The Secretary of the Treasury

July 27, 1995

NOTE FOR LARRY SUMMERS

FROM: BOB RUBIN

Tim's analysis is, in my view, very good. I think we've done everything we can do to try to affect this situation.

Attachment

[redacted]

95-148454

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

UNDER SECRETARY

July 26, 1995

To: Larry Summers
From: Bob Rubin
Tim's analysis is, in my view, very good. I think we've done everything we can to try to affect this situation.

MEMORANDUM FOR SECRETARY RUBIN

FROM: Lawrence Summers
Under Secretary
(International Affairs)

SUBJECT: Update on Japan

This memo takes stock of what we have done about our concerns over the unfolding economic crisis in Japan.

Efforts to Convey Concern to the Japanese. We have on numerous occasions communicated our concern about economic prospects and the state of health of the banking system, most notably at the Halifax G-7 Summit in June.

1. At your meeting with Japanese Finance Minister Takemura in Halifax, you emphasized the need for Japan to take aggressive action to address its economic problems.

2. At your request, I underscored your concern with my counterpart at the time, Vice Minister Nakahira.

3. You also expressed your concern in meetings with Minister Takemura in Bali (on the edges of the April APEC Ministerial) and in Washington (May), and in your May meeting with a Diet delegation.

4. I chaired meetings of Working Party 3 of the OECD (consisting of high-level economic policy officials from the 11 major industrial countries, including Japan) in March and July 1995. At these meetings, the outlook for Japan was the centerpiece of the discussion, with the health of the banking system receiving special attention at the July meeting. By the time of the July meeting, the concern was widespread among the group's participants, and the Japanese delegation said that they would take the message of concern home with them.

5. We have avoided public criticism of Japanese policy, but on several occasions in our public statements both you and I have noted the weakness in activity in Japan and the need for strong policies in order to gain the confidence of markets.

[redacted]
Classified by Timothy Geithner

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Authority:
Date: 4/30/08

<u>Effort to Gain Information</u>. In light of the complexity of the issues involved, we have made special efforts to improve our information base.

1. We sent Deputy Assistant Secretary Timothy Geithner to Japan in July to review developments and assess prospects in meetings with the public and private sector. (See attachments for more detail.)

2. You asked the Comptroller of the Currency to review exposure of major U.S. banks to Japan and Japanese borrowers.

3. Treasury staff has stepped up its informal contacts with private sector analysts. They have reviewed all available analysis, and prepared forecasts and scenarios with an emphasis on downside risks to the Japanese outlook. The outlook was discussed at an interagency meeting hosted by Treasury.

<u>Efforts to Brief the Administration</u>. We have been pro-active in ensuring that Administration officials are aware of our concern.

1. At your request, I participated in a NEC meeting with representatives of State, the Federal Reserve, CEA, and the NSC to discuss implications of the current crisis.

2. In more general terms, I have briefed members of the Administration on risks associated with Japan in a number of meetings over the last few months.

3. You met with John Deutch, and I met with Richard Cooper, to get their insights and request their input into the magnitude of the Japanese banking problem and the practical leverage we have to encourage change.

<u>Efforts to Press Others to Remain Alert to Situation</u>

1. We have met with Chairman Greenspan, Vice Chairman Blinder and New York Fed President McDonough. I understand that Chairman Greenspan subsequently raised the issue within the G-10 and, privately, with his Japanese counterpart.

2. You have discussed the issue with Michel Camdessus.

3. You have instructed the U.S. Executive Director to the IMF to express our concern in the context of Board meetings on World Economic and Market Developments (WEMD) and the July Article IV Board review of the Japanese economy.

4 Treasury staff has met with Federal Reserve staff to share assessments of banking system developments.

cc: attachments

[redacted]
Classified by Timothy Geithner

DECLASSIFIED BY TREASURY DEPARTMENT
Authority:
Date:

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

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July 13, 1995

MEMORANDUM FOR LAWRENCE SUMMERS
JEFF SHAFER

FROM: Timothy Geithner

SUBJECT: Japan

Here's a summary of my meetings in Tokyo with the Finance Ministry, the Bank of Japan, and a number of private economists and analysts.

1. There is deep pessimism about the outlook for the real economy. Output fell in the second quarter, and although it looks likely to come back a bit in the third and fourth quarters, even the relative optimists (including the BOJ) expect very little growth if any over the next 18 months.

   - Consumption is being hurt by low nominal income growth, employment insecurity, and the adverse effects on confidence of the fall in land and equity prices. (Some analysts put the broad measure of actual unemployment now above U.S. levels.)

   - Net exports are expected to be a substantial drag on demand, with imports continuing to grow remarkably rapidly despite the weakness in demand, and export growth slowing in response to the yen's appreciation and the deceleration in the United States.

   - Private investment is now growing again, but the pace is slow and it's not clear why it should be sustained given the outlook for exports and domestic demand.

   - Housing investment has not yet responded to the fall in interest rates, and may be held back by consumer pessimism and the negative wealth effects of the Nikkei's fall.

   - Public investment fell off in the first part of the year, and is only expected to get a modest boost from the supplemental budget approved in April.

   - Prices are now falling across the board.

These developments leave the economy vulnerable to a further contraction or deflationary spiral, but all but a very few analysts still expect Japan to bump along at the bottom for a while, rather than falling into the "black hole."

2. Despite the recovery in the equity market over the past several days, there is still a lot of unease. Most think that land prices have considerably further to fall and that the stock market is still wildly overpriced.

3. Fears that the yen might rise further have faded somewhat, and the general sentiment is more positive about the dollar, but all this is still tentative.

   - There is no evidence yet that the major institutional investors are beginning to move back into dollar assets. They are still sitting on a huge mountain of cash invested in the call money market at rates below one percent.

