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Resumen

Los bancos japoneses se encuentran entre los intermediarios financieros globales más grandes del mundo, con una presencia significativa en muchas regiones, particularmente en Estados Unidos y el sudeste asiático. Sin embargo, además de estar entre los bancos más grandes del mundo, los bancos japoneses tienen algunos de los problemas más grandes del mundo. Estudios recientes han encontrado que los bancos japoneses han reducido sus préstamos como consecuencia de estos problemas, y que esta reducción, a su vez, ha estado concentrada en sus operaciones en ultramar y ha afectado la actividad real en Estados Unidos. Las economías del sudeste asiático, con una amplia presencia de grandes bancos japoneses y mercados de capitales menos desarrollados que los de Estados Unidos, probablemente sean más severamente afectadas por cualquier retroceso significativo de los bancos japoneses. Adicionalmente, dados los recientes problemas en muchos países asiáticos, la medida de cualquier banco japonés de retirarse puede ser magnificada por los problemas del país huésped y el de origen. Este trabajo examina las actividades de los bancos japoneses en tres dimensiones. Primero, documenta la expansión y la etapa inicial de la reducción del crédito de los bancos japoneses en el sudeste asiático. Segundo, examinamos la respuesta de los bancos japoneses a los problemas en su país de origen, usando como ejemplo su comportamiento crediticio en el sudeste asiático. Evaluamos esta respuesta de los bancos japoneses relativa a aquélla en su mercado de origen y en Estados Unidos. Tercero, la respuesta de los bancos japoneses a los problemas en el sudeste asiático es luego comparada con aquélla de sus competidores de EEUU y de Europa.

Abstract

Japanese banks are among the world's largest global financial intermediaries, with a significant presence in many regions, particularly the United States and Southeast Asia. In addition to being among the world's largest banks, they have some of the world's largest problems. Recent studies have found that Japanese banks have reduced lending as a consequence of these problems, that this shrinkage has been concentrated in their overseas operations, and that this shrinkage has influenced real activity in the United States. Southeast Asian economies, with both a large Japanese bank presence and capital markets less developed than those in the United States, are likely to be even more severely affected by any major retreat by Japanese banks. In addition, given recent problems in many Asian countries, the extent of any Japanese bank retreat might be magnified by host country as well as home country problems. This paper examines Japanese banking activities along three dimensions. First, it documents the expansion and the initial stage of retrenchment of lending by Japanese banks in Southeast Asia. Second, we examine the response of Japanese banks to their problems at home, as exemplified by their lending behavior in Southeast Asia. We evaluate this Japanese bank response relative to that in their home market and in the United States. Third, the Japanese bank response to the problems in Southeast Asia is then compared to that of their U.S. and European competitors.

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Japanese Banking Problems: Implications for Southeast Asia

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During the late 1980s, Japanese banks substantially increased their global presence. In part the expansion was undertaken to help service Japanese companies that were increasingly involved in foreign direct investment. However, this expansion also can be attributed to Japan's position as the world's preeminent source of surplus capital. And because Japanese banks faced only limited foreign competition for domestic deposits, Japan's high saving rate provided them with large and growing volumes of low-cost deposits. The substantial rise in Japanese stock prices raised the value of the extensive cross-holdings of equity shares by Japanese banks, providing the increase in the bank capital base that supported their dramatic asset growth. This expansion catapulted many Japanese banks into the ranks of the largest banking organizations in the world, with Japanese banks accounting for thirteen of the world's fifteen largest banks in 1994.

While Japanese banks expanded quite dramatically worldwide, much of their rapid growth initially occurred outside of Southeast Asia.[1]

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1. For purposes of this paper, Southeast Asia is defined to include Indonesia, Malaysia, the Philippines, the Republic of Korea, Taiwan, Thailand, Hong Kong, and Singapore. Korea is included despite its different geographical location for ease of exposition. The offshore banking centers of Hong Kong and Singapore are considered separately from the other six Southeast Asian economies in the figures and tables.

