

Crisis Resolution and Credit Allocation: The Case of Japan

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How Do Banking Crises Affect the Real Economy?

■ Credit Crunch

- Banks fail to make all +NPV loans → worsening business downturn
- US 1930s & 1990s

■ Forbearance (“Evergreening”)

- Banks fail to cut back on -NPV loans → lengthening business downturn
- Japan in 1990s

■ Both are stories about bank loan **supply!**

What are possible causes of credit crunches?

■ Moral Hazard

- Reductions in firm net worth lower ability to commit to work hard
- Reductions in bank net worth lower ability to commit to monitor (Holmstrom and Tirole, 1997)

■ Regulation

- BIS risk-based capital requirements & cost of raising new equity

■ Supervision

- Over eager bank supervisors force banks to reduce risky lending

Where will we likely see effects of credit crunch?

- Risky firms
 - Where regulation & supervision effects largest
- Small firms
 - Where bank monitoring most relevant
- Poorly capitalized banks
- Evidence in the U.S. consistent with these predictions

What are causes of “Evergreening”?

■ Agency Problems

- “Crony capitalism”: Connections between bank managers and borrowers
 - In Japan: cross shareholdings, main bank, Keiretsu links
- Failure to maximize bank shareholder wealth
 - In Japan: ownership of the bank, governance, regulation

■ Weak Supervision

Where would we expect to see effects of “Evergreening”?

- At firms connected to banks
 - Main bank, keiretsu, family connections, etc.
- At banks that are poorly governed
 - Ownership structure
 - Political & regulatory connections

Findings

- Among first-section Tokyo firms:
 - Loan growth *positive* from 1992-98: 4.2%
 - But slow, especially for *surviving* firms.
- No correlation between loan growth and firm profit or leverage
- No correlation between loan growth and bank profit or risk

What is going on in Japan?

- Is there evidence of a loan supply shift?
 - Hard to say from these results
 - No identification strategy is described (in contrast to Peek and Rosengren, 2000)
- Three demand related reasons for lending to change during downturns
 - Risk increases during downturn → higher loan demand
 - Investment decreases → lower loan demand
 - Cash flow dries up → higher loan demand

Possible Identification Strategies

- Compare loan growth for keiretsu v. otherwise similar non-keiretsu firms
- Compare loan growth for well-governed vs. poorly governed banks
 - Example: Hanazaki, Souma & Wiwattanakantang: Japan banks where top 3 owners are other financial institutions:
 - Loan growth higher at entrenched managers during both boom and bust
- Test whether loan growth reflects a firm's political or regulatory connections

Conclusions

- Japan offers further support for the importance of banking to real economy. Implications for:
 - Long-Run Growth
 - Stabilization (What is Monetary Policy Transmission?)
 - Regulation & Supervision (Tough or easy during downturn?)
- Future research questions:
 - When should we worry about credit crunches?
 - When should we worry about evergreening?