   - There is a growing sense, however, that these institutions may be on the verge of raising their dollar holdings.

     o With guaranteed returns to policy holders now set at between four and five percent, they face huge pressures to increase yield, with no yen based alternatives.

     o The share of foreign securities in total assets has now fallen to very low levels -- seven vs 15 percent at the peak.

     o In the wake of last week's rate cuts and intervention, the press is proclaiming a new era of monetary cooperation between the U.S. and Japan, encouraging a sense of protection against the risks of further yen appreciation.

4. The authorities are very concerned about the banking system, but believe they can get through it with a combination of gradual write offs and a case by case, gradual approach of forced mergers/consolidation and selective liquidation for those institutions that will not make it, drawing on official resources as necessary.

   - MOF and the Bank of Japan are confident that the core of the system, the 21 national banks that account for 60 percent of banking assets, are in sufficiently strong shape to gradually absorb the current stock and expected growth in non-performing assets.

     o This will take up to five years for some, less for others. Two (Long-term Credit Bank and Hokkaido Takushoku Bank) are in much worse shape than the others, but will still make it.

   This assessment, according to the authorities is not dependent on a rapid recovery in demand or a rise in stock prices above 15,000. Earnings are sufficiently strong that liquidity is not a problem, provide there is no precipitous cut in credit lines by foreign financial institutions or substantial withdrawals of deposits. The Bank of Japan says it will do whatever is necessary to stand behind these institutions.

- The rest of the banking system, 130 banks and 5000 credit unions and cooperatives, is in comparatively worse shape overall and with pockets of institutions that will not remain viable.

  - o For these institutions, the authorities expect to adopt a case by case approach of forced mergers, the liquidation of bad assets, and the transfer of whatever viable business remains to other financial institutions.

  - o In this model, shareholders will be forced to absorb a considerable hit, and a combination of official and private resources will be used to cover the gap between outstanding deposits and the remaining assets. For at least the next five years, the Government has committed to make all depositors whole. Despite a Y10 million limit on coverage by the deposit insurance system.

- The Bank of Japan believes the likely cost of the effort will be high -- perhaps between 10 and 20 trillion yen. (They declined to provide a more precise estimate.) This cost exceeds what they are willing or able to finance on their own balance sheet, but there is no political consensus yet on the use of tax payer financed resources.

  - o The BOJ is now preparing with the Finance Ministry legislation that would expand the amount of assistance they are able to provide in specific cases and to relax the conditions on which they can do so.

- The MOF and the BOJ acknowledge the risk of a crisis and they fear the consequences of another failure before they have the political consensus and legislation in place to support a program of forced mergers and resolutions with public money. But, they believe these risks are manageable.

  - o Foreign financial institutions have begun to reduce they exposure to Japanese banks and have reduced the maturity of their credit lines, in some cases to overnight exposure only. The BOJ says this has not yet occurred to a degree that has caused significant problems.

  - o There has been some movement of deposits out of the banking system into postal savings accounts, but no general flight to quality within the banking system. In those cases where reports of vulnerability at individual institutions have led to withdrawals of deposits, the moves have been short-lived, contained, and generally reversed.

- This general assessment is shared by the best of the private, independent analysts. Even those that place the estimate of non-performing loans higher than the Finance Ministry's recent Y40 trillion estimate, believe the 21 national banks can absorb the problem over time and that the authorities will be able to contain the risk of a significant crisis resulting from weakness in the rest of the system.

5. The policy response to these developments is still in doubt, but there is some evidence a more aggressive approach will emerge this fall, after the upper house election and the formation of the new cabinet.

- Some in the Finance Ministry and many private sector economists believe monetary policy will move again in the fall, with another 50 to 75 basis point cut in official interest rates. Bank of Japan officials also believe they have room for another cut, but they did not say when or if they would use it.

- There will be another supplemental budget this fall, with estimates ranging from four to ten trillion yet in public investment spending and perhaps some tax measures.

- The Finance Ministry is in the process of preparing a set of specific administrative changes to encourage institutional investors to move back into dollar assets. Among the steps they are considering are changes in the solvency ratios that apply to insurance companies and require a haircut on foreign, but not domestic government securities, and the so-called "15 percent rule."

- The Ministry is considering tax changes to revive the stock market, including a temporary suspension of the securities transaction tax and the removal of the current disincentive for companies to buy back their own shares, which would help absorb the selling pressure from the continued unwinding of cross shareholdings.

- The Finance Ministry is also looking at steps to liquify the real estate market, including securitization and some tax changes.

- The MOF and the BOJ are working together to develop the specific proposals in the banking system outlined above. They have formed an advisory group to help build the political consensus in favor of some use of public resources and expect to have a detailed plan with legislation in place this fall.

It is not clear whether this activity will produce the more forceful policy response that many believe is necessary. MOF and the BOJ display a much greater sense of urgency and concern than they have in the recent past. The political leadership seems in favor of action, and Koichi Kato, the most likely candidate to replace Finance Minister Takemura, has advocated in public a more aggressive response to the banking problems. The authorities no

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longer claim they can simply wait for recovery and growth out of there problems.

On the other hand . . . . MOF and the BOJ both have little faith in the efficacy of macroeconomic policy in the current environment. Their approach to the banking problems may be too incrementalist and evolutionary to prevent the problems from remaining a constraint on a meaningful recovery. The political transition may continue to constrain more aggressive action, even if the bureaucrats unify in favor of a solution. The focus of current activity in the MOF on administrative efforts to boost the stock market and push the yen down reflect a disturbing tendency to view the current problems as no deeper than an overshoot of the exchange rate, which once corrected will precipitate a virtuous circle of stock price recovery, improved confidence, and a recovery in demand.