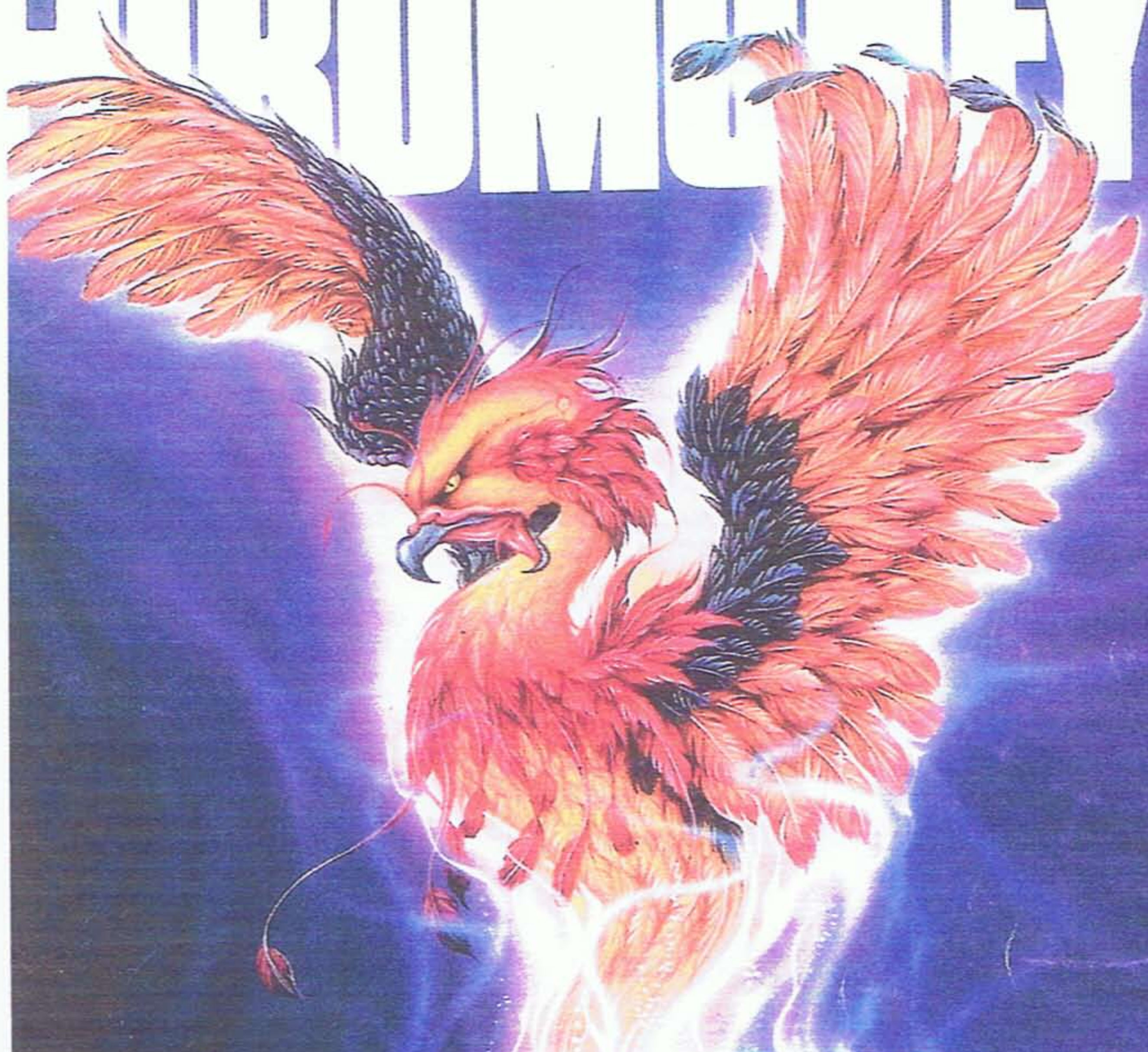
SEPTEMBER 1987 / SPECIAL IMF WORLD BANK ISSUE

EUROMONEY



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THE BIRTH O[illegible] MARKET

WHY JAPANESE BANKS ARE SHAKY

THE WORLD'S WORST FINANCE MINISTER

AFTER THE CRASH OF 1989

1983

1986

EUROMONEY

The journal of the world's capital and money markets.
Euromoney Publications PLC,
Nestor House, Playhouse Yard,
London EC4V 5EX
Telephone: 01-236 3288
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Reed Publishing International, 205 East 42nd Street, New York, NY 10017. Telephone: (212) 867 2080. Annual subscription $144
US Editorial Office: 205 East 42nd Street, New York, NY 10017. Telephone: (212) 867 2080.

Euromoney is published monthly (ISSN 0014-2433) by US mailing agent: Mercury Airfreight International, Ltd, 10 B Engelhard Avenue, Avenel NJ 07001, USA.
Second class postage paid at Rahway, New Jersey.
Postmaster: Send address corrections to: *Euromoney*, c/o Mercury Airfreight International, 10 B Engelhard Avenue, Avenel, NJ 07001, USA.

