Japan's banking crisis could trigger global financial collapse

by William Engdahl

Details are only beginning to surface in Japan of a banking crisis which could well detonate a global systemic financial crisis of titanic dimensions. On June 6, the Japanese Ministry of Finance revealed details of total loan losses of all Japanese banks, which they now admit to be "approximately" $471 billion. This figure, which according to informed accounts vastly understates the problem, already puts the Japanese bank crisis at a scale far beyond the 1980s crisis of U.S. savings and loan institutions, and orders of magnitude beyond the recent losses of France's Crédit Lyonnais.

On June 8, the Ministry of Finance also unveiled a long-awaited proposal for dealing with the bank crisis, but the details, which were few, did not reassure anyone. The proposal called for better bank disclosure of bad loans—present rules are extraordinarily liberal, meaning accurate estimates of the damage are almost impossible to formulate. A second proposal was to increase the now tiny bank deposit insurance fund through a levy on the banks themselves, which the banks argue they cannot do in their present difficulties. No Japanese bank has been allowed to fail in the past 50 years, but this would presumably pave the way for some failures to be admitted. What was conspicuously absent were any proposals for a U.S.-style Resolution Trust Corp., in which the government would step in to assure liquidity while the bad debts are disposed of. Failure to include this provision led to near-panic selling of Japanese stocks and the collapse of the Nikkei Dow to the dangerous low of 14,600 by June 13.

"Japan's banking problems outweigh all else now in the global financial domain as a focus of systemic concern," emphasized S.J. Lewis, a senior City of London financial figure. "This is the real 'Tokyo earthquake' doomsday scenario. If Japanese banks now begin to admit and write off their actual bad loans, it could well start a snowball effect of every bank rushing to dump bad debts, a process which could well pull the entire system down with no government safety net in place. This is one reason the Nikkei stock market has been so weak in the past days."

For a nation renowned in the West as the epitome of organized action and coordinated industrial efficiency, the disclosure of bank bad loans marks the first official Japanese government estimate of bank losses in a crisis that is now five years old. The $471 billion figure includes all loans to firms now bankrupt, loans on which no interest has been paid for six months or more, as well as restructured loans to weak borrowers. But even this figure, equal to some 9% of the total Gross Domestic Product (GDP) of Japan, vastly understates the reality, according to informed banking analysts. Yukiko Ohara of UBS Securities Ltd. calculates that actual problem loans could reach as high as 100 trillion yen, that is, $1.15 trillion, a sum equal to one-quarter of the GDP of the world's second largest industrial nation.

According to a number of Japanese financial sources, this higher figure of $1.15 trillion in bad debts is realistic. "The Ministry of Finance and Bank of Japan figures deliberately understate the problem so as not to cause panic," according to one such report. Banks have been allowed to extend "cosmetic" loans to many insolvent clients, only those companies, often real estate construction companies, can in turn use the new loans to make interest payments on their old loans. Of course, bank loans to problem companies merely increase as a result, even if the banks can pretend the loans are still good. This perverse example of "throwing good money after bad," has turned what may have been a manageable bank problem of 1990 into what today is threatening to become a global systemic breakdown.

The net result of this dangerous practice has been that, despite the deflating of the huge Japan real estate and stock speculation bubble more than five years ago, Japanese banks today are in far worse condition than they were in 1990. This is the element which is beginning to create alarm in banking circles from Europe to New York.

A world-class financial bubble

The size of the Japanese financial structure is so great that, were a full-scale banking crisis to erupt, it would detonate a domino-style series of financial liquidations which would be felt around the world.

Nine of the world's ten largest banks in asset size are Japanese. The three largest each has assets of more than $500 billion, dwarfing every major European bank and even the large New York banks. Only Mitsubishi Bank has felt strong enough to begin to write off most of its bad loans. All the rest are left holding a growing pile of uncollectable debt. Technically, almost the entire Japanese banking system is bankrupt—liabilities far in excess of assets and income. The political issue is whether the Japanese taxpayer now will be forced to pay the bill for bailing out those banks or the problem will be allowed to grow to the point that it is fully out of control.

During the 1980s, as the yen began its rise following the October 1985 Plaza Accord of the Group of Seven (an agreement to stop the rising dollar), Japanese banks began to reap the rewards of a 60% appreciation in the yen. As their international lending was done in dollars, and their bank balance sheets were calculated in yen, their paper profits and assets exploded.

