Credibility of Government, Corporate,
and Banking Sectors in Japan

1. Public fund injection into banks inevitable

Due to the prolonged stagnation in asset prices and deflation in the Japanese economy, the capital bases of financial institutions have become more fragile than any other time in history. We have also seen some active shifting of funds among deposits ahead of the lifting on the ban of the “payoff” (the government’s discontinuing its full guarantee of term deposits). In order to maintain stability in the financial system, it will be inevitable that the majority of the banks in Japan be nationalized or will receive a public funds injection yet again. By injecting government funds into these banks, the anxiety in the financial system will be alleviated for the time being. However, if we do not take action on the deteriorating tax revenues resulting from deflation and the rapid increase in government debt, it will only be a matter of time until the creditworthiness of the Japanese government, Japanese financial institutions and corporations are lost.

1.1. Woefully Low Capital in the Banking Sector

As of September 2001, the large Japanese banks engaged in international business all met the 8% capital requirements of the Bank of International Settlements (BIS) making it appear as though the banking business is healthy. However, in actuality, there is no real capital remaining in financial institutions. No matter how stringent the auditing may be for banks, if the financial auditing manual, that is, the rules that the banks must abide by are lax themselves, then there is no point to the auditing exercise. There remain to be issues with the loan loss provision requirements for loans in the “requiring attention” category, as well the current practice of classifying lending that is guaranteed by listed companies that give dividends as “normal” loans.

If we adjust the capital levels of the major banks to a real figure corrected for loan loss provisions and the writing off of bad loans that are considered too low, for deferred tax assets that have no liquidation value, for subordinated loans that are weak in their nature as “capital”, we find that as at September 2001, the capital adequacy ratio (as against to total asset) of the major banks would be only 1.07%. Moreover, if we remove the two injections of public funds by the government in the past, the real capital level of major banks would be negative 0.14%, showing that their capital has all but dried up (Figure 1). If we include regional banks and second regional banks to this data, then on an all-bank basis, we find that the capital adequacy rate is at 0.72% (if the public fund injection is included, 1.61%) and is the lowest ever.
Figure 1. Real Capital Adequacy Ratios of Banks (as to total asset)

Notes
1) Real Capital Adequacy = Total Capital + Gains or Losses on Valuation of Marketable Securities + Gains or Losses on Valuation of Derivatives + loan loss reserves - bad loans to be written off - deferred tax assets - gains or losses on revaluation of real estate - public funds injected
2) “Bad loans to be written off” are the sums of the provisions required for each of the types of loans according to the following schedule and as per their self-evaluations of their loan portfolios (Type 4 - 100%, Type 3 - 70%, Type 2 - 20%, Type 1 - 1%)

Due to the banks’ unwillingness to continue to lend to them, two general contractors, Aoki Corporation and Sato Kogyo have filed for bankruptcy since the end of last year. Although banks appear to be getting serious about clearing up bad loans that had originated in the past, since there continue to be new bad loans emerging, the outstanding figure for these loans is actually increasing. Unless banks can raise their interest rates on lending by about 1% (and thus realize an increase in about 5 trillion yen in their lending margins) to match the annual rate of credit losses, then their capital will decline even further.

If public funds are injected into the Japanese banks while nothing is done about the excessively small margins on current lending, it would be like pouring water into a bucket with a hole in the bottom of it, and not help to solve the problem at all. Banks have to fix the hole in the bucket by establishing lending rates that are commensurate with the risk of default on these loans. In order for this to be realized, the government and the Financial Supervisory Agency (FSA) must lift the requirements they have on banks to loans to small and medium-sized enterprises, and raise the lending rates of government financial institutions. However, unless deflation is brought to an end through strong policy measures, raising lending rates and revitalizing the financial sector will be impossible because then bankruptcies will increase even further.
2. Fears of a Financial Collapse

If the government were to provide 5 trillion yen of public funds a year to the banks, then a collapse in the banking sector can be averted. However, this would lead to a financial collapse of the government.

