Economic Development of Japan

No.8 Showa Financial Crisis

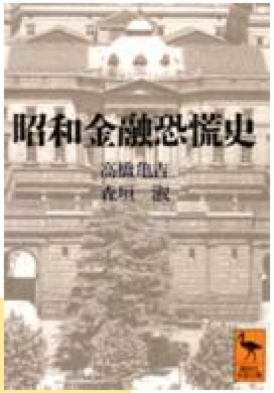
Topics for Discussion

- How did the collapse of the WW1 export boom in 1920 lead to the nationwide banking crisis in 1927? Explain the *kikan ginko* problem.
- What is the proper policy response when:
  (i) A bubble collapses, weakening firms and banks (1920)
  (ii) Bad debt continues to rise with no prospect of automatic solution (1920-27)
  (iii) Serious bank runs occur (1927)
  (iv) The financial crisis is over (1927-)
  Evaluate actual policy responses of the Japanese authorities.
- What are the common and different factors between Japan’s 1927 bank runs and financial crises of our time?

After the Bubble, Bad Debt Rises

- The most fundamental cause of the banking crisis of 1927 was the pre-modern nature of the Japanese banking system which lacked information disclosure and risk management. A large number of small banks were created in the 1890s serving local industries but without proper supervision or regulation.
- The WW1 export boom ended in 1920, leaving many firms and banks with overcapacity and impaired balance sheets. During the recessionary 1920s, *kikan ginko*, or banks serving only one or a few firms with little information disclosure or risk management, continued to accumulate bad debt.
- At the time of the Great Kanto Earthquake in 1923, the Bank of Japan rediscounted commercial bills to supply emergency liquidity. But bad debt unrelated to the earthquake was also rescued. In a parliamentary debate over the normalization of unrecoverable "earthquake bills," a small misstatement by the finance minister started the first wave of bank runs in March 1927.
- The Bank of Taiwan, a colonial central bank which also had commercial operation, had huge but unreported bad debt with Suzuki Shoten, a rapidly rising trading house. This was the largest kikan ginko problem. When the Bank of Japan refused to rescue BOT, bank runs spread nationally.

Kamekichi Takahashi & Sunao Morigaki, *History of Showa Financial Crisis*, 1968 (reissued 1993)



According to the authors, the fundamental and immediate causes of the 1927 banking crisis were as follows.

Fundamental causes

- ☐ Internal problems in the banking system (*kikan ginko*).
- ☐ Rescuing weak businesses generously without serious restructuring after the collapse of the WW1 bubble.
- ☐ The 1923 earthquake and exchange rate instability further weakened the Japanese economy.

Immediate causes (triggers)

- ☐ Political fight over the unsettled earthquake bills.
- ☐ A minor misstatement by Finance Minister Kataoka.

The 1927 banking crisis was caused by Japan's internal problems, not by global economic shocks.

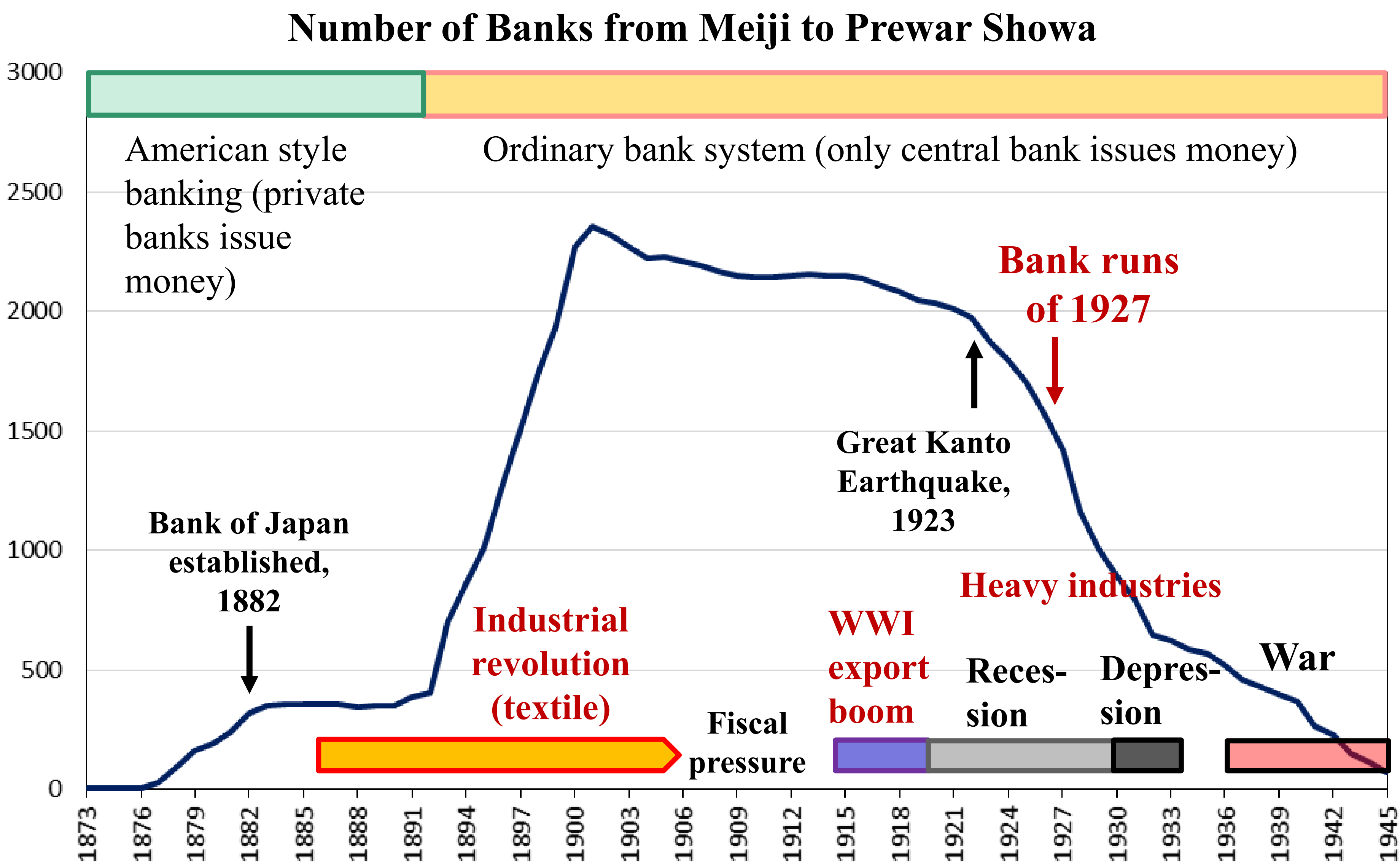
> "Fundamental causes of the Financial Crisis were as follows: (i) despite the fact that Japan's economy grew strongly in quality and quantity during WW1; (ii) the banking system remained pre-modern with many defects; (iii) as a result, after excessive speculation ended in 1920, both government and private businesses made the mistake of implementing only temporary measures hoping that the next boom would bail them out. But the economic malaise was deeply rooted, and temporary measures only made things worse.
>
> In addition, the 1923 earthquake and exchange rate instability further damaged the economy. Profits fell, bad debt rose, and most banks were on the verge of collapse."

