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# Japan's Banking Crisis and Low-Interest Rate Trap

by

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Since the end of the so-called bubble economy in 1991, Japan's economic slump has been dismayingly persistent. I shall argue that perverse exchange rate expectations are an important part of the problem. Otherwise, two related financial mysteries associated with the slump seem to defy explanation.

The first mystery is the banking system's ongoing bad loan problem. Despite repeated government attempts to recapitalize the banks and help clean up their balance sheets, new bad loans keep appearing. Officials at the Financial Services Agency (FSA) estimate existing bad loans to be about Yen 47,000 billion, whereas the Democratic Party of Japan (DPJ) believes that the true figure is closer to an incredible Yen 150,000 billion. This would be about 30 percent of GNP, which is extraordinarily high by international standards. And, even though the overall money supply continues to grow, new bank lending—good or bad—continues to decline.

The second mystery is the low level of nominal interest rates on yen assets in comparison to those on dollar assets. The current three-month money market rate in is 0.03 percent in Japan, and 4.6 percent in the United States. On ten-year government bonds, the rate is about 1.3 percent in Japan, and 5.3 percent in the United States. Because these interest differentials of about 4 percentage points have persisted since 1978, why don't Japanese business firms and households demand dollar assets with much higher yields at every term to maturity? The pressure from such arbitrage should force Japanese nominal interest rates upward toward international levels.

Instead, this interest rate differential has been sustained because market participants implicitly believe that the dollar value of the yen is likely to be much higher in the future. Today, for example, a holder of a 10-year JGB would accept the very low yield of 1.3 percent only if he or she expected the yen to be much higher 10 years from now than it is today. And, from August 1971 at 360 yen per dollar through to a peak in April 1995 of 80 yen per dollar, the yen did rise enormously—with serious deflationary consequences for Japan's economy.

Although the yen has come down to about 122 per dollar, market expectations that the yen will rise, if only erratically, remain surprisingly strong—as revealed by the persistence of the interest differential. In our book, *Dollar and Yen: Resolving Economic Conflict Between the United States and Japan* (Nikkei, 1998), Kenichi Ohno and I hypothesized that recurrent American mercantile pressure since 1971 to get the yen up, in order to reduce Japanese trade surpluses, created the expectation that the yen would naturally move higher. Since 1995, when Secretary of the Treasury Robert Rubin announced a strong dollar policy, this overt pressure from the Americans has been muted. However, with the current downturn in the American economy leading to rising unemployment, this pressure could well return.

American nominal interest rates have themselves fallen from the very high levels of the 1970s and 1980s to the moderate levels we see today. Combined with the expectation of an ever-higher yen and ongoing deflation in Japan, this pushes yen interest rates toward zero. In this externally imposed low-interest liquidity trap, the Bank of Japan is powerless to stimulate the Japanese economy. First, no matter how much base money it creates, yen interest rates cannot be driven below zero. Second, at 122 yen per dollar, Japan's currency today is very close to purchasing power parity with the dollar. (Indeed, the yen is slightly undervalued by *The Economist's* (April 21) Big Mac hamburger standard!) Thus, if Japan tried to use a much weaker yen to export its way out of its current difficulties, American mercantile pressure—and pressure from other important trading partners such as China and Korea—would return with a vengeance.

This unnatural compression of nominal interest rates toward zero also worsens the banking crisis. Apart from past and existing bad loans, Japanese banks cannot make *new* loans to high-quality borrowers on a sufficiently profitable basis to restore their balance sheets. Today, the prime loan rate in Tokyo and Osaka is just 1.4 percent—a spread of 1.3 percentage points over the banks' virtually zero-interest cost of funds in the interbank market. In comparison, in the United States, the prime loan rate remains at 7.5 percent—a spread of 3 percentage points over American banks' cost of funds in the money market of about 4.5 percent. By this particular measure, American banks enjoy gross profit margins more than twice those of their Japanese counterparts.

Another measure of bank profitability on new lending would be the spread between interest on checking accounts, usually zero in both countries, and their prime loan rates. An American bank can attract checking accounts, which are costly to maintain, at zero interest and lend the proceeds to prime quality borrowers at 7.5 percent. A Japanese bank would only get 1.4 percent. No wonder Japanese banks remain reluctant to lend, and cannot generate a flow of profits to restore their capital positions depleted by the large losses on past loans. As long as market interest rates remain compressed toward zero, just cleaning up bank balance sheets, i.e., taking away old bad loans and recapitalizing, will fail to stimulate new bank lending.

Consequently, escaping from the low-interest liquidity trap is necessary for two reasons: to restore the power of the Bank of Japan to macro manage the economy, and to widen bank profit margins sufficiently to stimulate new lending and rebuild bank capital.

The expectation of a higher future value of the yen and associated deflation can be changed by government policy. However, a credible signal from *both* the American and Japanese governments that the future dollar value of the yen will not differ substantially from what it is today is necessary. From 1971 to 1995 there was substantial implicit and explicit political pressure from the United States, backed up by threats of trade sanctions, to get the yen up. While this higher-yen policy failed to reduce Japan's trade surpluses, it imparted deflationary momentum, ending up with the low interest rate trap, to Japan's economy. Surprisingly, this deflation has now taken on a life of its own and has lasted into 2001 even though the yen is not now overvalued. The problem is the *long-term* expectation of an ever higher yen. Today's exchange rate of 122 yen to the dollar seems correctly valued at close to purchasing power parity.

To quash the expectation of an ever-higher yen and future deflation, Ohno and I proposed a bilateral trade and exchange rate pact between the United States and Japan. The trade pact would restrain mercantile pressure from the United States for a higher yen, but also require Japan to continue with its economic liberalization. Then an agreement to stabilize the yen to anchor expectations against future deflation becomes feasible. The new

parity rate, say 122 yen per dollar, would be a long term benchmark towards which the two governments would occasionally intervene to nudge the market rate. (No hard short-term fix is necessary.) Then, as deflationary expectations decline, Japanese nominal interest rates, and bank profit margins, will increase to “normal” international levels.

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