In addition, Japanese banks, alone of all major banks in the Organization for Economic Cooperation and Development, count their stock holdings as part of their core bank capital. Most OECD bank regulators regard stocks as far too speculative for such purposes. During the 1980s, as the Nikkei Dow seemed to rise with no limit, Japanese banks' capital base for further lending grew with it to dangerous heights. This sudden explosion of paper "riches" in the end turned out to be a curse.

Japanese banks gloried in overtaking Citicorp to become the world's "largest" banks. Compounding the problem, as Japanese industrial exports stagnated or fell under the pressure of the more expensive yen in the late 1980s, many Japanese firms like Toyota turned from industrial expansion into what Japanese called "Zaitech," or financial engineering—that is, speculation on international currencies, stocks, interest rate moves, or real estate. All Japanese business was caught up in the fever of financial speculation to a degree not witnessed even in the United States of the 1980s.

By 1989, Japan had created a speculative bubble of gargantuan proportions. Banks and companies' assets were mainly cross-holdings of other companies' stock shares. As the banks were flooded with new money from the speculative bubble, they poured a portion into the Tokyo Nikkei Stock Exchange. The Nikkei Dow index rose that year to an all-time high of 38,916 yen by December 1989. The total value of all stocks traded in Tokyo at that point was near to $5 trillion, making Tokyo the largest stock market in the world, larger even than New York.

When the new governor of the Bank of Japan, Yasushi Mieno, took office in December 1989, he was alarmed that the runaway speculative frenzy in stocks and real estate, termed the "bubble economy" in Japan, threatened to collapse and bring down with it the entire Japanese industrial economy. To control that danger, Mieno began a series of calculated interest rate rises aimed at "slowly deflating" the stock and land prices.

It was anything but slow and painless, as the Nikkei crashed to 18,000 from 39,000 in only a few months. Real estate firms, construction companies, and others became insolvent overnight. Japanese industry went into a deep recession which today threatens to become a major depression. Rising stock and land prices were used during the bubble years as backing or collateral for corporate new investment, for consumer purchases, in short, the entire economy had tied itself to the soaring prices of land and stocks by 1989.

Further, the added 25% drop of the Nikkei this year alone, has severely impaired bank earnings by wiping out much of banks' so-called "hidden assets" in long-term stock shares in other companies which were badly needed to offset losses from the old bad loans on real estate and other speculations of the past decade. In a vicious circle, much of that Nikkei fall came from desperate Japanese banks selling their stocks to cover bad loan writeoffs. This in turn has forced Japanese insurance companies to dump their stocks, further fuelling the Nikkei fall.

The other shoe to drop

For most of the past two years, while U.S. and European financial structures have been rocked by a series of crises (from the Metallgesellschaft derivatives debacle in Germany and Spain's Banesto Bank failure in December 1993, to the bond market crisis in February 1994, to the Orange County, California derivatives collapse and Mexico's peso crisis in December 1994, and, more recently, to the dollar crisis), little attention has been paid to the fragility of the Japanese financial structure. With the latest admissions from the Japanese government, that is beginning to change rapidly.

In a lead editorial on June 1, the *Wall Street Journal* wrote, "Today's Japan is not the economic powerhouse that gripped the conventional wisdom five years ago. Instead, it is the most fragile member of an interdependent world economy." They warn about "any economic implosion in Japan and the shock waves this would send through the world economy."

By the early 1990s, Japanese banks and investors held the largest share of bank loans in America's largest state, California, of nearly 40%. Japanese investors recently were forced to declare Chapter 11 bankruptcy on their ownership of a major New York office complex, Rockefeller Center, further depressing weak New York real estate prices. Japanese investors and the Bank of Japan are estimated to be the largest single foreign holders of U.S. Treasury bonds and bills. Were the Japanese to liquidate those Treasury securities, it would collapse the U.S. bond market, forcing U.S. interest rates through the roof, and those of Europe with it. For more than a decade, Japanese banks and investment institutions had been the largest source of foreign capital for much of the world.

At this point, Japanese authorities are estimated to have till Sept. 30 to come up with a convincing resolution of the bank crisis. That is when Japanese companies must report semi-annual profit results. If this has not materialized, there will erupt a full-blown Japanese banking crisis and a continuing stock market fall. In that case, the growing Japanese bank crisis could very well be the detonator to a new, global system-wide crisis of the form which Lyndon LaRouche forecast in June 1994.