(Takahashi & Morigaki, 1993, p.7)

The Rise of Kikan Ginko

- *Kikan Ginko* literally translates as “institutional bank,” but what it really means is a bank that lends to one or a few firms without proper risk management.
- Japan achieved a light manufacturing industrial revolution in the 1890s. Demand for industrial funds rose sharply. Many small private banks were set up and contributed to this early industrialization. But most of such banks had only a very small number of customers.
- Over 2,000 banks existed in the first few decades of the 20th century, which was excessive in a developing country of the size of Meiji and Taisho Japan (by contrast, in 2021, the number of Japanese banks was only 122).
- Regulation on loan ceiling on any one borrower (max. 10 percent of bank capital) was removed in 1895 under the pressure of the Banking Association. The Ministry of Finance tried to strengthen supervision and reduce loan concentration, but the Banking Association resisted.
- Dualism in banking—large zaibatsu banks such as Mitsubishi and Sumitomo lent to group companies while kikan ginko served numerous small local businesses.

Timeline of Japanese Banking System



Coverage: "national" banks, private and ordinary banks and special banks.

Source: Bank of Japan (Historical Statistics of Japan, vol.3, p.166)

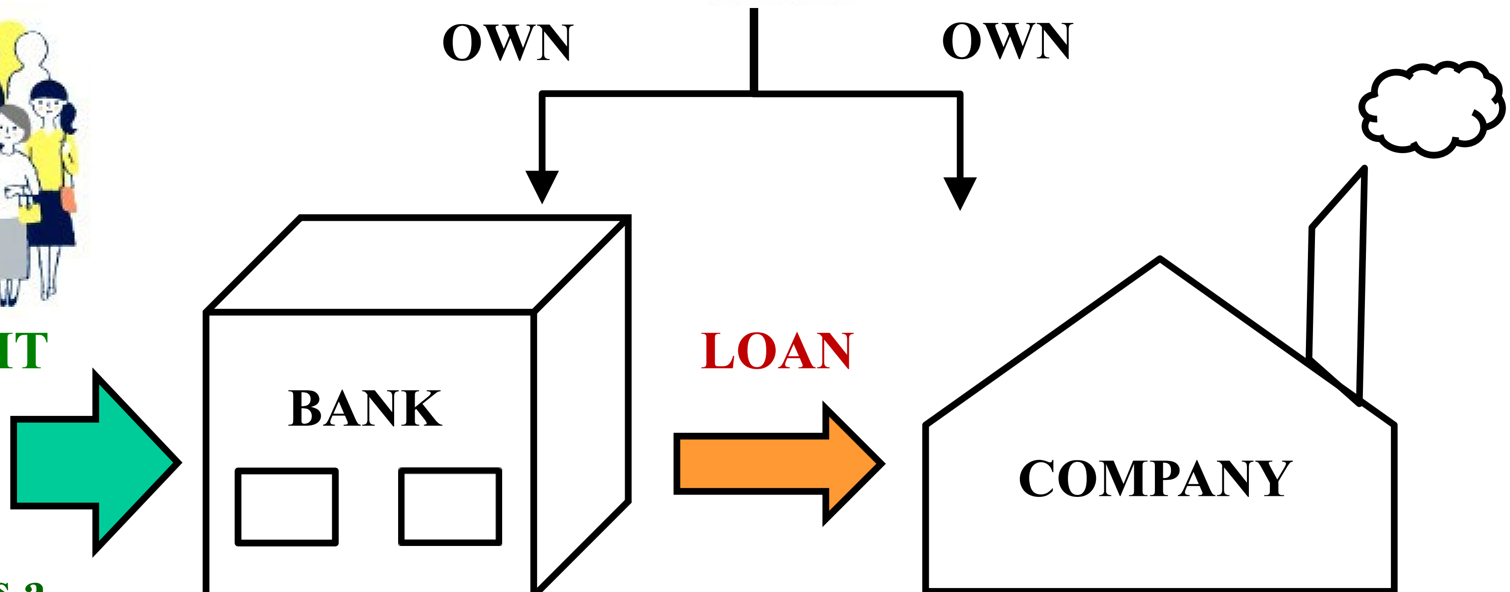
Kikan Ginko Visualized

A respected and influential man in the local community…

creates a bank to finance his company.

DEPOSIT

Local residents



