferred shares) was announced to help banks' capital positions
- No major banks wanted to apply; They were forced to apply because they did not admit responsibilities (management change)
- 1<sup>st</sup> major capital injection, March 1998—failure
  - 1.8 Trillion yen into major 21 banks
  - Limited effects on Japan Premium
  - Nonperforming loans (NPL) still underreported

# Deepening crisis, 1998

- Second wave of big falls, LTCB and NCB May-Dec 1998
- LTCB was viewed as too big to fail
  - Large international presence
  - Large derivative transactions, too complex
  - No law to nationalize a bank
- As the Diet debate whether and how to bail out LTCB, the stock prices continue to decline
- The law passed, and LTCB temporarily nationalized
- Dec 1998, NCB was nationalized (a big surprise)
- 2<sup>nd</sup> capital injection, March 1998, much larger scale
  - 7.5 trillion yen capital injection
    - These capital injection was mostly to be paid back with profits later

# Intermission to real crisis

- Intermission, 1999-2002
  - Deflation spiral and slow deterioration, again
  - Build up of deferred tax asset (DTA) as tier-1 capital
  - Loss of tier-2 capital due to stock price decline
- Takenaka Plan, 2002
  - “No bank is too big to fail”
  - Original proposal and compromise
  - Deny unrealistic DTA
  - Special examination by FSA
  - Finally, trust in accounting of the B/S restored
- Final Showdown between Takenaka and bankers,
  - Failures of Resona Bank and Ashikaga Bank, 2003
  - Stock price nadir, Nikkei 7606yen

# Final showdown

- Big debate within the cabinet
  - Yanagisawa vs. Takenaka
  - Takenaka won the fight and go FSA minister
- Tough policy
  - Prompt Correction Actions, seriously introduced
  - FSA prepared to use the law to take over the banks with

# The Takenaka Plan

- Takenaka Plan, 2002
  - “No bank is too big to fail”
  - Original proposal and compromise
  - Deny unrealistic DTA
  - Special examination by FSA
  - Finally, trust in accounting of the B/S restored

# Trough, 2003

- Showdown between Takenaka and bankers,
  - Failures of Resona Bank and Ashikaga Bank, 2003
  - Stock price nadir, Nikkei 7606yen

# Japan's lesson

- Banking crisis has to be better dealt with
  - Dynamic provisioning (and prudential regulation on lending to real estate sector; loan to value ratio) to prepare for the burst
  - Transparent and conservative accounting (to expose problems early)
  - Arm's length relationship between the regulator and the regulated
  - Careful use of “too big to fail” principle. If necessary, nationalization (and restructuring) of a large bank should not be hesitated

# (4) Lessons from Asian Crisis

## (4.1) Capital Account Crisis

- Thailand, Indonesia, Korea (IMF programs)
  - Slightly different reasons
    - Thailand, typical capital account crisis
      - Large capital inflows > Large current account deficits
      - Overheating
      - Then burst, → speculative attack → crisis
  - Common
    - Short-term external liabilities > foreign reserves
    - De facto Fixed Exchange rate regime (impossible trinity)
    - Double mismatch: Currency mismatch and maturity mismatch
    - Banking vulnerability
- Singapore, Malaysia, and others felt also currency declines
- Hong Kong defended fixed exchange rate; China maintained fixed exchange rate

# **(4) Lessons from Asian Crisis**

## **(4.2) Wrong Sequencing**

- Korea liberalized portfolio flows ahead of FDI
- Indonesia had liberalized capital flows for many years. The authorities did not know how much firms were borrowing from foreign institutions, although they had bank supervision on how much banks could borrow
- Thailand liberalized offshore markets to encourage financial institutions to engage in offshore (out-out) transactions. However, some came into domestic markets and contributed to overheating.