The focus was on Japan's largest trading partners, such as the United States.[2] Another motivation for the surge in foreign lending by Japanese banks was to avoid Bank of Japan window guidance (Frankel and Morgan, 1992).

In the 1990s the lending focus of Japanese banks was redirected to Southeast Asia. As with the expansion in the 1980s in the United States, much of the initial expansion in Southeast Asian lending was to subsidiaries and affiliates of Japanese firms.[3] These firms increasingly were using the relatively low-cost labor in other Asian countries to maintain price competitiveness.[4] As the influx of foreign direct investment buoyed the economies of these countries, the Asian markets began to appear to be attractive lending markets because of their own expected rapid domestic growth, rather than just as sources of bank loans to Japanese affiliates that were using these countries as low-cost production platforms. Through the mid-1990s, Japanese banks aggressively expanded their lending to Southeast Asia, and by the end of 1997 they accounted for one-third of cross-border loans by foreign banking organizations to customers in Southeast Asian countries.

The recent economic crisis in Southeast Asia has called into question the future role of Japanese banks in the region. Their much-heralded difficulties with nonperforming loans in their domestic portfolios and the depletion of their risk-based capital ratios resulting from the dramatic declines in Japanese stock prices in the early 1990s have caused Japanese banks to decrease their foreign lending (McCauley and Yeaple, 1994). For example, Peek and Rosengren (1997, 1998) have found the decline in lending by Japanese banks in the

2. For example, from June 1986 to June 1990, total lending by Japanese banks in the United States increased by over $97 billion, according to U.S. call report data. In comparison, using the Bank for International Settlements (BIS) data for total cross-border claims, a broader category than the definition of loans in the U.S. call reports, the increase in Japanese claims in the set of six Southeast Asian countries that excludes the two offshore banking centers was only about $6 billion.

3. Several papers (Seth and Quijano, 1991, 1993; Nolle and Seth, 1996) have found that Japanese banks did initially appear to follow their customers abroad. However, they then typically expanded their customer base. For example, by the late 1980s Japanese banks operating in the United States had substantially broadened their customer base to include numerous domestic U.S. companies.

4. Goldberg and Klein (1998) discuss the sectoral and temporal patterns of foreign direct investment by Japan to Southeast Asia. They note that much of the investment was to the same industries that accounted for much of Japanese production in the early 1980s. This is consistent with outsourcing, frequently to subsidiaries, of goods that can be produced at lower cost abroad.

United States to be strongly associated with problems at the Japanese parent banks.

This paper examines the Japanese banks' response to home- and host-country shocks in Southeast Asia. The paper finds that Japanese lending in Southeast Asia appears to be far less sensitive to home-country problems than their lending in the United States. In fact, the pattern of lending to date has more closely followed trends in Japanese domestic lending than it has followed Japanese lending outside of Asia. However, as lending problems continue to swell and more restrictive disclosure rules are adopted, lending by Japanese banks to both domestic and Southeast Asian markets may be adversely affected. These problems could be compounded as Japan's "big bang" deregulation exposes Japanese banks to greater competition in their previously insulated domestic market (Gibson, 1998; Hanazaki and Horiuchi, 1998). Thus the continuing problems plaguing Japanese banks may impede the ability of the Southeast Asian economies to rebound from the serious domestic economic problems they currently face.

Section 1 of the paper examines recent patterns in the global expansion of Japanese banks and documents their organizational trends. Section 2 examines patterns of Japanese lending in Southeast Asia compared with their lending at home and in the United States. Section 3 examines the impact of Southeast Asian loans on problems at Japanese banks. Section 4 considers how Japanese operations in Southeast Asia compare with those of their banking competitors from Europe and the United States. Section 5 examines the penetration of Japanese banks in Southeast Asia. Section 6 draws conclusions and speculates on future trends in Japanese bank operations in Southeast Asia.