"I know he is a good man who supports our town. I can trust him."

- No disclosure of bank or company performance
- No prudential regulation or deposit insurance
- Concentration of bank lending to one or a few companies

The Boom Ends in 1920

WW1 ended in 1918. Export-led speculation fever ended in 1920. The stock market dropped, prices fell and credit crunch began. In 1920 alone,

- Corporate bankruptcies—Mar (7) Apr (45) May (106), Jun (127)
- 169 bank runs during Apr.-Jul. 1920; 21 banks were closed

Joint statement of Chambers of Commerce: "Government should supply sufficient funds and lower interest rates to overcome short-term difficulty."

Prime Minister Hara: "Credit crunch is a temporary phenomenon; stability will return sooner or later."

Finance Minister Takahashi: "Crisis is the result of over-optimistic expansion and speculation during the War."

Bank of Japan Governor Inoue: "This is a reaction to the previous boom. Bold restructuring is necessary. Each business must make effort. Do not just ask for help."

➔ **Actual policy response was generous assistance**

Rescue Measures by the Bank of Japan, 1920

- ☐ Infusion of bank reserves (35 banks, 109 million yen)
- ☐ Supply of liquidity to foreign exchange banks (3 banks, 50 million yen)
- ☐ Loan provision to targeted industries through banks—sugar, wool, cotton, chemicals, steel, machinery, paper, power, shipbuilding, textile, railroad, etc. (360 million yen)

This caused:

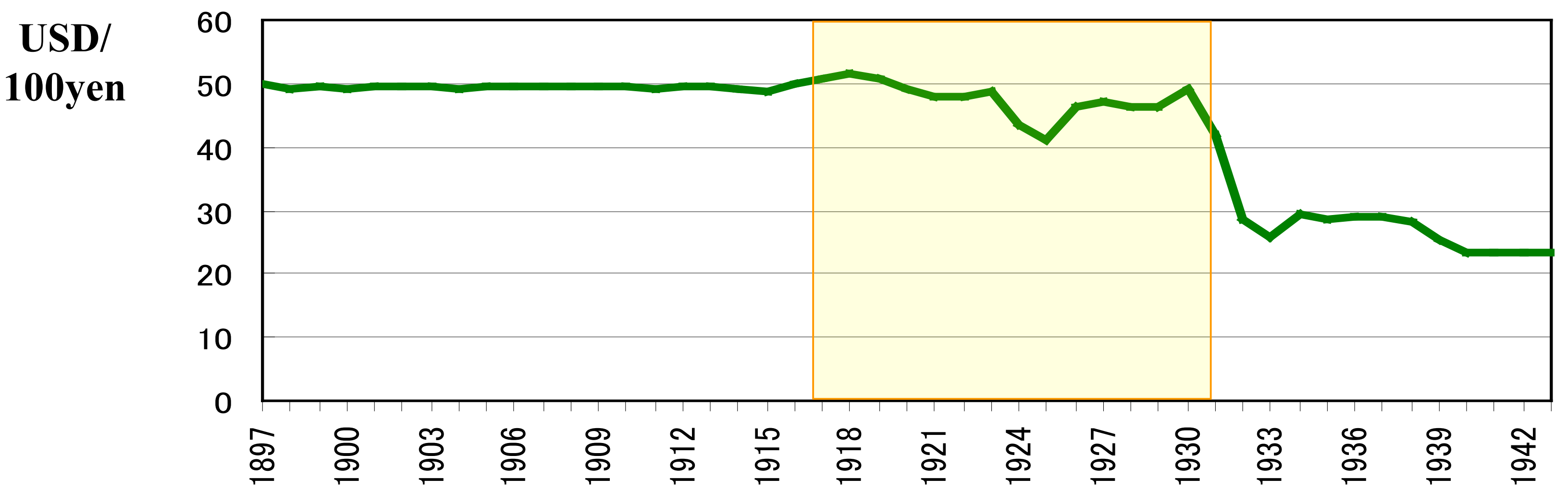
1/ Business dependency on BOJ rescue measures