The long-term outstanding debt of the central and local governments (central and local government bonds and borrowings) was 675 trillion yen at the end of fiscal year 2001. This is almost 1.4 times the nominal GDP and is far higher than the average of about 0.5-0.6 times GDP normally recorded by the industrialized countries. This occurred because after entering the 1990s, tax revenues were stagnant, and with the numerous economic fiscal stimulus packages unveiled by the government, the fiscal deficit ballooned. Although the yield on government bonds will not be negative, the nominal economic growth rates have been negative for the past few years. This shows that although the tax revenues of the government are falling, the principal and the interest burden of the government debt have been increasing, and so the debts have been snowballing.

The US credit rating agency, Moody’s, downgraded the rating on yen-denominated government bonds issued by the Japanese government in December of last year, and then in February of this year, announced that they would be put on Credit Watch with a view to downgrading them one to two notches from the current rating of Aa3 (three notches lower than the top rating, and equivalent to a AA-). If tax revenues continue to deteriorate due to deflation and the fiscal deficit does not improve, then we may even see the ratings of Japanese government bonds downgraded to speculative grade (BB+ and lower) within five years. The current AA is already the rating for the top-tiered developing countries. Any further downgrading will mean that Japan is only as creditworthy as the developing countries.

Unlike the developing countries, however, Japan is a net external creditor and so there are views that even if Japanese government bonds are downgraded, the effects will be limited. However, can we say this is true?

First of all, a credit downgrade could have grave effects on the government’s ability to raise funds. We have already seen a tender for five year government bonds that was almost undersubscribed, that is, the amount bid for almost did not reach the amount the government had intended to issue.

Although the outstanding amount of government bonds issued is rising at a rapid rate, because of the low interest rate policy, the interest expenditure of the government has been flat at about 10 trillion yen a year. If we look at the tenors on the government bonds that are issued each year, we see that in fiscal 2001, short-term bonds accounted for about 40% of those issued that year, and there is a trend favoring the short-term.

Even if long-term interest rates increase due to the downgrading of government bonds, if
the government depends on only short-term bonds for financing, then so long as a zero interest rate is maintained under deflation, then the interest expenses will not increase. However, this would also mean that when short-term interest rates have to be raised because a tightening of monetary policy is necessary for some reason, then the interest expenditure would expand by a very large margin.

Second, a downgrading of government bonds would have grave effects on the international operations of private financial institutions and corporates. This is because unless these entities are fortunate enough to have a large revenue in a foreign currency, the credit rating of the country will limit how high the corporate or the financial institution is rated, (the “sovereign ceiling”).

Some overseas financial institutions are already reviewing whether they should continue to accept Japanese bonds as collateral for long-term transactions from Japanese banks because of the danger that they may be downgraded further. As a result, in the near future it is likely that Japanese financial institutions will encounter more and more difficulty in entering into long-term transactions with foreign financial institutions.

3. Two Scenarios

We consider the debt ratio on a general government basis, that would include central and local governments, and the social security funds that manage pensions and healthcare, and look at two possible scenarios, 1) a moderate inflation scenario and 2) a rapid inflation scenario to make some estimations (Tables 1, 2)

In the two scenarios, there is no effective anti-deflation measure put in place, deflation continues at a moderate rate, and the creditworthiness of government bonds deteriorates. As result, in the year 2006, the outstanding government debt grows to twice the nominal GDP, and Japanese bonds are downgraded to speculation grade. There results a full-fledged capital flight due to the downgrade of government bonds, and the economy frees itself of deflation in fiscal 2007.

In the first scenario, we assume that from fiscal 2008, the GDP deflator begins to grow by 2% per year, showing a moderate inflation. In this scenario, the increase in interest expenditure rises to about 2% of GDP, and a collapse in the economy is successfully averted. However, we believe the possibility of this scenario actually happening to be low.

If, like in Scenario 2, capital flight intensifies and inflation occurs at a rapid rate, the situation will be very serious. If the inflation rate is to accelerate to 10% in fiscal 2008, then the weighted average interested rate on government debt will jump from 1.8% in fiscal 2006 to 5.4% in fiscal 2008, and will reach 6.5% in fiscal 2009.
If inflation occurs when the government debt grows to twice the GDP and if the interest rate to fund the total government debt grows by 5 percentage points, then if we take the current GDP of 500 trillion yen as a starting point, the interest expenditure of the government will grow by 50 trillion yen and all of the tax revenue will be spent paying interest.

