# EIR Economics

# Bank of Japan tries a 'backdoor bailout'

by William Engdahl

On Sept. 7, the Bank of Japan dropped its Official Discount Rate (ODR), its key lending rate to the banking system, to 0.5%. The ODR stood at 6% in 1990, when the collapse of Japan's spectacular financial bubble began. At that time, a new governor of the Bank of Japan, Yasushi Mieno, implemented a series of rate rises in an effort to "let the air out of the bubble" which had built up on the Nikkei Dow stock market and in Japanese real estate speculation, following the 1985 Plaza Hotel Accord of the Group of Seven countries to force the dollar lower.

After 1985, as the yen soared against the dollar, the paper profits of Japanese banks exploded. Banks awash with liquidity made huge speculative gambles in California real estate, buildings like Rockefeller Center, and stocks and real estate throughout Japan. By December 1989, as the Nikkei Dow index reached a record Y 39,000, a consensus was reached that the speculation had gone out of control, and the brakes were applied by the Bank of Japan, via higher interest rates.

But today, more than five years later, Japanese companies are in the most severe depression they have experienced since the 1920s, and Japanese banks, instead of stabilizing, have become more exposed to bad loans, as banking regulators allowed them to lend new funds to bankrupt creditors, mostly housing and construction firms, so those companies could continue to be shown on the books of Japan's banks as "performing" loans, rather than the defunct loans they were. It was throwing good money after bad. The Bank of Japan had gambled, and lost, on an expected recovery in Japanese real estate and stock levels, a recovery which did not happen.

By April of this year, alarm bells began to go off, and the government began to take drastic steps to try to control what threatened to become a banking system meltdown. In May, the Bank of Japan started to inject liquidity into the financial system at a rate "not seen in 15 years," according to one analyst. As well, the Japanese government moved to improve overall relations with Washington, which had become badly strained in recent years, by compromising on important issues relating to the large deficit in U.S.-Japan auto parts trade. Securing U.S. cooperation to bring the inflated yen down from its record high level was obviously part of the background to Japan's trade compromise. That cooperation has been very visible since the end of July.

The latest interest rate move, portrayed in the media as an effort to "jump start" Japan's failing economy, in reality is part of a frantic series of moves designed to bail out Japan's banking system, a "backdoor bailout."

Its aim is to prevent a systemic bank crisis from occurring. Because the latest measure of cutting the discount rate does not take on the issue of direct bailout by the government through public funds, as was done in 1989 under the U.S. Resolution Trust Corp. taxpayer bailout of the savings and loan institutions, but rather hopes for bank revival through use of the almost cost-free Bank of Japan funds, it has been called the "backdoor bailout." Whether the strategy will work is far from clear at present.

## The main features of the policy

The cut in the Japanese central bank's ODR to 0.5%, followed an earlier cut in April to 1%. In April, the yen had reached its postwar high of 79 to the dollar, and the Nikkei Dow stock index had fallen to the Y 14,000 range. Many informed Japanese financial analysts had predicted that the entire edifice of the complex Japanese financial system would collapse domino-style had the Nikkei Dow continued to fall below Y 14,000. The April ODR cut was designed to stimulate the stock market, as well as to lessen the attraction of the



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yen for foreign speculators. But it did not work on either count. The yen fell only slightly, and the Nikkei rose only slightly, but the banking situation worsened.

The latest rate cut followed on the heels of an unprecedented series of failures of Japanese financial institutions over the past two months, including the first failure in the postwar period of a Japanese commercial bank, Hyogo Bank. According to Japanese banking sources, these failures of medium-size financial institutions are but the beginning of what is expected to be a major wave of such failures, unless the government takes resolute action to deal with the crisis-ridden banking system.

While the Ministry of Finance and the Bank of Japan recently took the bold step of admitting a far larger sum, approximately $500 billion, of bad loans held by Japanese banks, private estimates put the actual sum of worthless loans held by the country's banks as high as $1.2 trillion or more. Japan's accounting rules and its official bank disclosure requirements are among the world's most lax. Few details of the real state of affairs are usually made public. All agree the problem is staggering in size.