2/ Political connection became important in obtaining rescue

"Easy rescue in 1920 led to the ballooning of banks' bad debt, but authorities continued to avoid needed business restructuring for fear that they would be criticized of previous inaction or a subsequent shock. This became the "Cancer in the Business Community." The government could not cure the cancer and invited the brutal natural force, namely the Great Depression, to solve the problem." (Takahashi & Morigaki, 1993, p.77)

Two More Blows to Japanese Economy

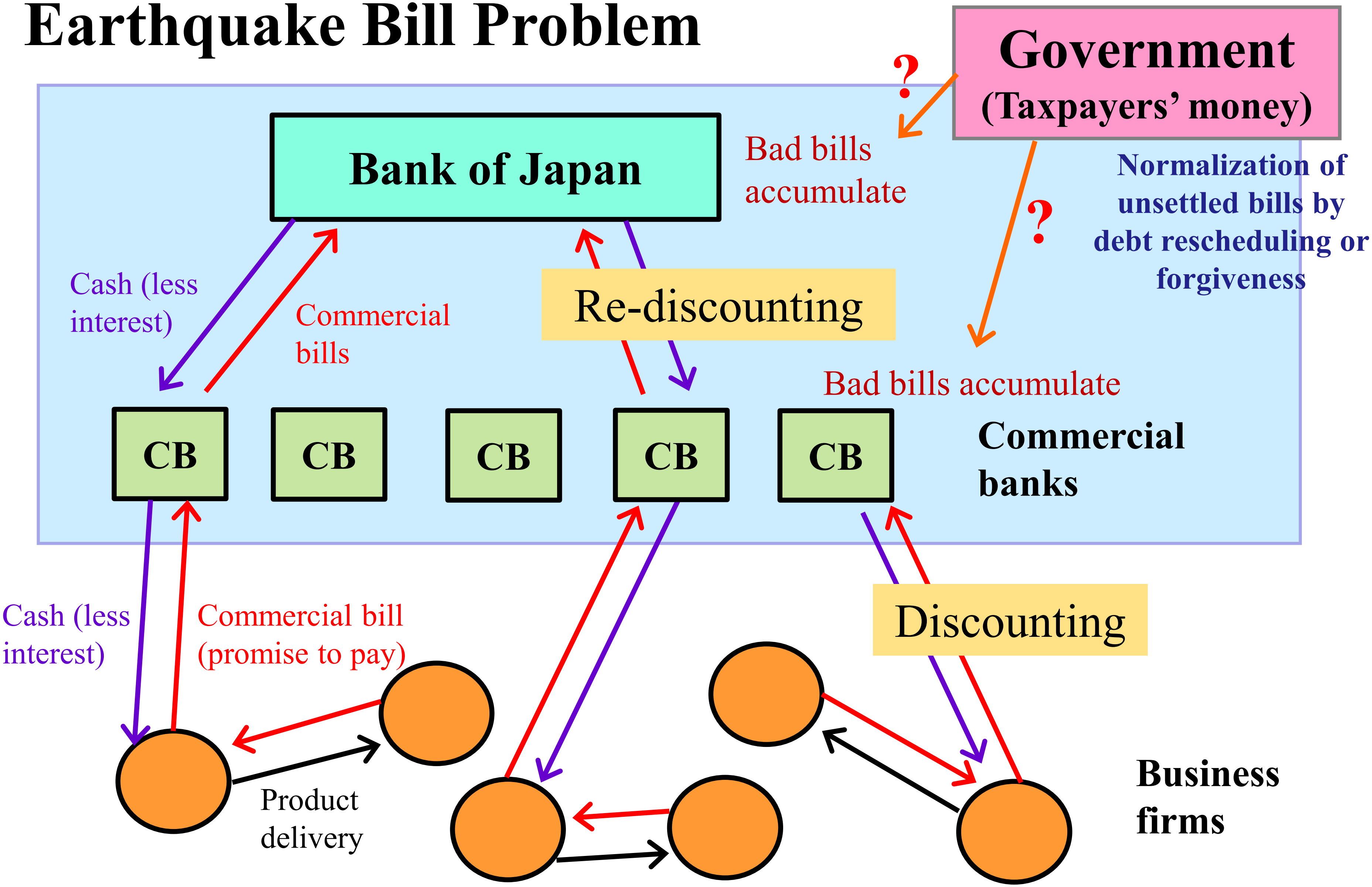
- **Great Kanto Earthquake, 1923**
  - 100,000 dead; 200,000 houses burnt or destroyed
  - Loan recovery problem, deposit withdrawal and credit freeze
  - Earthquake bill problem emerged (see next two slides)
- **Yen Fluctuation, 1917-1930**
  - People blamed currency speculators (big businesses and foreign exchange traders)
  - Agreed policy goal was "Return to Old Parity" ($1=2 yen), for which business restructuring and tight budget were considered necessary