1. Recent Trends in the Global Operations of Japanese Banks

Table 1 illustrates the increase in the global importance of Japanese banks, based on the volume of assets measured in U.S. dollars. As recently as 1980, only one Japanese bank appeared among the ten largest banks in the world, although four more were among the five poised to enter the top-ten list. By 1988 Japanese banks accounted for all of the ten largest banks in the world, and by 1994 for thirteen of the top fifteen. However, shortly thereafter the tide ebbed: the

Table 1. Fifteen Largest World Banking Organizations, Based on Total Assets, Selected Years

	1980		*1988*		*1994*		*1997*	
Rank	*Name*	*Country*	*Name*	*Country*	*Name*	*Country*	*Name*	*Country*
1	Citicorp	United States	Dai-Ichi Kangyo Bank Ltd	Japan	Sanwa Bank Ltd	Japan	Bank of Tokyo-Mitsubishi, Ltd.	Japan
2	Banque Nationale de Paris	France	Sumitomo Bank Ltd	Japan	Dai-Ichi Kangyo Bank Ltd	Japan	Deutsche Bank, AG	Germany
3	Bank America Corp	United States	Fuji Bank, Ltd	Japan	Fuji Bank, Ltd	Japan	Sumitomo Bank Ltd	Japan
4	Credit Agricole Mutuel	France	Mitsubishi Bank Ltd	Japan	Sumitomo Bank Ltd	Japan	Credit Suisse Group	Switzerland
5	Credit Lyonnais	France	Sanwa Bank Ltd	Japan	Sakura Bank, Ltd	Japan	HSBC Holdings, Plc	United Kingdom
6	Societe Generale	France	Industrial Bank of Japan, Ltd	Japan	Mitsubishi Bank Ltd	Japan	Dai-Ichi Kangyo Bank Ltd	Japan
7	Barclays Bank Ltd	United Kingdom	Norinchukin Bank	Japan	Norinchukin Bank	Japan	Sanwa Bank Ltd	Japan
8	Deutsche Bank	Germany	Tokai Bank Ltd	Japan	Industrial Bank of Japan, Ltd	Japan	Credit Agricole Mutuel	France
9	National Westminster Bank Ltd	United Kingdom	Mitsui Bank, Ltd	Japan	Mitsubishi Trust & Banking Corp	Japan	Fuji Bank, Ltd	Japan
10	Dai-Ichi Kangyo Bank Ltd	Japan	Mitsubishi Trust & Banking Corp	Japan	Long Term Credit Bank of Japan Ltd	Japan	ABN-AMRO Bank, N.V.	Netherlands
11	Chase Manhattan Corp	United States	Credit Agricole Mutuel	France	Deutsche Bank, AG	Germany	Societe Generale	France
12	Fuji Bank, Ltd	Japan	Citicorp	United States	Sumitomo Trust & Banking Co Ltd	Japan	Sakura Bank, Ltd	Japan
13	Mitsubishi Bank Ltd	Japan	Sumitomo Trust & Banking Co, Ltd	Japan	Tokai Bank Ltd	Japan	Union Bank of Switzerland	Switzerland
14	Sumitomo Bank Ltd	Japan	Banque Nationale de Paris	France	Mitsui Trust & Banking Co, Ltd	Japan	Norinchukin Bank	Japan
15	Sanwa Bank Ltd	Japan	Barclays PLC	United Kingdom	Credit Agricole Mutuel	France	Barclays Bank Plc.	United Kingdom

Source: *American Banker,* various issues.

number of Japanese banks counted among the world's largest fell to five of the top ten and seven of the top fifteen by the end of 1997.[5]

The rapid expansion of Japanese banks was encouraged by a number of favorable trends. First, because the investment options of Japanese savers were restricted, Japanese banks could attract deposits at relatively low cost. Second, because Japanese banks held a large number of shares in other Japanese firms, the substantial rise in the Nikkei stock index increased bank capital. Furthermore, this increase in share values allowed the banks to boost their core capital by realizing some of the accrued gains on their extensive cross-holdings of shares, and it provided an attractive environment in which to issue new equity of their own. Third, many Japanese firms were undertaking extensive foreign direct investment, frequently relying on their Japanese bank to fund their expansion abroad.

