Since 1995 several revolutionary changes have been observed in Japanese financial markets, and also the steady decline in the health of its banking system. This decline began with the bursting of the asset bubble, leading to a serious crisis in April 1997, when gross domestic product and industrial output posted their first decline. Moreover, several problems for the banks surfaced in 1992 and a decade-long slump caused considerable disruption in the flow of credit to business firms. Given the very large size of Japanese banks, this crisis had deep implications for the global economy. During the 1980s, the economy posted a growth of 5 per cent on average, as well as the stock and real estate market being in a boom, fuelled by expansive monetary policy and huge lending by the banking sector. The tightening of monetary policy by the BOJ in mid-1989 to slow down overheating was crucial, leading to a slump of stock and real estate prices. In autumn 1989, a falling market for Japanese equities, when the Nikkei 225 index fell from 38,900 in October 1989 to less than 13,000 and the Dow-Jones index boomed from 2400 in 1989 to more than 10,000. Hence Tokyo, by market capitalization in 1989 still the largest stock exchange in the world by ¥385 trillion, fell to rank third behind New York and London.

Moreover, during the decade, the number of foreign companies quoted on the Tokyo stock exchange declined and the total number of companies quoted was unchanged, but the New York stock exchange showed an increase of 45 per cent.

While most of the underlying causes – excessive asset growth in the boom times, weak corporate governance and regulatory forbearance when the system is under stress – are typical of a banking crisis in general, the Japanese banking crisis serves as a warning that such a crisis can befall a robust and sophisticated financial system. The crisis
shows that the cost associated with such a crisis can be considerable. Beyond the fiscal cost associated with the restructuring of the banks (about 12 per cent of GDP already allocated by the government), the banking crisis was responsible for stagnation of the Japanese economy in the 1990s.¹

Several observers suggested that, because of the importance of credit channels in the economy, the weakening of the banks reduced the effectiveness of loose monetary policy. Recently Kanaya and Woo have argued that weak corporate governance and regulatory forbearance stifled any incentive for meaningful restructuring of the banks and their corporate borrowers.²

Against the background of a spiral of deflation, the Japanese financial sector began to suffer during early 1990. It is true that the licensed banks extended only 20 per cent of their total loan book to the real estate and construction sectors; about 80 per cent of total loans were secured by real estate collateral. Against all the odds, Japanese banks managed to tackle the increased pressure for disposal of their problem loans.³

**The bubble economy and after**

The Japanese microeconomic environment during the second half of the 1980s recorded above-trend economic growth and near-zero inflation that led to a significant decline in the country-risk premium and upward adjustment in growth expectations and also fuelled rapid credit growth during this period.⁴

In the second half of the 1990s, acceleration in financial liberalization and deregulation, consisting of relaxation of interest rate controls, started with liberalization of term-deposit rates in 1985, as a result of the pressure from the US government and capital market deregulation, lifting of prohibition on short-term Euro-yen loans to domestic borrowers in 1984, gradual removal of restrictions on access to the corporate bond market and creation of the commercial paper market in 1987.

Relaxation of restrictions on permissible activities of previously tightly segregated institutions included the raising of different types of lending ceilings; for example, agricultural, fishery and credit cooperatives saw an increase in their lending ceilings to non-members.

The MOF gave the following rationale for its deregulation programme:

The financial system forms the base of an economy. In order to maintain Japan’s economic vitality as its society ages in the 21st century,