Typeset by Christie Typeset (UK) Ltd., Bristol and printed in the UK by Presscraft (Hartlebury) Ltd, Nr. Kidderminster, Worcs.

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EDITORIAL

HUMPTY DUMPTY MOVES TO TOKYO

What goes up must come down and banks are no exception. Those that shine brightest are precisely the ones most likely to come crashing down. In the US, for example, Continental Illinois and the rapid rise and fall of a posse of Texan banks have proved that. The next accident may be in Tokyo.

Some of the shining Japanese banks appear, on close inspection, to be rather fragile: they are fragile mountains of assets, some of them dubious, piled on tiny capital bases. In the first feature article in this special IMF edition of *Euromoney*, deputy editor Eamonn Fingleton documents headlong lending for speculation in the equity and real estate markets – Continental Illinois all over again, except that there it was oil and real estate. The most telling detail comes from Tokunosuke Hasegawa, a former Japanese government official, who runs the Research Institute of Construction and Economy. He revealed that some banks had been lending real-estate investors more than 100% of the cost of the buildings securing the loans. "The situation is now very dangerous," he said. Last month's slight downgrading of some Japanese banks by American rating agencies is another straw in the wind.

In the great scheme of things, the collapse of one or two respected names in Tokyo may not matter very much – the financial system has survived failures before. Nevertheless, there are important policy questions here for bank regulators in Europe and America. The Federal Reserve and the Bank of England have been forcing their charges to increase their capital in recent times. Meanwhile, the Japanese regulators have allowed Tokyo banks to operate on very thin capital ratios: the argument that the Japanese banks have large hidden reserves may be spurious. These low capital requirements have not only permitted the Japanese banks to lend recklessly at home, but also left them free to suck up business overseas, because they can offer cheaper money than their western counterparts. The Japanese took more than 20% of all new lending in Europe last year and have come to dominate markets such as sterling lending to UK local authorities.

The response of the Fed and the Bank has been to nag the Japanese about raising their capital ratios in an attempt to level the global banking playing field. There are also proposals for a supranational regulatory body: Salomon Brothers economist Henry Kaufman recently suggested an international board of overseers for major financial institutions and markets.

Perhaps the Japanese will respond to pressure: Bank officials say the Japanese are beginning to accept the principle of harmonisation. But there is another possible outcome. It may well be that Japanese authorities will continue to allow – and perhaps even encourage – the rapid growth of Japanese banks and other financial services companies. The Japanese know that once borrowers and other sorts of customers are lured away from western banks, many of them will never return. They also know that if a Tokyo bank fails, Japan Inc can be rallied round for a rescue operation, just as Yamaichi Securities was rescued in the 1960s. That would be costly and embarrassing, but the damage to western competitors would remain. The Fed and the Bank of England may be better advised, therefore, to stop talking sweet reason to the Japanese and, instead, begin providing government support for their own banks.

JAPANESE CAPITAL IS NOT WHAT IT SEEMS TO BE

Japanese banking will stay sound, if stock and real estate prices never come down. By Eamonn Fingleton

Brian Quinn, chief banking supervisor at the Bank of England, has a neat metaphor for recent tensions in international banking. "We are in a football game where the Japanese keep score by different rules. Other people count the number of times they score a goal; the Japanese count how often they kick the ball."

His point is that the Japanese have maintained their traditional devotion to asset growth long after US and European banks, battle-scarred from heavy write-offs, have narrowed their focus to profitability. He might have added that the Japanese banks have sometimes not been choosy where they have kicked the ball. Some of their lending has ended up in strange places, such as helping speculators to buy Tokyo real estate at anything up to 10 times Manhattan prices.

Measured in dollars, assets of the Japanese banks have more than doubled in the past three years. Even measured in terms of the superstrong yen, Japanese banks' assets have soared by more than 40%.

The banking community abroad, which has watched the Japanese take a market share of more than 20% of lending in Europe last year, has so far been more awe-struck at their confident push into unfamiliar terrain than concerned that they might be biting off more than they could chew.