With funds available and new lending opportunities overseas, Japanese banks began aggressively expanding abroad. Since Japanese banks frequently had cost advantages over their foreign competitors, they could undercut prices for transactions with blue chip firms. These loans had relatively low risk and did not require extensive retail operations or private knowledge about the borrower. Large market shares could be quickly obtained by pricing competitively.[6] To service their Japanese customers with foreign operations, as well as to expand wholesale banking operations, Japanese banks substantially increased their presence in the United States and Europe.

Table 2 provides an organizational overview of the expansion of foreign branches and agencies, sub-branches, and representative offices of Japanese banks from 1986 through 1997.[7] From 1986 to 1990, Japanese banks added twenty-nine branches and agencies in the United States (a 46 percent increase), nineteen in Europe (a 39 percent increase), and eight in Asia (a 14 percent increase). Most of this expansion was undertaken by the large, internationally active Japanese city banks, whose branches expanded in number from thirty-nine to fifty-six in Europe and from forty-six to seventy in the United States.

5. The large swings in the yen-dollar exchange rate contributed to the rise and subsequent fall in the number of Japanese banks among the largest banks worldwide, as measured by assets denominated in U.S. dollars.

6. Such policies likely contributed to the low profitability of Japanese banks. Although they are among the largest banks worldwide, they are also among the least profitable (Bank of Japan, 1993).

7. This table includes only the nineteen largest banks, composed of the city banks, long-term credit banks, and the major trust banks. It does not include the regional banks, which have some international operations but are primarily domestically focused.

Table 2. Japanese Banking Affiliates Worldwide, by Region

Host country or region	Branches and agencies				Sub-branches				Representative offices			
	1986	1990	1993	1997	1986	1990	1993	1997	1986	1990	1993	1997
United States	63	92	98	67	1	1	10	2	40	39	20	35
Latin America	10	8	5	5	8	6	4	0	45	46	39	27
Europe	49	68	75	66	1	2	2	1	52	61	52	34
Asia	59	67	97	121	14	26	38	30	103	107	94	103
Total	181	235	275	259	24	35	54	33	240	253	205	199

Source: Federation of Bankers Associations of Japan and bank annual reports.

From 1990 through 1993, following the sharp decline in the Nikkei, the number of new branches grew more slowly in Europe and the United States, while accelerating in Asia. The slower growth in Europe and the United States is not surprising, since several Japanese banks had reported interim risk-based capital ratios below the 8 percent required by the Bank for International Settlements (BIS), as a consequence of the decline in capital associated with the sharp decline in Japanese stock prices. More surprising is how rapidly branch activity had begun to grow in Asia, despite the serious and mounting problems at the Japanese parent banks. In part, this lending growth was related to a surge in foreign direct investment by Japanese companies in Southeast Asia during the late 1980s and early 1990s (Goldberg and Klein, 1998).

Between 1993 and 1997, the differences between, on one hand, the Asian activities of the Japanese banks and, on the other, their European and U.S. activities became even more striking. Over that four-year period, Japanese banks reduced the number of branches in the United States by almost one-third and that in Europe by one-eighth, while increasing the number of Asian branches by one-fourth.[8] The increased focus on Asia may be attributed to a perception (at the time) of better risk-return prospects in Asia (McCauley and Yeaple, 1994).

The nature of the expansion in Asia also changed between 1986 and 1997. Table 3 lists the numbers of Japanese bank branches and agencies, sub-branches, and representative offices in China and each of the economies in Southeast Asia. In 1986 over two-thirds of these

8. As part of the recently proposed assisted merger of the Long Term Credit Bank with Sumitomo Trust, the Long Term Credit Bank agreed to cease its international operations. Similar actions are likely in the future as the consolidation of problem banks in Japan continues. This will likely result in further significant decreases in Japanese branches abroad.