# (4) Lessons from Asian Crisis

## (4.3) Banking Crisis

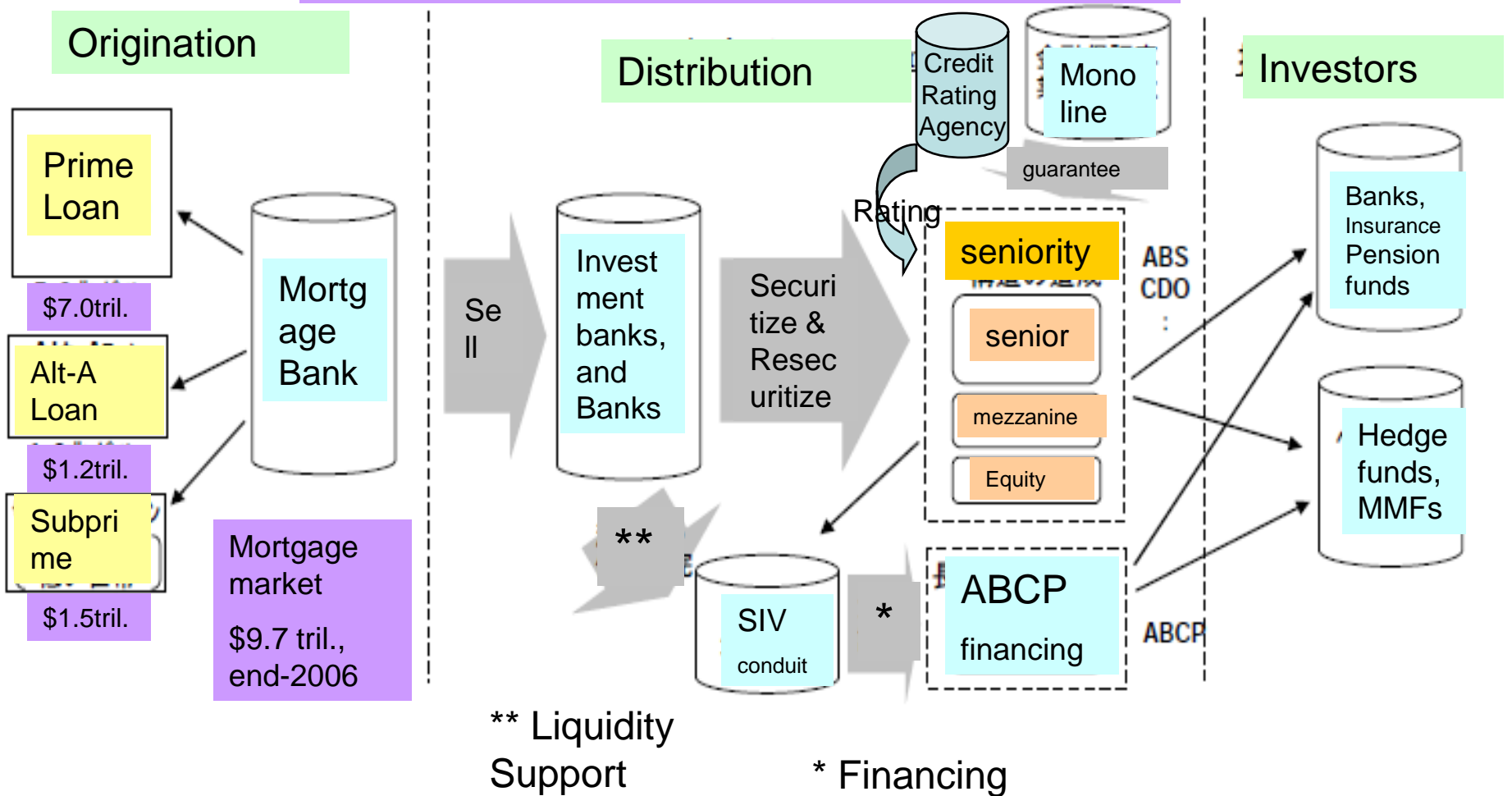
- Asian currency crisis resulted in banking crisis
- In Thailand, finance companies were already in trouble before speculative attacks occurred, so banking crisis might cause currency crisis; but large banks became troubled only after currency crisis. Nonperforming loans increased due to corporations became near bankrupt due to declines in sales.
- In Korea and Indonesia, currency crises resulted in banking crisis.
- In Indonesia, almost all banks lost capital, as losses became huge. The government had to give government bonds as bank capital.
- In the three countries, some banks were sold (M&A) to foreigners

# (5) Global Crisis of 2009

## (5.1) Moral Hazard

- The originator bank screen potential buyers of homes and originate mortgages
- The originator then sells the mortgage to commercial or investment banks, they securitized the loans
- Since the originator did not hold on to the loans, they have little incentives to screen buyers rigorously.
- The originator of mortgages had moral hazard—less and less concerned about the quality of borrowers: eg. NINJA loans
- Home buyers could make payments in the first two years, since the interest rate was set low for the first two years (teaser rate).

# Subprime Loans and Securitization



Source: Bank of Japan, Financial Stability Report, March 2008

# **(5) Global Crisis of 2009**

## **(5.2) Securitization and Alchemy**

- Creating Senior, Mezzanine, Equity from a collection (pool) of securitized mortgages was done with some questions
  - Credit rating agencies had conflict of interest
  - Assumption on correlation among the pool must have been too optimistic
  - Re-securitization (CDO<sup>2</sup>) was too complex
- Investors might not have understood the underlying risk