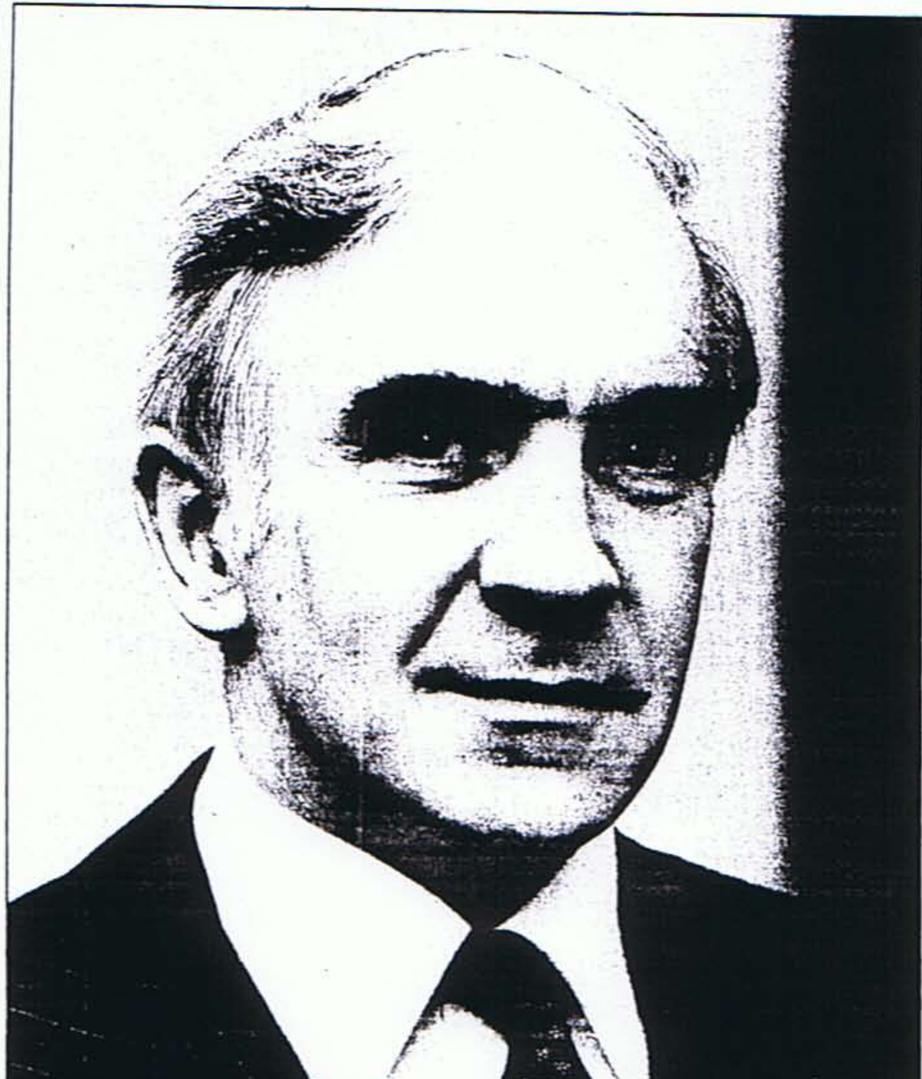
As the Japanese have stretched their capital ever more thinly, that may be changing. A recent multilateral drive to enforce common capital adequacy ratios around the world was originally supported by US and UK competitors as an expedient to handcuff the Japanese; now it is looking increasingly like a merciful attempt to deprive the Japanese of the rope with which they might ultimately hang themselves.

As the Japanese have become more and more aggressive, an increasing number of observers have been wondering how the banks would hold up to a sustained financial crunch in Tokyo.

Johsen Takahashi, chief economist at the Mitsubishi Research Institute, observed that the strain might prove unbearable. He explained: "Although we don't feel that real-estate lending alone can threaten the banks, in combination with several other dangerous factors, such as the volatile stock market, it might cause problems.

"We have to bear in mind that the banks have also been hit by losses in US bonds and problems with Latin American borrowers. Meanwhile interest rates have been going up, which could cause problems for many borrowers. The total situation is certainly looking more and more unstable."

At first sight, the Japanese bankers' claims that their capital ratios are more than adequate look convincing. Most of the big commercial banks – known as the city banks – are sitting on impressively large unrealised capital gains on their stock investments, so that they are not nearly as undercapitalised as the crude equity ratios suggest. Official



Brian Quinn, at the Bank of England: "Other people count the number of times they score a goal; the Japanese count how often they kick the ball."

figures are not available on portfolio gains, but informed observers in Tokyo reckon that marking to market would take the industry average equity ratio from the published figure of about 2.5% to well over 10%.

One analyst reckoned that, in the case of Dai-Ichi Kangyo Bank, the ratio of equity to total assets would rise from 2.9% to 13%, if portfolio gains totalling about $20 billion were included in. Even if, as Japan's ministry of finance has suggested, only 70% of unrealised gains were included, Dai-Ichi Kangyo's ratio would be about 10% – super-strong by the standards of banks in other countries.

Whether 70% would be conservative enough, however, is hotly debated in Japan and abroad. Gerhard Hinterhauser of Deutsche Bank Capital Markets in Tokyo pointed out that realised capital gains were subject to tax, and by factoring this in one wiped out about 50% of the so-called "hidden reserves". At the Bank of England, Quinn argued: "Reserves should be free of tax obligations. Otherwise they should not be called reserves."

But Itsuo Murakami, a general manager at Dai-Ichi Kangyo, maintained that capital gains tax was not relevant, because the only time the portfolio gains would have to be realised would be when a bank was in severe financial difficulties – and in that case, the realised capital gains would be offset by losses elsewhere.