Table 3. Japanese Bank Affiliates in Other East Asian Countries

	Branches and agencies				*Sub-branches*				*Representative offices*			
Host country	*1986*	*1990*	*1993*	*1997*	*1986*	*1990*	*1993*	*1997*	*1986*	*1990*	*1993*	*1997*
China	3	4	16	26	0	0	0	3	53	58	48	44
Hong Kong	21	24	24	21	11	22	23	15	1	0	0	0
Singapore	20	20	19	17	1	1	1	1	1	0	0	0
Thailand	2	2	8	21	1	1	1	1	9	2	7	9
Korea	9	13	14	13	0	0	0	0	6	7	5	4
Indonesia	1	1	1	2	1	2	3	3	14	13	13	11
Malaysia	1	1	11	11	0	0	10	7	14	13	12	10
Taiwan	1	1	3	6	0	0	0	0	0	0	1	2
Philippines	1	1	1	2	0	0	0	0	5	4	4	5
Total	59	67	97	119	14	26	38	30	103	107	90	85

Source: Federation of Bankers Associations of Japan and bank annual reports.

Japanese branches were located in Hong Kong and Singapore. Both are major offshore banking centers, and activity in those locations more likely reflects wholesale bank lending to established borrowers rather than retail banking operations. Thus the initial Japanese bank activity in Asia was focused much as it had been in the United States, on syndicated loans to blue chip borrowers whose business could be attracted by exploiting cost advantages over foreign competitors, and on loans to large Japanese corporations seeking to finance their foreign direct investment.

However, in the early and middle 1990s Japanese banks reduced the number of their branches in Hong Kong and Singapore while substantially increasing their presence in other Asian countries, particularly China, Thailand, and Malaysia. This trend reflected a shift in emphasis toward retail banking operations, where margins were higher than those available in the wholesale lending market (McCauley and Yeaple, 1994). Japanese banks increasingly lent to affiliates of Japanese companies that were expanding their operations in Asia (often with guarantees from the parent), as well as to the local suppliers of these Japanese subsidiaries.

2. Patterns in Japanese Lending in Southeast Asia

The organizational trends follow a pattern very similar to that for lending by Japanese banks. Unfortunately, individual Japanese banks do not regularly provide data on their exposures in individual countries or regions. We therefore used publicly available data on the exposures of Japanese banks gathered by the BIS, which provides semiannual reports on cross-border exposures of banks from eighteen major industrialized countries (called here the reporting countries).[9]

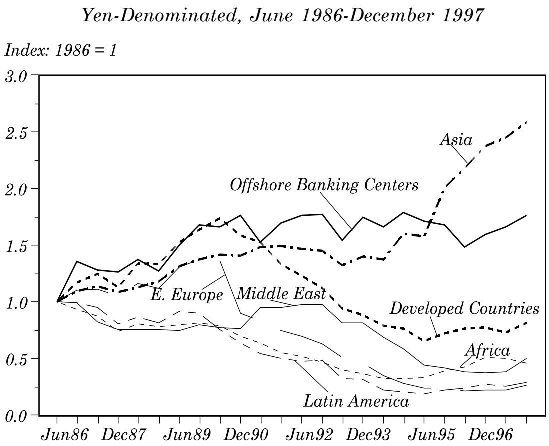
Banks headquartered in the reporting countries are asked to report their entire exposure to customers in a borrowing country. This includes all cross-border exposures of all the bank's offices worldwide, including local claims of foreign affiliates of the bank. The assets and liabilities in local currency of foreign bank affiliates are included as a confidential memorandum item and thus are not included in our data.[10] The BIS data exclude positions between different offices of the same bank, as well as claims on other banks from the reporting countries, to avoid double counting. The claims of the banks include deposits and balances with other banks, loans and advances to banks and nonbanks, holdings of securities, and participations. The data are also disaggregated by the maturity of the claim and by whether the borrowing entity is in the public sector, the private nonbank sector, or the banking sector. However, the detailed data by source country are confidential.