Earthquake Bill Problem

- In normal business, the buyer writes a promissory note to the seller promising payment after 3-6 months. This bill is often taken to a commercial bank for immediate cashing (“discounting”). Commercial banks may also take it to the central bank (“re-discounting”).
- To prevent liquidity freeze, the Bank of Japan re-discounted bills without quality check in quake-affected areas. Some banks and firms took advantage of this and cashed bad debt unrelated to the earthquake.
- BOJ thus accumulated bad debt (431m yen, of which 100m yen was deemed unrecoverable). Commercial banks also held unsettled bills.
- Government proposed two Earthquake Bill Acts:
  (i) 100m yen forgiven (Government provides bonds to BOJ)
  (ii) Max 170m yen rescheduled (commercial banks borrow from government for ten years, receive repayments from the issuers of the bills to pay back this debt; government bonds used as collateral)
- In the parliamentary debate in early 1927, the opposition Seiyukai Party criticized the Kenseikai government for bailing out big businesses and political friends. Facts were gradually revealed, and the size of BOT-Suzuki debt shocked the nation.

Earthquake Bill Problem



Inability to Repay: Two Types

There are two types of inability to repay which are fundamentally different and require very different solutions.

Liquidity problem—out of cash temporarily; if the lender waits long enough the money will be paid back (budget constraint is secure)

➔ Solution: **debt rescheduling** (delayed payments)

Solvency problem—unable to pay now or in future; waiting will make the problem worse (budget constraint is breached)

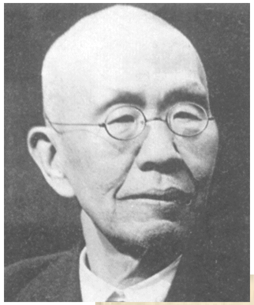
➔ Solution: **debt forgiveness** (cancellation)

- However, it is usually difficult at the outset to tell whether the problem is illiquidity or insolvency. It is customary that lenders first assume (less serious) illiquidity but later insolvency has to be admitted. Solution normally proceeds from debt rescheduling to debt forgiveness.
- Solution to the earthquake bill problem, including the Suzuki-BOT bad debt, assumed both types of inability to repay.

The Bank of Taiwan & Suzuki Shoten

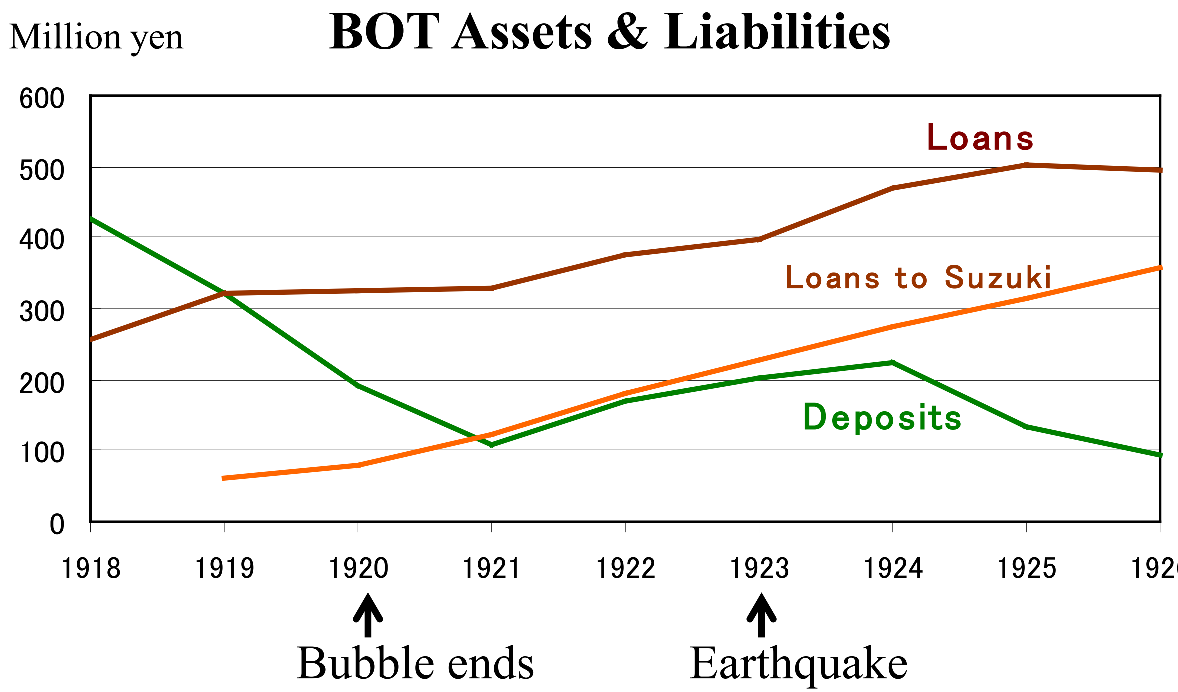
- The Bank of Taiwan was a semi-official bank serving as the central bank of colonized Taiwan as well as a commercial bank extending business loans.
- Suzuki Shoten was a Kobe-based trading company which rose rapidly through speculation in steel, wheat and ships during WW1, temporarily surpassing even Mitsui and Mitsubishi. Kaneko Naokichi was its aggressive manager.
- Suzuki had a close business tie with Taiwan via camphor and sugar trade. The Bank of Taiwan financially backed Suzuki's global activities.
- When the export boom ended, Suzuki's business went sour and bad debt mounted. The Bank of Taiwan was forced to support Suzuki, its top customer, by refinancing loans. As it was later disclosed, Suzuki and BOT were responsible for 48.4% of total unsettled earthquake bills followed by the Bank of Korea (10.4%), Murai Bank (7.4%) and Omi Bank (4.5%) at end 1926.
- In March 1927, BOT finally refused to refinance Suzuki in the hope that the government would bail them out—BOT and Suzuki were too big to fail.
- But the Bank of Japan refused to help BOT, in order to protect its political independence and financial soundness. This shocked the nation and caused nationwide bank runs.