Quinn argued for further caution on the grounds that most of the stocks concerned were not trading assets, because they were held as part of long-term relationships with key corporate customers. Thus a bank could not realise its potential capital gains without damaging its basic banking business.

Akio Mikuni, president of the Tokyo bond rating agency, Mikuni, agreed. He pointed out that, in the past, when banks have needed to realise capital gains to bolster the balance sheet – for instance, after the collapse of a major customer – they have usually felt the need to buy back the holdings within a short time of selling.

In effect, the holder does what in British financial jargon is called a "bed-and-breakfast" trade, an artificial transaction in which a holding is sold for the minimum period necessary to count as a disposal for legal purposes.

To Mikuni, this is a clear indication that the holdings are a prerequisite for their corporate banking business and that unrealised gains cannot be regarded as being available to meet sudden losses. "Apart from window-dressing the balance sheet, the only thing accomplished by realising gains is to utilise tax losses," he said.

He maintained that another factor making permanent disposal unthinkable was Japan's system of interlocking shareholdings. A major corporate customer in many cases owns shares in its main bank. If a bank permanently disposes of a holding it therefore risks losing the company not only as a customer but as a shareholder. He suggested that, if banks started unwinding their stock positions in customer companies, it would unleash a tidal wave of competitive stock selling that would devastate Tokyo's traditionally high stock valuations.

Even in the absence of a system-wide collapse, an individual bank would drive down the price against itself if it wanted permanently to dispose of a holding – and with stocks in Japan on price-earnings ratios of 60 or 70, the floor is a long way down. Fears of how substantial blocks of shares would fare on the open market probably explain a phenomenon noted by Roger Taillon, a managing director of international finance at Standard & Poor's. He reported that often the bed-and-breakfasting procedure involved selling the holding to another bank with an undertaking to buy it back at market within a few months.

Mikuni feared that the banks might get caught up in a dangerous self-feeding cycle. He said: "Because the Japanese banks regard unrealised gains as hidden equity, they are encouraged to extend their balance sheets. If they continued to lend in this way, directly or indirectly a lot of the money would find its way to the stock market, driving up share prices. Thus the banks would think they had more hidden equity and lend even more money. I wonder what would happen if, later, we got into a downward spiral of falling stock prices and contracting bank lending."

Mikuni added that the stock-price cycle was only part of a syndrome of danger for the Japanese banking system. He was one of the early critics of the bank's role in the recent Tokyo real-estate boom, and his scepticism has now been vindicated by a Bank of Japan pronouncement admonishing the banks for over-enthusiastic lending to property speculators. As he pointed out, the banks' exposure to real estate also has a self-feeding mechanism, but in a slightly different way.

"The banks feel reassured because of high real-estate prices, so they are prepared to back the next borrower who wants to buy an expensive piece of real estate. What the banks do not stop to consider is that the high

real-estate prices are largely a reflection of their previous liberal lending policies."

Tokyo real-estate prices are breathtaking. Tait Ratcliffe, president of the Tokyo financial consultancy firm IBI, pointed out that office rents in central Tokyo exceeded ¥50,000 a month per *tsubo* (the Japanese unit of area). That is equivalent to more than $120 a year per square foot – about three times the rent for equivalent space in Manhattan.

More worrying for the stability of the banking system, Tokyo developers are prepared to invest in projects with returns as low as 2%, compared with the returns of between 5% and 10% that developers in other countries expect. The result is that new space in Tokyo's choice business districts is valued at 10 times or more the Manhattan equivalent. As one foreign banker in Tokyo commented: "The only thing supporting this market is the banks' continued willingness to believe these prices are for real. The Japanese banks are talking to themselves."

Even more than in other bull markets, billions are staked on continued liquidity and confidence. At the Harvard Center for International Affairs, a research associate, Akira Arai, pointed out that a rush by foreign securities houses and banks to expand in Japan had been a major factor in pushing up rents in Tokyo's business districts.

Mikuni said that developers who accepted an initial yield of 2%, when long-term interest rates were about 5%, were betting that the continued appreciation of property prices would make good their revenue shortfall. One thing is clear: hopes that rents will quickly rise to close the gap are folorn, because tenants are protected by an elaborate system of rent controls.

Another worrying feature is the way that the stock market and real estate booms have fed off each other. Speculators have been borrowing against appreciated property values to play the stock market, and vice versa. An economist in Tokyo pointed out that some banks were prepared to advance 75% or more of the value of securities used as collateral and, in the past at least, had not always asked embarrassing questions about how the money would be used. If the excess liquidity were sapped – either by a trade war or by a sudden upturn in investment in plant and equipment and other productive assets – stocks and real estate could falter together, putting an unprecedented strain on banks' capital ratios.

