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Yale Program on Financial Stability
Lessons Learned

Hiroshi Nakaso

By Maryann Haggerty

Hiroshi Nakaso joined the Bank of Japan (BOJ) in 1978, rising to deputy governor in 2013. He was instrumental in addressing Japan's domestic crisis of 1997 and its response to the Global Financial Crisis (GFC). He retired from the bank in 2018 and has since served as chairman of the Daiwa Institute of Research in Tokyo. This Lessons Learned summary is based on a November 2021 interview with Nakaso; the full transcript may be accessed here.

Crises often happen in stages, so it is very important to anticipate future stages and develop plans to address them.

Japan's financial crisis in the 1990s had its roots in the bursting of a real estate and stock market asset bubble, which revealed the bad loans and undercapitalization of Japan's banking system. Recovery was very slow, resulting in what's known as the Lost Decade—a protracted period of economic weakness. Nakaso says the official response to the Japanese financial crisis can be seen as occurring in three periods: "the period when we were behind the curve, the climax, and then the more systematic approach."

The first period began in 1994, with sporadic failures of smaller institutions. The climax came in 1997, especially in what's known as Dark November—when, in one month, four major financial institutions went under. "Dark November turned out to be a turning point in the sense that it proved to be a wake-up call as it became visible to lawmakers and the general public that there is in fact a serious crisis," he said. "The Japanese lawmakers, who had lagged behind, recognized the need to install necessary, much-needed legislative measures."

After 1997, Japanese policymakers "turned from defensive to offensive," he said:

> As the central bank, we deployed what may be called the "lender of last resort" function or emergency liquidity provision. . . . This lender-of-last resort function, as performed by the Bank of Japan, evolved, expanded over time beyond what was regarded as the traditional sphere for the lender of last resort as stipulated, so to speak, by Walter Bagehot a century ago. So, it was a continuous evolution or departure from the traditional notion of lender of last resort.
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> The tool that we missed the most was not necessarily something that could be deployed by the central bank, but was in the hands of the government. And that is, of course, capital injection using public money. This is something that we lacked until the later stage of the financial crisis. It was only in 1998, almost four years after the emergence of the financial disruption, when this capital injection framework finally was installed.

It is important to learn from the experiences of others and to discard your basic assumptions early to speed the crisis response.

Japan had few precedents to follow when facing its 1990s crisis. Smaller financial system crises have erupted over the centuries. But, Nakaso said:

> First of all, we were the first major economy to encounter a financial crisis of this size. Of course, you know there were banking crises—the secondary banking crisis in the UK or the S&L [savings and loan] crisis in the US—but they were mostly to deal with smaller institutions. We were the first to encounter a major collapse of major, big, internationally active financial institutions. And there were no textbooks, so to speak, or precedents from which we can get insights. So, what we had to do was to explore ourselves how to deal with the underlying problems and overcome the crisis.
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> So, it was kind of navigating uncharted waters. Of course, in retrospect, we should have actually focused more on the Nordic case. They had a major crisis involving big banks a little earlier than Japan, in the early '90s. But this is something we didn't pay enough attention to. We thought this was not something that's going to happen in Japan. We were focusing on small institutions. We were aware that problems were building up at smaller institutions like credit unions, credit cooperatives, but we were not necessarily focusing on larger banks because we thought, assumed, they were well capitalized. Of course, we turned out to be wrong.

That lack of precedents contributed to the slow response to the crisis, he said. Several other factors also came into play:

> First of all, I think the authorities tend to be caught by what may be called wishful thinking, assuming things simply cannot be that bad, particularly after a period of booming economy. . . . Not surprisingly, this is the same thing that happened to the US authorities 10 years after in dealing with the subprime loans. You might remember, initially, the US authorities were downplaying the significance of the seriousness of the problem. So, that is first.
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> And secondly, we lacked the mechanism . . . to capture the right size of nonperforming loans, which resulted in unfortunate delay in recognizing the seriousness of the problem. The absence of a capital injection framework using public funds until the later stage of the crisis was another factor.
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> And thirdly, why it took long. This is something that may be referred to as the cost of democracy. Particularly these policies dealing with problem banks encounter resistance from the general public or lawmakers, politicians. Very unpopular, always.

A bailout or merger is less costly than letting a bank fail, but sometimes other considerations come into play.