Figure 1 shows the patterns of Japanese lending to groups of borrowing countries, based on the semiannual BIS data. Because we want to examine this lending from the perspective of the Japanese banks, we converted the BIS data, reported in dollars, to Japanese yen, using the exchange rate as of the last day of the reporting period (June and December). Given that Japanese bank capital is denominated in yen, the value of these banks' risk-based capital ratios will depend on the yen value of their assets. And because many of the assets of Japanese banks are denominated in dollars (and other foreign currencies), they will be sensitive to fluctuations in the exchange rate. For example, any

9. Our data actually include only seventeen of these reporting countries. Switzerland is omitted because it provides data only on a confidential basis. The BIS also reports a quarterly series, although this does not include coverage on a worldwide consolidated basis, and an interbank series, which provides bank claims on related offices of the same institution and those on unrelated banks.

10. When we combined the confidential local-currency claims with the cross-border claims to obtain a measure of total lending by a reporting country to each borrowing country, regardless of the currency in which the loan is denominated, the qualitative stories in the figures and tables were not significantly affected. However, although the local-currency exposures were generally small relative to the cross-border exposures, the recent sharp declines in the values of the local currencies cause both the yen and the dollar values of this broader measure of cross-border lending to rise less (or decline more) in 1997.

Figure 1. Cross-Border Lending by Japanese Banks



Source: Bank for International Settlements.

depreciation of the yen would inflate the yen value of their nonyen-denominated assets, reducing their capital ratios. In fact, exchange rate movements during the period under consideration have been substantial and have significantly altered the yen value of risk-weighted assets. To the extent that lending patterns are affected by Japanese banks' shrinking of assets to satisfy BIS capital requirements, nonyen lending by capital-impaired Japanese banks can significantly increase the risk that the bank may need to shrink to maintain the required risk-weighted capital ratio.

For purposes of presentation in the figure, the (yen-denominated) BIS data were scaled by their 1986 value (the index equals 1 in 1986) to highlight which geographic areas were the focus of expanded Japanese lending during this period. "Offshore banking centers" in the figure includes Hong Kong and Singapore in Asia, as well as such centers as the Cayman Islands and the Bahamas. The Asia aggregate includes all countries in the BIS Asian category, which excludes Hong Kong and Singapore.

Figure 1 shows Japanese banks reducing their exposure to many parts of the world after 1989. The largest proportional declines are in the developed countries other than the eighteen reporting countries (nonreporting developed countries), Eastern Europe, and Latin America. Japanese banks also decreased their exposure to the Middle East following a temporary increase in the aftermath of the war with Iraq. The need to shrink assets to satisfy capital ratios, the strong competition from non-Japanese banks, and a decision to focus on more strategic markets each likely contributed to the significant decrease in lending by Japanese banks in these areas.

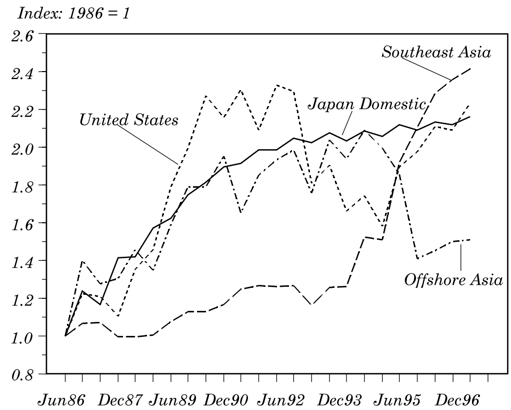
The two major exceptions to the widespread declines in Japanese bank lending shown in figure 1 are the offshore banking centers and Asian markets. Lending by Japanese banks to the offshore banking centers shows no upward or downward trend in the 1990s. In part, this may be an artifact of the dramatic changes in the exchange rate. The yen appreciated sharply from 1990 until mid-1995. Since 1995 it has experienced a sharp reversal in its value. Thus, when offshore lending is expressed in dollars, it reaches a sharp peak in 1995 before falling even more steeply than it had risen, and then leveling out in late 1996. Since many of the offshore loans are dollar-denominated, it is likely that the volume of lending by Japanese banks has declined since 1995. In fact, it is possible that the depreciation of the yen in the most recent period placed added pressure on Japanese banks to shrink such dollar-denominated lending in order to ease the pressure on their capital ratios, as the yen value of dollar-denominated assets rose relative to the banks' yen-denominated capital.