The extent to which borrowed money has been fuelling Tokyo's stock market boom is difficult to determine. Margin debt, as officially measured, amounts to ¥3.9 trillion – representing a mere 1% of the Tokyo Stock Exchange's capitalisation. That looks unremarkable, compared with New York. But the float in Tokyo represents a much smaller proportion of total capitalisation than in the much deeper NYSE.

Much of the borrowed money feeding the Tokyo boom does not show on the surface;

Akio Mikuni, president of the Tokyo bond rating agency: "Because the Japanese banks regard unrealised gains as hidden equity, they are encouraged to extend their balance sheets."

it comes, for instance, from consumer credit companies, whose total lending has been soaring by about 30% a year in recent years. One consumer credit company, Family Shinpan, recently reported that, in the year to September, about 70% of its money was being used to finance stock purchases. If that ratio applied industry-wide, the consumer credit companies would probably account for ¥1.7 trillion of new money going into the stock market last year, equal to 0.3% of market capitalisation.

The city banks have also been feeding the boom. Precise figures are not available, but the situation was so worrying recently that the Bank of Japan ordered the banks to restrain this kind of lending. Takahashi of the Mitsubishi Institute reported that the city banks were exposed indirectly as well as directly, because they had become a major source of funds for the consumer credit companies.

The banks' lending in the real-estate area probably dwarfs anything they have been doing in stocks. The trend, according to Ratcliffe of IBI, is doubly troubling; the banks have not only extended their exposure dramatically in an industry whose insidious charms have often in the past led other countries' bankers astray, but in doing so they have also driven up real-estate prices to unrealistic levels for their own borrowers.

There is another danger. The banks have been propping up many near-insolvent industrial companies on the grounds that they possess vast hidden assets. In most cases, the assets are unrealised gains on land and buildings the companies own.

The trend has gone so far that Kimio Miyaoka, president of the shipbuilding giant Nippon Yusen, has flouted the Japanese tradition of not rocking the boat by publicly criticising the banks. He accused them of using their apparently bottomless purses to finance expansion by weaker companies in the ship-building industry. "We can cope with competition from other shipbuilders," he declared. "Our problem is that we are competing with the banks."

As for the flow of bank funds into real estate, Sadaaki Hosoya, an economist at the Bank of Japan, pointed out that such lending accounted for 46% of all bank lending in the first quarter of 1987. In addition, the banking industry pumped trillions of yen into residential property.

An unquantifiable amount of lending in other categories was keyed to real-estate values – many of the loans to the shipping, shipbuilding, steel and textiles industries, for instance, were probably in this category.

At Kleinwort Benson in Tokyo, Simon Smithson pointed out that the banks' lending on residential property had been increasing

remarkably for several years. He cited figures showing that in the five years to March 1986 their total exposure grew on average by about 18% a year. For the city banks, the growth was 23%. In the year to March 1987, city banks' housing loans rose by 31% to ¥11.9 trillion – representing 7% of total loans outstanding. Saitama had the biggest exposure (10.3%), followed by Kyowa. Mitsui had the lowest at 6.1%.

Consequently, house prices have more than doubled in the past two years in the Tokyo area. A cramped three-bedroom dwelling, an hour and a half from the centre costs $400,000. Prices of $1 million are commonplace for houses that, in other cities, would be thought merely comfortable. Some analysts brush aside suggestions that such prices are dangerously out of touch with reality, maintaining that space has always been at a premium in the world's most populous metropolitan areas. But more sober observers look at the demand side of the equation.

The ability of people to pay such high prices is a function of credit, and banks are prepared to advance sums that would be considered in other countries to entail dangerously high debt-service costs. Many employees receive mortgages amounting to up to five times their annual income. In addition, they probably borrow from a credit company or from family sources to make up the balance of what they need for a house purchase. The most sinister thing about the arrangement is that no one in Tokyo thinks that the five-times multiple – which compares with a multiple of about three times annual salary in England – is excessive.

Bankers exhibit a degree of complacency that some foreign observers find shocking. One Japanese banker commented: "Debt-service should not be a problem, because Japanese interest rates are low. Anyway, house prices have always risen in Japan."

Japanese bankers admittedly have some reason to be nonchalant, because the life-time employment system has traditionally ensured that, with salary increases later in his career, an employee can easily pay off debts that once seemed towering. But, as workers in some basic industries have discovered, life-time employment has started to crumble – leaving an increasing number of mid-life executives with mortgage problems.

Takahashi, a noted pessimist about Japan's economic prospects, argued that the huge flow of funds into real estate was a consequence of recent unhealthy economic conditions. The high yen has discouraged more productive use of investment funds, such as installing new plant and equipment.

Speaking before the recent Bank of Japan directives to the banks to curb real-estate lending, Takahashi reported evidence that the real estate boom might have passed its peak. He predicted that the proposed reform of Japanese agriculture would add to downward pressure on real-estate prices, by bringing more land on to the market.

If Tokyo's property bubble bursts?