In 1997, Sanyo Securities failed; the government let it collapse. And that brought on a run in the interbank market. Other financial institutions failed soon after, including Yamaichi

Securities. In the Yamaichi case, the Bank of Japan provided liquidity support upon request from the government for a more orderly wind down and eventual liquidation. The crisis continued, though. Long-Term Credit Bank, a huge institution, failed in 1998. That was handled with an orderly resolution, rather than liquidation.

Nakaso recalled:

> By the late summer of 1998, we knew that the Long-Term Credit Bank was going to fail. Because of the sheer size of the bank, the legislators worked vigorously to make new laws to contain systemic disruptions. . . . Long-Term Credit Bank was the first bank to be nationalized under the Financial Revitalization Act. The Long-Term Credit Bank was judged to be insolvent. Therefore, first of all, the existing shareholders were wiped out before the government injected new capital. The residual loss was covered by the [Deposit Insurance Corporation of Japan]. In this way, the nationalized bank was able to continue to provide financial services without interruption. So, an entirely new bank was established. This was a very different approach from the conventional ways of dealing with a failed bank.

Initially, he said, authorities thought a merger could be worked out between failing Long-Term Credit and the healthy Sumitomo Trust Bank, with the government providing capital post-merger:

> Because we knew that making a bank go bust is more costly than a bailout merger. Bailout is less costly, because the capital may be recovered if the merger turns out to be successful in reviving the bank. Whereas if you let the bank go bust and nationalize the bank after cleaning up the balance sheet, you have to cover all the losses by using the taxpayers' money. And that money is not coming back. So initially, we were looking for a less costly solution, which was also possible under this new Revitalization Act.
>
> But legislators or politicians wanted justice to be done. Straight, stringent measures in order to penalize the Long-Term Credit Bank, which was managed very badly, understandably. That is why all the existing shareholders were wiped out and the management fully replaced. But in a purely economic sense, bailout was probably less costly.

Central bank tools must evolve to address the particular challenges presented by each crisis.

The lender-of-last-resort function of central banks has evolved over recent decades because of needs revealed during crises. Traditionally, central banks have acted as “lender of last resort” for banks that need liquidity to maintain stability. In Nakaso’s view, that function has evolved over the years. During the Japanese crisis, the Bank of Japan not only provided liquidity, the long-established function, but also injected capital into weak banks. In the Global Financial Crisis, other central banks further expanded their roles, he said:

In the GFC, the BOJ was joined by other major central banks, and together with them we further deviated from the traditional notion of the lender of last resort.

Namely, I think there could be three major areas that major central banks, along with the BOJ of course, expanded the role of lender of last resort. One is provision of foreign currency. From our perspective, dollar liquidity. So, in this case, because the dollar is the key currency used in trade and financial transactions, the Fed became the key lender of last resort. And the swap lines . . . functioned very effectively, meaning that other central banks provided dollars they borrowed from the Fed in their own jurisdictions to satisfy the demand for dollars in their own markets, particularly by big internationally active banks. So, this is something we call a global lender of last resort, which is unprecedented. The traditional notion is that a central bank takes care of its own banks in the home jurisdiction, with loans denominated in its own currency. But global lender of last resort was different in the sense it provided dollar liquidity instead of their own currencies. So, global lender of last resort is one thing.

The second one is what we call the market maker of last resort, which means that the central banks intervene in the markets that have become dysfunctional. We saw in the GFC that some markets were disrupted, losing market functioning. Be it government bonds or CPs, corporate bonds. Some of these market segments became dysfunctional in the early stage of the GFC. And also, in the early stage of the [COVID-19] pandemic. So, this is where central banks stepped in to perform as a market maker of last resort by purchasing the instruments, the markets for which have become dysfunctional. So, this is, again, another expansion of lender of last resort.

And the third category is the increased focus on the corporate sector. Lender of last resort traditionally meant to help deal with liquidity problems with the banking sector or, a bit more broadly, nonfinancial or nonbank sector. But after the GFC, many central banks focused on supporting corporate financing, directly or indirectly. For example, BOJ's Special Funds-Supplying Operation and [the European Central Bank's] TLTRO were facilities that back-financed, with favorable conditions, those banks that were lending to the corporate sector, particularly with a focus on [smaller and mid-sized firms], which had no credit channel other than the bank loans. Meanwhile, the Fed's Main Street Lending Program was, in my view, de facto direct lending by the central bank to corporate firms. So, these measures may be called expanded lender of last resort, as the focus shifted from banking to corporate sector.

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