Suzuki Shoten & Bank of Taiwan



Kaneko Naokichi,
Suzuki manager

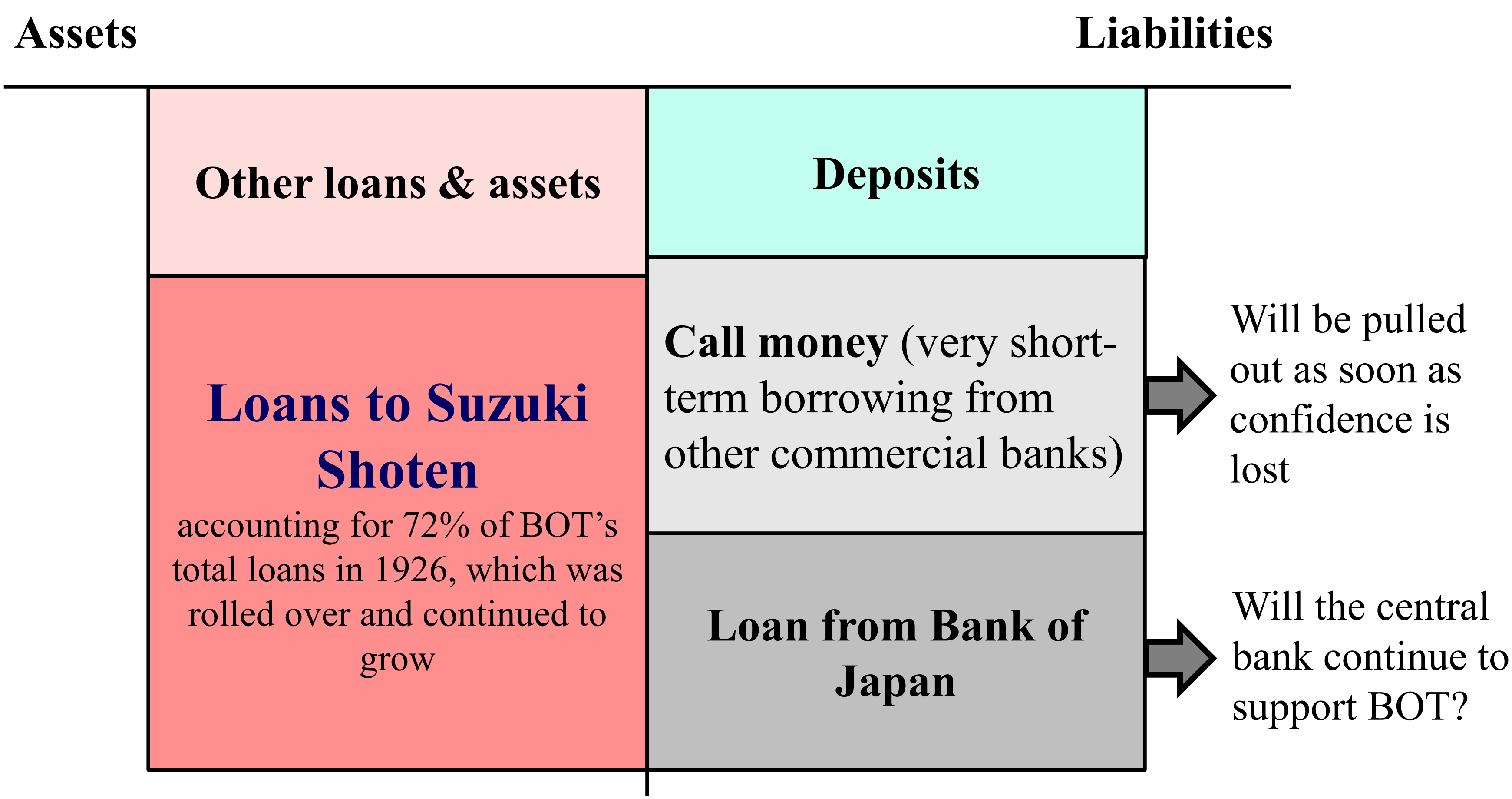
Suzuki Shoten



- During WW1, Suzuki expanded greatly with speculative trade in steel, ships, wheat, etc. It became the top trading firm in Japan.
- After WW1, Suzuki faced a debt crisis. It was the largest customer for BOT, so BOT was forced to roll over Suzuki's bad debt (*Kusare En* = undesirable relationship which cannot be ended).
- Both BOT and Suzuki expected government to eventually rescue them because they were "too big to fail" (moral hazard problem).