Will the great Tokyo real estate bubble lay low the Japanese banking system? Doom-mongers in Tokyo certainly have plenty to feast on. Two essential ingredients for financial disaster are present: the real estate industry has clearly been pumped up to giddy heights of folly, and the banks have a much greater exposure to risky real estate lending than appears from the crude statistics.

In the opinion of some observers, the only thing that will avert disaster is an adroit, eleventh-hour intervention by the Japanese government along lines similar to its handling of a financial crisis in the early 1960s (when the entire establishment pulled together to support collapsing stock prices and thereby rescued Yamaichi Securities). For the moment, the smart money in Tokyo is betting that though progress will be painful, and some real estate speculators will go to the wall, in the end the establishment will stave off a system-wide collapse.

It is certainly clear, as thoughtful people in Tokyo have observed, that something has to give way. Hiroshi Takeuchi, managing director and chief economist of the Long-Term Credit Bank of Japan, was among many observers who pointed out that high real estate prices threatened to sap entirely the Japanese economy's fabled resilience. He said: "Soaring land prices are suffocating the economy. With land selling for ¥30 million (about $216,500) per square metre, there is no way any company – be it a department store or whatever – can break even on an investment like that." Taking a homely example familiar to Tokyo residents, he calculated that a noodle shop on a newly purchased site would have to charge ¥1,500 for a simple, no-frills bowl of noodles – more than twice what the market will bear at present in central Tokyo.

He added that Japan's inept land policies were largely to blame for a stunning economic irony that although the Japanese now had the highest per capita GNP in the world, in some respects their living standards lagged behind countries only a fraction as wealthy. Citing Japanese living costs that were three times as high as in the US, he said: "The Japanese salaried worker in Tokyo does not even live as well as his Korean counterpart in Seoul. Yet South Korean per capita income is only one-seventh of the Japanese figure. The average worker in Seoul has a nice house with about twice as much room as the Tokyo worker has and, even though Seoul has a population of about 10 million and only four subway lines, the average commuting time is only 40 to 50 minutes. By contrast, an hour and a half commuter journeys are not uncommon in the Tokyo area. Though

A cramped three-bedroom house an hour and a half from the centre of Tokyo costs $400,000.

South Korea still lags behind Japan in industrial capacity, it has a far greater capacity to implement a land and housing programme effectively."

The main impetus for change will probably not come from the long-suffering Japanese consumer, however. As one foreign banker in Tokyo observed: "The consumer does not count in Japan, and the newspapers and politicians openly espouse the causes of vested interests against the public good. In a country where the contraceptive pill, for instance, has been suppressed by the medical profession to protect the abortion industry, the real estate issue just does not have a chance. It is too complicated, and there are just too many vested interests who control what is printed in the press."

The Japanese press has certainly been playing an odd role in the debate. As one analyst pointed out, opinion leaders in Tokyo seemed completely unable to understand even basic economic mechanisms, and refuse to acknowledge that the crux of the matter is an artifical shortage of development land coming on the market.

Editorials in the press and pronouncements from politicians advocate policies that add further to the shortage and seem almost deliberately calculated to push real estate prices even higher. Newspapers and politicians have, for instance, been waging trench warfare against proposed land sales by the Japanese National Railways organisation, one of the biggest land-owners in central Tokyo.

In a latter-day variation of the custom of

Continued from page 62

chopping off the messenger's head for bringing bad news, the establishment argues that land sales should be blocked because the prices would be too high. The *Asahi Shimbun*, one of Japan's most influential newspapers, commented: "It is said that the Japanese National Railways Accounts Settlement Corporation intends to sell several plots of choice land in the centre of Tokyo. This is unthinkable. If the former residence of the JNR president, for instance, is placed on the market, the price would by ¥40 million to ¥50 million per tsubo (3.3 square metres) and would serve only to promote spiralling land prices. It is no wonder that the metropolitan government fiercely opposes the sale of this land."

In many cases, government policies have been perverse. An example is a recent move to "curb" land prices by raising the tax on short-term gains in real estate transactions. Gains realised within two years of purchase will now be subject to a tax of 94% – up from 84%. As one real estate analyst pointed out, the only effect of the tax would be to encourage even more land hoarding. The new rate comes in next year.

Such back-handed props to land prices are not likely to prevail for much longer, particularly in light of the way that US and other foreign governments are shaping up for a long drawn out fight on trade friction. As many economists in Japan and outside recognise, one way to act against Japan's bloated trade surplus would be to stimulate the local economy. But, first, Japan's land mess has to be untangled, for high land prices have thrown a monkey wrench into the normal mechanisms a government might use.

James Doherty, a real estate analyst at the Tokyo office of broker Jardine Fleming, reckoned that as much as 80% to 90% of government spending on such public works programmes as road-building sometimes went on land acquisition costs. Worse, the real estate owners who sell are encouraged by rollover-relief to reinvest their money in the dwindling stock of privately owned land available, adding yet another twist to the price spiral.