## 'Cost-free' money

The essence of current Bank of Japan strategy is to allow private banks to borrow funds from the Bank of Japan at the nearly cost-free rate of 0.5%. Then, the banks are expected to invest the funds in risk-free assets, rather than engage in traditional bank lending. That, in order to allow the banks to make huge paper profits over the coming period. A similar strategy was pursued by the U.S. Federal Reserve when a domino-style bank collapse threatened banks as large as Citicorp, Chemical, and others in the early 1990s. But even Alan Greenspan's Fed never put its Fed funds rate below 3%. And that created one of the most dangerous speculative financial bubbles in U.S. history.

With borrowed funds at 0.5%, Japanese banks are now expected to go into Japanese government bonds and similar "safe" securities. That is, they will try to invest in "risk-free" assets, rather than lend further to private companies or individuals. Investing in Japanese government bonds and short-term government paper, will immediately allow Japanese banks to increase average profits by almost 600%, because they can make interest income alone of 2.1% or higher on domestic government debt holdings.

But the Ministry of Finance has added a second element in their byzantine "backdoor bailout" attempt. In August, the ministry announced a series of measures which have liberalized restraints on investment abroad by Japanese financial institutions. This was announced in the context of repeated Bank of Japan interventions to sell yen and buy dollars.

The more liberal investment rules have encouraged Japanese funds to flow out of the yen into the dollar, where U.S. Treasury securities yield a current average near 6%. For Japanese banks, able to borrow new funds at 0.5%, the gains are enormous. But the funds did not begin to flow into the dollar and out of the yen before the latest rate cut, as investors feared the yen's fall was only temporary. Were the dollar to fall, they faced loss of all their gains from higher U.S. interest yields.

Now, the last weeks of aggressive intervention, new investment rules, and the strong public support of the ODR rate cut by U.S. Treasury Secretary Robert Rubin, have combined to convince Japanese banks and other investors that at least a share of their funds can secure bigger gains in the U.S. bond markets, without fear of a new dollar collapse.

## Bad loans are the issue

This last point underscores that Japan's crisis is not for want of paper money. The issue is how the government deals with the awesome $1.2 trillion in bad loans of the banking system. By encouraging an increase of Japanese investment into U.S. Treasury securities, the government calculates this will, de facto, push the yen even lower, and with it, help Japan's depressed industrial companies to export more. Already since the high of April 19, the yen has fallen 21%. By early September, indications were that this is only the beginning, as funds started to flow out of Japan into the dollar. The falling yen, in turn, is also fuelling new investment into the depressed Nikkei Dow stocks, as investors reckon Japanese export profits will now improve.

But Japanese banks' assets, unlike those of any other major industrial country, are uniquely tied to their holdings of stocks in major Japanese industrial and trading companies. When the prices of those stocks rise, the value of Japanese bank core assets, vital for meeting international bank capital adequacy ratios, will rise with it. At the same time, the banks will gain major risk-free profits on U.S. Treasury paper. That, anyway, is the hope.

Whether it will work, and work fast enough to stop a meltdown, is far from clear. On Sept. 5, Ryutaro Hashimoto, trade minister and the man slated to be the next head of the Liberal Democratic Party, declared, "We should take every possible step to change the current economic situation. . . . Japan's current industrial output figures are so bad that the word 'weakening' does not describe them sufficiently." That same day, the Japanese government revealed data showing an all-time record influx of deposits into the State-owned Japanese Postal Savings Bank, the largest bank in the world. Some $7.5 billion came out of private banks into the Postal Savings system in August, in the wake of the recent bank failures and growing anxiety over the financial system's health. On Sept. 11, Soichiro Toyoda, head of the Japanese industrial association Keidanren, stated that the economy had entered a "state of emergency."

The question is whether the Bank of Japan and the government have done too little, too late. The next weeks will be tense ones, not only in Japan, but also for the entire global credit system, as a Japanese bank collapse would detonate a global financial crisis on a scale never before seen.