# **(5) Global Crisis of 2009**

## **(5.3) Banking Crisis**

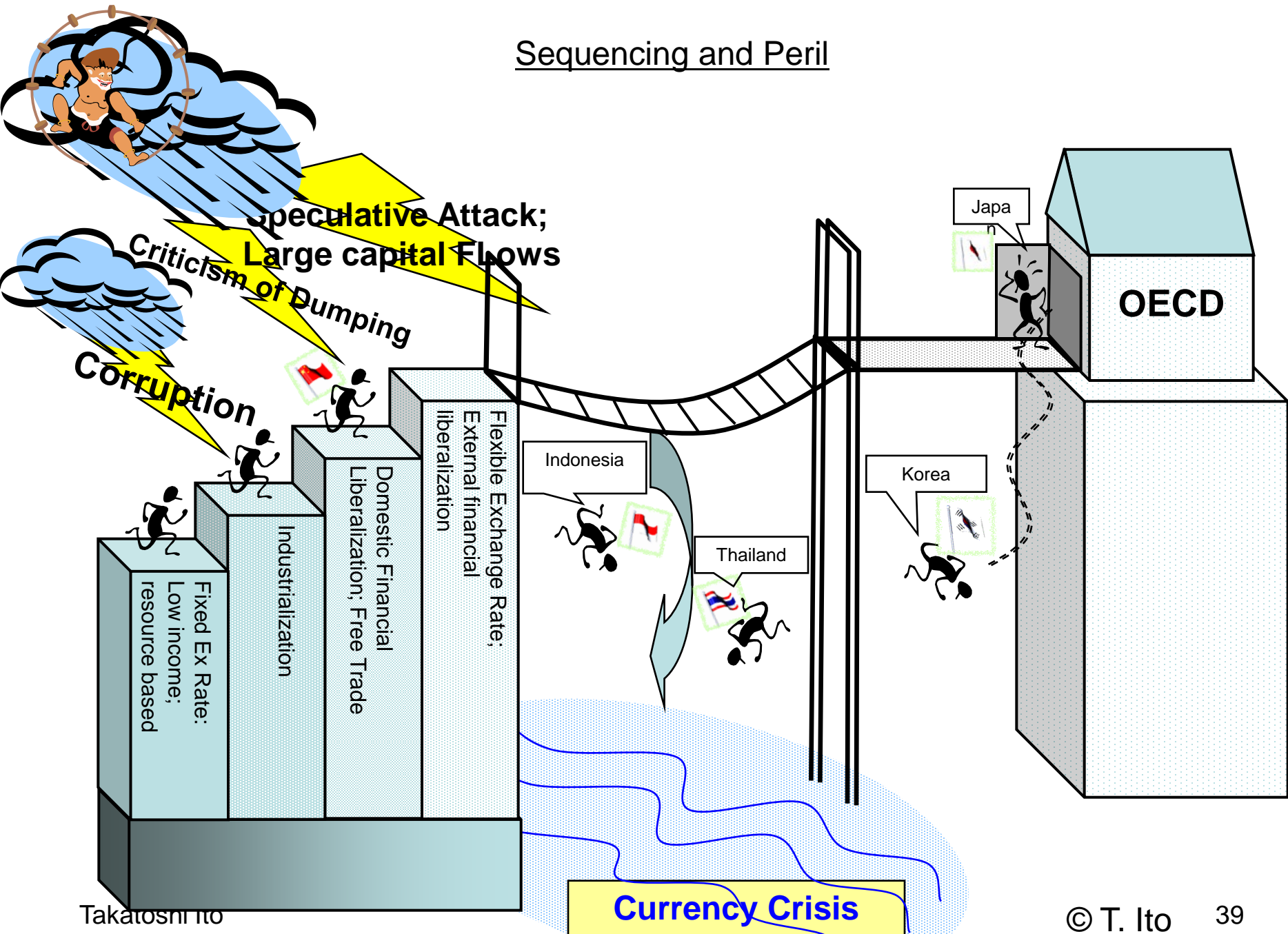
- Banking crisis that resulted from the subprime mortgage crisis was not handled properly
- No principle. Swing from “rescue merger” (JP Morgan Chase taking over Bear Stearns with FRB guarantee of losses) to “let it fail” (Lehman Brothers), to “too big to fail” (repeated capital injection to AIG, Citi and BOA, and others, without stringent conditions)
- US is repeating very similar mistakes of the Japanese authorities and Asian authorities

# **(6) Lessons for Dev. Countries**

## **(6.1) Middle-Income countries**

- Growth
  - Strong macro fundamentals; Growth oriented policy promoting education (human capital) and
- Avoiding crises
  - Perils in the last step of financial liberalization
- Sequencing is important
  - Trade to Finance; Domestic to External; FDI to portfolio
  - The last step from emerging market economies to an advanced country with fully convertible currency is the hardest
- Role of IMF
  - Surveillance to spot vulnerability;
  - Lender of Last Resort to a country with strong fundamentals (FCL)

# Sequencing and Peril



# **(6) Lessons for Dev. Countries**

## **(6.2) Low-income countries**

- “Development” rather than growth
  - Precondition (take advantage)
  - Governance
- What makes country to “click” (“take off”, “big push”)
  - Industrialization
  - Tourism
  - Leap frog to IT sector and education services
- Role of the World Bank
  - Remove corruption; market infrastructure as well as social and physical infrastructure