High land prices are also being seen as a direct cause of the trade deficit. Because the Japanese live in such cramped conditions, so the thinking goes, they have little room for affluent-society pursuits – so they save instead. Meanwhile the money they pay to buy or rent accommodation goes to wealthy landowners who have an ultra-high propensity to save. Thus Japan's savings rate remains above 20% – and money that might be used to import goods is remitted abroad instead as capital exports.

If the growing pressure to reduce land prices finally translates itself into an effective political movement, Japanese officials have plenty of effective tools at their disposal. Long-Term Credit Bank's Takeuchi pointed out that the supply of land could be increased at a stroke by a few small corrections in tax policy. He cited, for instance, a rule that exempted farmers from heavy taxes on land ownership (which has the effect of encouraging many owners in cities to hold on to vacant lots on the spurious argument that they were farmland). "If the government actually investigated the use of this land, they would find that it is not used for agriculture, and the owner would have to sell or pay higher tax," he said.

A noodle shop on a new site would have to charge ¥1,500 for a simple, no-frills bowl of noodles.

Meanwhile other idle lots in prime city areas are reclaimed waterfront or abandoned railway yards. And other landowners hoard under-used property simply because of Japan's swingeing taxes on sales of land.

He commented: "If all these sites were developed, there would be a rush of new building that could quickly meet the demand for office space. In fact, we might even end up with a glut."

Takeuchi emphasised that the supply of land could be increased without precipitating a dangerous crash in real estate prices. Other observers are not so sure. "If there is too much pressure, the authorities might be forced into uncoordinated action," said James Doherty. "Everyone – particularly Japan's critics abroad – must act with maturity and care."

For the Japanese banks, it will be a testing time. Their exposure is probably a lot greater than many bankers realise. There are few reliable figures on real estate lending because of definition problems. Bank of Japan figures widely bandied about in Tokyo suggest that a mere 11% of bank lending is for real estate. But some experts believe that in reality the banks' exposure is probably three times that – and one-third of it has been taken on in the past 18 months, a period when properties financed by bank credit changed hands at uniformly stratospheric prices.

Takeuchi agreed that on a broad definition of real-estate lending these figures were probably close to reality – after factoring in residential property and land mortgaged by troubled industrial companies that have recently needed credit to survive.

Looking simply at the narrow definition of real-estate lending, it is clear that the banks' role in driving up prices has been palpable. Simon Smithson, an analyst at Kleinwort Benson's Tokyo office, quoted figures showing that the banks' yen lending for real estate had been growing by more than 30% a year on average since 1982.

Loan officers have clearly been under such pressure to get money out of the door that they have not always worried about the niceties of textbook practice. Tokunosuke Hasegawa, a former government official who is now executive director of the Tokyo-based Research Institute of Construction and Economy, reported that in many cases banks had been so cocksure real estate prices would continue to be strong that they had financed 100% of the cost of a speculator's purchase. Not only that, they had advanced the money for commissions, registration tax and in some extreme cases his first interest payments. "There are no limits to speculation because when the land buyer is not putting up money of his own he doesn't have to take any risks," he said. "Financial institutions are fanning that speculation by unbridled, irresponsible lending. The situation is now very dangerous."

Hasegawa calculated that a 30% fall in real-estate prices would be a disaster for the Japanese financial system. He said: "You must realise that our entire credit system depends heavily on real estate as collateral. A fall in real estate prices would have very far-reaching effects."

Other analysts calculated that in the event of a financial squeeze that knocked stock market prices and cut the value of land by 50%, the entire system would clearly be insolvent. A fall of that magnitude in an economy as regulated as Japan's is probably preventable. But the cost of preventing it might prove almost as bad as the disease: what may have to give way is Japan's recent world-beating record in controlling inflation.

If things do turn choppy, it will embarrass the big American rating agencies. Belatedly, Moody's has announced plans to review its ratings, but as we went to press it was maintaining triple-A ratings on eight out of 14 Japanese banks it covers. Even Standard and Poor's has triple As on two Japanese banks.

Ernest Napier, an analyst at Standard and Poor's, commented that the Japanese banks had a history of prudence. He added: "There would be a problem only if they all hit trouble together – but we don't think that is going to happen." He reported that, on a visit to Tokyo in May, he discovered that Japanese banks were well aware of the need for care in the real-estate area and were taking precautions.

Roger Taillon said: "We are not concerned to justify the loans to the real-estate industry. What matters is the likely impact on the banks if there were trouble, and we are confident they would hold up well."

He pointed to the banks' unrealised securities gains as a cushion that would see them through any problems. Under a formula that averages stock prices over three years and deducts a 50% imputed capital gains tax charge, Standard and Poor's takes between 30% and 40% of the unrealised gains into account in equity ratio calculations. "That is still a very sizeable sum," Taillon commented, adding that it produced equity ratios of about 8%.