Japanese bank loans to Asian economies, not including loans to the offshore banking centers of Hong Kong and Singapore, rose only gradually in yen terms during the early 1990s. However, the series then experienced a burst of rapid growth. Asia is the only area where Japanese banks expanded their lending aggressively in 1996 and 1997. However, when stated in dollars rather than yen, Japanese bank lending to Asia actually declined in 1997, suggesting that loan growth there may be coming to an end.

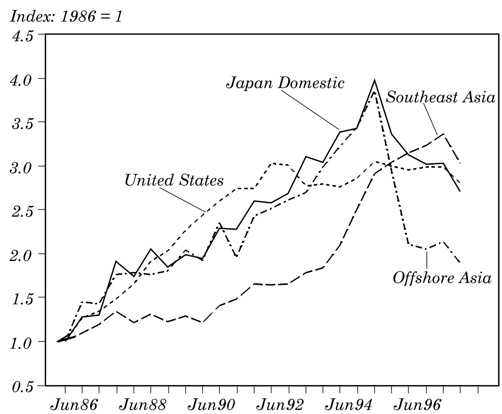
Figure 2 shows cross-border Japanese bank lending to offshore Asia, Southeast Asia, and the United States, as well as domestic lending by Japanese banks. The series for offshore Asia (Hong Kong and Singapore) and Southeast Asia (Indonesia, Korea, Malaysia, the Philippines, Taiwan, and Thailand) are based on BIS data; the U.S. data are taken from bank call reports; and the domestic Japan lending data come from the Bank of Japan. Although the definitions of lending vary across these three sources, each individual series is defined consistently over time. For figure 2a the BIS and call report data have been converted from dollars to yen (as in figure 1) and then scaled by their 1986 values. For figure 2b the BIS dollar magnitudes have been scaled by their 1986 values.

Figure 2. Japanese Bank Lending to Selected Markets

a. Yen-Denominated, June 1986-December 1997



b. Dollar-Denominated, June 1986-December 1997



Source: U.S. Call Reports, Bank for International Settlements, Bank of Japan.

Perhaps the most striking series in figure 2a is that for domestic Japanese loans. Despite suffering a major economic slowdown and declines in excess of 60 percent in both Japanese commercial real estate prices and Japanese stock prices, Japanese domestic lending did not decline; it merely grew more slowly. This may reflect a major advantage of a main bank system from the perspective of the borrowers: In time of crisis, such banks will be less likely to sharply reduce credit to their customers (Hoshi, Kashyap, and Sharfstein, 1990, 1991). Moreover, Japanese banks may have been "evergreening" loans already on their balance sheets to avoid having to classify problem loans as nonperforming; that is, they may have continued to lend to a troubled borrower to enable that borrower to meet interest payments on an existing loan. However, the downside of a main bank system is that if a bank has financial difficulties and reacts by shrinking lending, it may be difficult for its loan customers to find alternative sources of credit (Gibson, 1995; Kang and Stulz, 1998).

In contrast, Japanese bank lending to the United States (denominated in yen) grew much more rapidly during the 1980s, leveled off (on average) in the early 1990s, and then declined from 1993 into 1995, even though the U.S. economy was expanding. The entire rise since that time is accounted for by the depreciation of the yen. Figure 2b shows that, in dollar terms, Japanese bank lending to the United States fell, even as the U.S. economy continued its expansion.