Balance Sheet of the Bank of Taiwan

(1926, just before the banking crisis)



On the asset side, loans to Suzuki dominated.

On the liability side, normal deposits were few; there was heavy reliance on short-term borrowing from other commercial banks, which could be withdrawn at any moment, and loans from the central bank.

How to End Crisis (when bank runs occur)

- Finance Minister Kataoka was blamed for the slip of tongue which started the initial wave of bank runs. But the crisis was structural and unavoidable with or without Mr. Kataoka.
- When bank runs got worse, newly appointed Finance Minister Takahashi ordered a banking holiday and temporary payment moratorium which calmed market psychology. Banks returned to normal after three weeks when the moratorium was lifted. His crisis management was appropriate.
- A number of commercial banks disappeared through closures and mergers. The government injected liquidity and set minimum capital requirements to enforce restructuring. People shifted their deposits to larger and seemingly safer zaibatsu banks.
- Bank supervision and prudential regulation were weak to nonexistent in the 1920s, and there was no deposit insurance against bank failure. Today, financial monitoring and rescue mechanisms are more developed though still imperfect, nationally and globally.

Earthquake Bill Problem

Proposed Rescue Measures and Parliamentary Debate

- The Bank of Japan accumulated bad debt by rediscounting earthquake bills (worth 431m yen, of which 100m yen was deemed unrecoverable). Commercial banks also held un-rediscounted bad debt.
- Government proposed two Earthquake Bill Laws:
  (1) 100m yen forgiven—government gives bonds to BOJ
  (2) Max 170m yen rescheduled—commercial banks borrow from government for 10 years; they should receive payments from businesses to pay back this debt over time; government bonds used as collateral
- Parliamentary debate in early 1927
  - Seiyukai Party (opposition) criticized and questioned the political intention of Kenseikai government (bailing out big business friends?)
  - Bad debt data was gradually revealed, BOT/Suzuki bad debt was reported, and the size of the problem shocked the nation.

Bank Runs in 1927

First Wave (March)—Finance Minister Kataoka misspeaks: "Tokyo Watanabe Bank went bankrupt today."

Second Wave (March)—The Bank of Taiwan refuses to make any more loans to Suzuki, which shocks the market.

Third Wave (April)—The Bank of Japan refuses to rescue BOT; the Privy Council (advisory body of the emperor) rejects an imperial edict that aimed to protect BOJ assets; Without BOJ help, BOT closes. Nationwide bank runs spread.