"On that basis the Japanese banks are as well capitalised as the best British or American banks. If you use 70% of their unrealised gains, they are as well capitalised as the Swiss banks."

Of 16 major Japanese banks rated by Standard & Poor's, 14 are given short-term ratings of A-1fi and two given A-1. On the long-term side, Norinchukin and Industrial Bank of Japan have AAA ratings while Sumitomo and Misubishi have AAfi; no bank is rated below AA. Taken as a whole, these ratings are probably the best for any major country's big banks.

Foreign competitors privately maintain that these ratings exaggerate the stability of the Japanese banking system. The issue touches a sensitive nerve. Japanese banks have funded their breakneck expansion in overseas markets on funds gathered locally and have had minimal recourse to capital exported from Japan. International assets of Japanese banks rose from $518 million to $1,118 million in the three years to December 1986; that gave them a 33% market share, which compares with only 23% three years before.

Clearly the perceived stability of the Japanese banking system has been a major help in expanding abroad. According to Tomas de Hora, counsellor for finance of the EC delegation to Tokyo, the Japanese banks are believed to account for as much as 30% of all deposits in Europe this year, up from around 20% two years ago.

The Japanese have combined their advantage in credit perception with their low cost

Real estate is seen clearly by bankers as a much hotter potato than has been acknowledged in the Japanese press.

of capital to undercut heavily local competition in foreign markets. Moody's Investor Services calculated that they earned only about 0.4% on their American assets – a return that appeared unacceptably low to American banks, whose average was more than twice that. Clearly that gives them an edge in pricing, particularly in products that put demands on the capital adequacy of American banks.

"They can look at anything and underprice the competition," said Walter E Hoadley, senior research fellow at the Hoover Institution.

Some Japanese bankers maintained that they were entitled to operate with lower capital ratios than other countries' banks because of Japan's unique banking structure. Dai-Ichi Kangyo's Murakami pointed out that the Japanese authorities have demonstrated in the past their willingness to support troubled banks.

This argument won short shrift from the Bank of England's Brian Quinn. He said: "If you take this argument to its logical conclusion you might say the Japanese banks don't need any capital at all because they have implicit government support – and I don't think anyone is saying that. If capital is needed it should be the right amount of capital – and, if we are to have fair internationalisation and a level playing field, all the banks should conform to the same adequacy requirements."

Some foreign competitors are particularly indignant about the Japanese expansion because of Japan's refusal hitherto to acknowledge clearly the damage to its banking system from Latin American loan losses. On this issue, as in the case of other sensitive issues touched on in research for this article, American and British banks firmly declined to be quoted. (Japanese banks are important customers and partners in day-to-day international banking activities, particularly in the Euromarkets.)

But the critics' thinking was reflected i comment from Quinn, who said: "T American banks are now provisioning ve substantially for LDC debt, typically abo 20% to 25%. In Britain, Nation Westminster has provided 29%, Midla 27% and Lloyds 31%. That leaves t Japanese very poorly provisioned. Und Japanese regulations, they cannot provi more than 5%, and they qualify for tax rel on only 1½%."

One analyst calculated that if the Japane banks' provisions matched those of t American and British banks, their equi would fall by nearly $10 billion – reduci their equity-capital ratios by more than on third of a percentage point on average.

One bright spot is that, whatever they ha done in the past, Japanese bankers no implicitly acknowledge the seriousness of t situation and are clearly working behind t scenes on damage control. Standard & Poo analyst Ernest Napier reported that on a vi to Tokyo in May he found Japanese banke already very conscious of the need to cu lending to the real-estate sector.

From its own contacts with Japane bankers, *Euromoney* also received evidenc of this in a backhanded way: althoug they are normally very open to requests f interviews, no bank contacted on the subje of real estate was prepared to discuss its ow exposure directly for the record – a obvious indication that real estate is se clearly by bankers as a much hotter pota than has been acknowledged hitherto in th Japanese press.

The full realisation of the problem ma explain why regulators in both the US an Europe have found Japanese officials an bankers surprisingly receptive to the call fo strengthened capital ratios.

The EC's de Hora said: "My thinking that although the Japanese are continuing resist the idea that a single ratio should appl worldwide, they will accept the need fo reserve guidelines."

Brian Quinn commented: "We have bee quite encouraged by the response from th Japanese. We had been worried that the would argue we were trying to put th Japanese banking system into a straitjacke In the event, they are accepting the princ ple of greater harmonisation, and they hav said so more publicly than we expected.

As foreign observers noted, the recent rus by Japanese banks to raise equity capital also a clear sign of the times. Banks th announced plans to issue shares or conve tibles over the summer included Dai-Ic Kangyo, Fuji and Sumitomo. The tot amount to be raised was expected to com to nearly $7 billion.

Quinn commented: "I have asked Japanes bankers why they are raising capital, an they have said that it is because of the U and UK proposals on capital adequacy Then, he added: "Also, people say th Japanese banks are not as asset-hungry a they were six months ago."