

JAPAN: A LONG EXPERIENCE WITH CREDIT CRUNCH

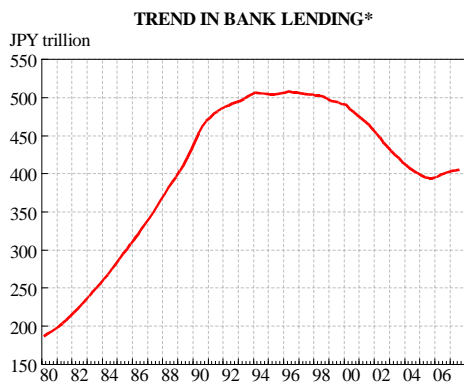
⌘ After the financial bubble burst at the beginning of the 90s, Japan experienced a longlasting credit crunch. It was particularly severe during the second half of the decade after the 1997-98 recession.

⌘ The source of this credit rationing lay in the extensive deterioration in bank balance sheets combined with tougher prudential regulations (application of the Cooke Ratio): the capital crunch. The channel of credit is frozen, leading the economy into a vicious circle. The government reacted too late but, although it held off a systemic crisis, it couldn't revive the credit.

The banking crisis at the root of the credit crunch

While the financial, property and investment bubble was forming (1985-1989), companies got into massive debt, in particular acquiring financial and property assets thanks to an almost unlimited availability of low-cost credit. When the bubble burst in the 1990s, there was a profound deterioration in balance sheets of Japanese companies and a fall in their profitability. Low growth and deflation kept domestic demand low and increased the burden of debt (debt deflation) generating a wave of business bankrupts that was amplified by the sudden fall in property prices and land that brought about a fall in the value of debt collateral. The result was an increase in non-performing loans on bank balance sheets (JPY 43 trn, or 8.4% of outstanding loans in March 2002) at a time when they were already vulnerable through depreciation in share portfolios, traditionally extensive because of close relationships with companies in their *keiretsu*.

Under the weight of increased provisions for non-performing loans and valuation losses in share portfolios, the solvability and profitability of banks plummeted. With rating agencies downgrading them, they found it harder to get external financing. As the cost of bank refinancing had risen, large Japanese companies resorted to using the markets. Banks therefore became more weighted towards the more risky SMEs. The banking crisis gained in intensity in 1994 with the multiplication of bank and *Jusen* (mortgage credit companies created by the banks in the 1970s) bankrupts.



The "lost decade" can be divided into three periods: (1) between the bursting of the bubble and 1992-1993, when access to credit, although slowed, remained relatively easy; (2) between 1992-1993 and 1997, when there was virtually no increase (+0.3% per year on average) in bank loans to domestic and foreign markets; (3) lastly, from 1997-1998, when access to credit rapidly became much tougher: outstanding bank loans collapsed, in particular for major banks. Foreign loans plummeted. The balance of opinions of large companies on credit rationing at the beginning of 1998 was, according to the Tankan, at its lowest since the third quarter of 1991.

The capital crunch

When prudential regulations became tougher with the implementation of the Cooke Ratio in 1992, the shareholders' equity of Japanese banks was badly impacted by the write-off of non-performing loans and the increase in valuation losses of asset portfolios due to the collapse in share prices, as these capital gains were included in Tier-2. At the same time, their operating income was poor. These constraints forced them to acquire Japanese government bonds (zero-weighted) and to reduce the distribution of loans: this was what is known as the capital crunch which set in from 1997 as the country entered recession. The under-capitalisation of banks was in part masked by the inclusion of significant deferred tax credits in Tier 1. Moreover, most major banks had been able to take advantage of public recapitalisation. Solvency ratios did not therefore properly reflect effective bank solvency.

The channel of credit is frozen, leading the economy into a vicious circle¹. After this the situation of the most indebted borrowers worsened, engendering a reduction in demand for credit. Moreover, company suspicion of the banking system probably led to a run on deposits, further worsening the difficulties facing banks.

Government interventions were not very efficient to revive the credit

Government intervention became more and more prominent as it tried to break the vicious circle, limit credit rationing and above all, avoid triggering a systemic crisis: recapitalisation of major banks (1998, 1999) through preferential share subscriptions; purchases of non-performing loans by the RCC; unlimited deposit guarantees in order to forestall bank runs; significant temporary nationalisations, etc.

For its part, the Bank of Japan eased its monetary policy from 1991 onwards, adopting a zero interest rate policy almost without interruption from 1999 to 2006; from March 2001, it adopted a quantitative easing policy with an increasingly large injection of liquidity into the banking system. This policy was not successful in spite of the extraordinary low level of nominal rates, due to a lack of demand in a context marked by the restructuring of production facilities and persistent deflation.

All in all, Japanese government interventions were probably too late in view of the extent of over indebtedness on the part of private players, the devaluation of assets and deflationary risk. However, although it was not successful in restarting economic activity by acting on credit, the government was successful in avoiding a major systemic crisis.

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¹ The credit crunch doesn't work anymore: made vulnerable by the rise in non-performing loans, as a result of the increase in business bankrupts and the downward valuation of collateral as well as the depreciation of their financial assets, the banks responded by reducing the supply of credit and increasing lending rates. The credit crunch slowed economic activity, brought about business bankrupts, and forced companies to look for other forms of financing. The recession worsened, leading to additional non-performing loans, making the banks even more vulnerable...

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