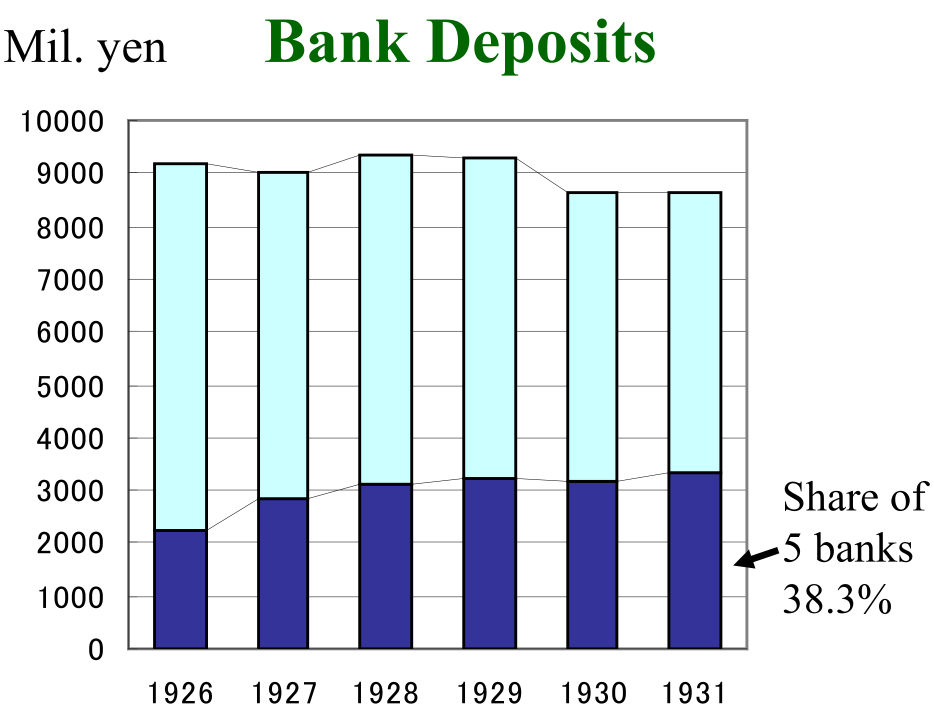
Government response

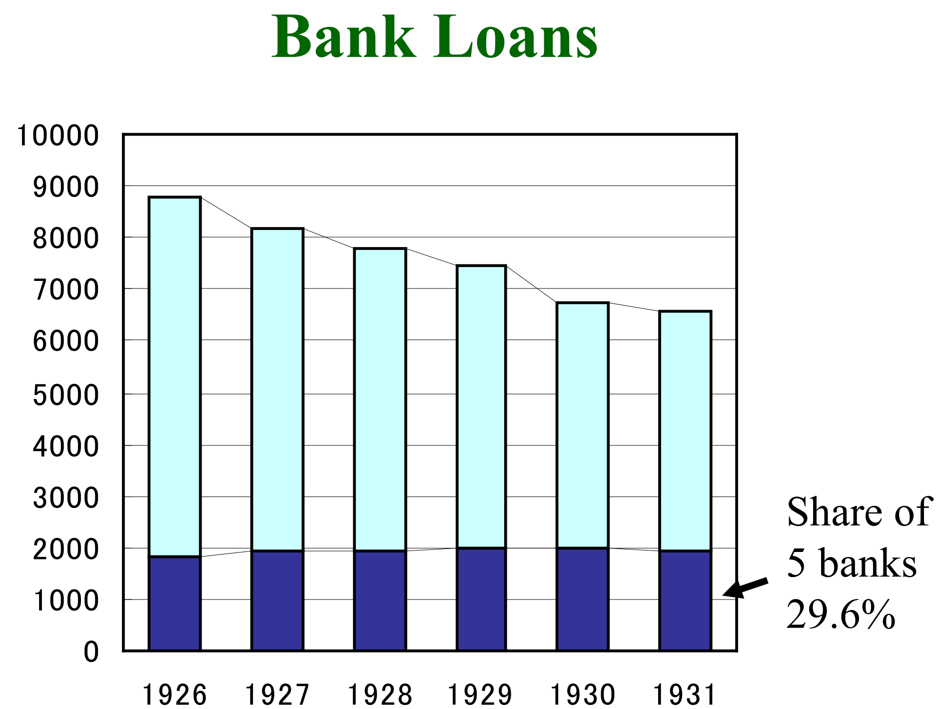
- The Wakatsuki Cabinet (Kenseikai Party) falls and is replaced by the Tanaka Cabinet (Seiyukai).
- New Finance Minister Takahashi immediately imposes bank holidays and a three-week moratorium on debt repayments (Apr.22- May 12), which calms market psychology and ends bank runs.

Finance Minister
Takahashi Korekiyo

Aftermath of the 1927 Banking Crisis

- 36 banks closed (but the Bank of Taiwan survived). One year later, they were reopened (15), merged (8), bankrupted (5) or in restructuring process (1).
- Depositors at failed banks could recover on average only 50-70% of their savings; there was no deposit insurance.
- Special laws were passed for liquidity injection and Bank of Japan loss compensation (max. 500m yen). This created a liquidity glut, lower interest rates and a bailout of unrecoverable debt at certain banks.
- The financial sector was shaken and the banking sector was restructured. But real growth and the manufacturing sector were not affected very much by the bank runs. The bigger shock would arrive a few years later (the Great Showa Depression).





- Five largest banks were Mitsui, Mitsubishi, Sumitomo, Daiichi and Yasuda.
- Depositors shifted their money to larger banks, leading to excess liquidity and low interest rates.
- Deposits and loans at small rural banks shrank, causing shortage of small business loans.

Possible Causes of Financial Crisis

1. **Unregulated domestic financial institutions**

   The lack of proper regulation, monitoring and safety measures may generate reckless lending by banks and other financial institutions.

2. **Mismanagement of the post-bubble economy**

   The collapse of artificial boom/bubble leads to financial losses, bad debt, impaired balance sheets, etc. The problem snowballs if government does not quickly eliminate bad debt and firms.

3. **Government overspending**

   Excessive government spending and/or monetary expansion causes fiscal and balance-of-payments crises and an external debt problem.

4. **The volatility of foreign private money**

   Under financial liberalization, a country may overborrow from foreign private sources (bank loans, bonds, equities) which may quickly reverse if the situation turns unfavorable.

Supplementary Note: A New Macroeconomic Problem under Financial Globalization

Japan's 1927 banking crisis was purely domestic. Today's financial crisis can occur from both domestic and global reasons.

- In 2007-08 and 2010-11, global commodity inflation and high capital mobility generated large capital inflows to many emerging and developing economies.
- Receiving too much foreign money relative to GDP causes inflation, consumption boom, construction boom, property speculation, asset bubbles, etc.
- In a financially integrated world, many developing countries are prone to the cycles of excessive capital inflows, overheating, and currency overvaluation.
- This is a new macro management problem different from the traditional one caused by fiscal and monetary expansion.

Foreign Fund-driven Overheating & Bubble

Many countries faced this problem around 2005-08:

Large export earnings from extractive resources ("Dutch Disease" "Curse of Natural Resources")

Russia, Kazakhstan, Mongolia, UK, Nigeria, Zambia, South Africa, Botswana, Mauritania, Angola…

Other large inflows ("Curse of Foreign Money" such as export receipt, remittances, FDI, ODA, military aid, bank loans, stocks & bonds, etc.)

China, Vietnam, UAE, UK

Large foreign capital inflow (up to 20-30% of GDP)
➔ Increase in money supply & bank credit
➔ Consumption & construction booms, asset bubbles, inflation, trade deficit, currency overvaluation, rise in foreign reserves
➔ **Reversal:** Collapse in domestic demand and currency as foreign funds are suddenly and massively withdrawn