### Table 1 Moderate Inflation Scenario

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<th>Fiscal Year</th>
<th>Nominal GDP Growth (%)</th>
<th>Change in GDP Deflator (%)</th>
<th>Primary Deficit as share of GDP (%)</th>
<th>Weighted Average Interest Rate (%)</th>
<th>Gross Debt of General Government Account as share of nominal GDP (%)</th>
<th>Net Debt of General Government Account as share of nominal GDP (%)</th>
<th>Net Interest Payments as share of nominal GDP (%)</th>
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Note: Actual Figures for Year 2000

### Table 2 Rapid Inflation Scenario

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<th>Fiscal Year</th>
<th>Nominal GDP Growth (%)</th>
<th>Change in GDP Deflator (%)</th>
<th>Primary Deficit as share of GDP (%)</th>
<th>Weighted Average Interest Rate (%)</th>
<th>Gross Debt of General Government Account as share of nominal GDP (%)</th>
<th>Net Debt of General Government Account as share of nominal GDP (%)</th>
<th>Net Interest Payments as share of nominal GDP (%)</th>
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### 4. The Danger of High Inflation

If the government does come face-to-face with a rapid increase in interest costs, the Bank of Japan has three choices. First, they can buy a massive amount of government bonds and supply a huge amount of base money to stop the acceleration of inflation and prevent government default. Second, the BOJ can lower short-term interest rates, thereby preventing the increase in interest costs but leaving inflation unattended. Third, it can do nothing about buying government bonds or lowering interest rates, and allow the government to default. In any case, the scenario leads to financial collapse.

There are several measures to prevent the financial collapse of Japan, but they all have their profound side effects. Before the government increases its short-term debt, the BOJ should collaborate with the government, and to both halt deflation and prevent excessive inflation, set
an inflation target of the consumer price index of about 1.5% plus or minus 1% and make sure that this is widely understood and accepted by the public. Since the economy is currently under a severe deflationary environment, the inflation target should be set for about three years in the future.

4.1 Three Options for Bank of Japan

As for what measures can be taken to meet this objective, by amending the Bank of Japan Law, they can expand their market operations to not just bonds, but to all securities. Then the BOJ can buy a few trillion yen per month of real assets such as TOPIX-linked mutual funds or REITs (Real Estate Investment Trusts). By using real asset market operations, they can prevent the decline in value of real assets as measured by cash or deposits from continuing any further.

4.2 Taxes on Financial Assets

In case Japan still cannot free itself of deflation, they can levy a tax equal to the deflation rate on the financial assets that the government guarantees until deflation ends and create an environment of negative interest rates. These assets would include deposits, central and local government bonds, postal savings, postal life insurance and cash. Under deflation, it is the safest and most advantageous asset management strategy to hold cash, and cash holdings are indeed increasing. We need to encourage investment into stocks and real estate by levying a tax on cash and deposits.

By having a negative interest rate policy, saving will be discouraged, and spending will be encouraged. For example, if currency redenomination is carried out with a rate of exchange of the new yen being equal to the old 102 yen, we can levy a 2% tax on cash. Over one quadrillion yen would be taxable, and the government would earn almost 20 trillion yen in tax revenue. We would, of course, have to anticipate quite a bit of confusion if this redenomination were to take place. However, the government would be able to use the increased tax revenue from taxing cash held to reduce the fiscal deficit or for unemployment alleviation measures.

5. Deflation if left neglected may lead to financial collapse

The economy, to be freed from this deflationary environment, will also experience an increase in interest rates. Depending on the timing, companies with real excess debt may go bankrupt or bond prices will plummet, making for the strong likelihood that some banks or life insurers will also collapse.

The economy will not be revived unless deflation is stopped, and we must endure the pain that will accompany this. If the Koizumi government continues to neglect deflation, Japan will meet with the worst possible outcome -- financial collapse.