In yen terms, the growth in Japanese bank lending to the offshore banking centers of Southeast Asia (Hong Kong and Singapore) slowed, on average, in the early 1990s following the sharp declines in the Nikkei and in Japanese commercial real estate prices, and then declined sharply after 1994. In dollar terms, the growth in Japanese bank lending to these centers was much more rapid in the early 1990s, and the peak occurred later, in June 1995 rather than December 1994. However, the subsequent decline was even larger because of the sharp depreciation in the yen.

In contrast, Japanese bank lending to Southeast Asia accelerated in recent years, whether denominated in yen or in dollars. After rising gradually from 1986 to 1992 and then declining temporarily, lending to these countries surged. Denominated in yen, Japanese bank lending to Southeast Asia began to slow only in the last half of 1997. The growth rate of the dollar-denominated series slowed in 1995, and the series actually declined sharply in 1997.

The recent sharp decline in Japanese bank lending to offshore banking centers, whether denominated in yen or in dollars, and the decline to the United States in dollar terms, although more moderate until 1997, are consistent with Japanese banks pulling out of low-margin wholesale markets. Such a response in these highly competitive markets might be expected, since Japanese banks have lost much of the competitive advantage that emanated from their traditionally low-cost funding sources. First, the decline in the Nikkei raised the cost of capital for Japanese banks. More recently, the cost to Japanese banks of attracting (or retaining) funds has been increased by two factors. The first is the country's severe banking problems, which have forced Japanese banks to pay a "Japan premium" in order to raise funds in the interbank market, and the second is the opening of Japanese financial markets to foreign financial firms, which has made the market for bank deposits much more competitive.

A reasonable response might be to turn increasingly to markets where margins are higher. In particular, Japanese banks might be expected to shift their emphasis in the direction of retail markets where lending relationships are more important, such as domestic lending in Japan and loans to Japanese affiliates and other private sector firms in Southeast Asia. And in fact, even though Japanese banks did retrench in Hong Kong and Singapore recently, loan growth to customers in Southeast Asian countries accelerated. It only slowed in yen terms (and declined in dollar terms) after the financial crisis hit Southeast Asia. Moreover, even in the face of continuing economic stagnation in Japan, Japanese banks have continued to increase domestic lending.

Figure 3 shows the volume of Japanese bank loans in each of the Southeast Asian countries, including Hong Kong and Singapore. In terms of the volume of lending, Singapore and Hong Kong received the vast majority of cross-border loans by Japanese banks to this region. Figure 3a shows that both of these offshore markets experienced a substantial decline in Japanese bank lending beginning in 1995, although the decline began earlier in Hong Kong. The declines in these two offshore markets more than offset any increases in the other Southeast Asian economies. Indonesia, Korea, and Thailand—all countries that experienced substantial difficulties recently—were recipients of the largest volumes and experienced the highest growth rates of loans from Japanese banks. Lending to Malaysia, another country that suffered greatly from the Southeast Asian financial crisis, was next in terms of volume and experienced a similar increase during the past two years. Taiwan and the Philippines account for the smallest volumes of Japanese bank lending among the economies of Southeast Asia.

Figure 3b tells much the same story. The primary difference is that, when denominated in dollars rather than yen, Japanese bank lending to Hong Kong and Singapore rose more in the early 1990s and declined more sharply after June 1995. Furthermore, the dollar-denominated data show declines, rather than just a slowing in growth, in the last half of 1997 for most economies.

Figures 2 and 3 are consistent with Japanese banks withdrawing from wholesale lending markets while continuing to lend in retail markets with higher margins and with more established lending relationships. Thus, offshore markets such as Hong Kong and Singapore are likely to experience a continued decline in Japanese bank lending, as those banks come under increasing pressure from mounting loan problems both at home and in Southeast Asian markets. On the other hand, lending to Southeast Asia is likely to follow a pattern closer to that of domestic Japanese lending, since many of these loans are to affiliates of Japanese firms. For example, loans to customers in countries such as Indonesia and Thailand include a particularly large proportion of loans to Japanese-affiliated companies. As a result, after the initial retrenchment associated with the Southeast Asian financial crisis, Japanese bank lending to these countries may decline only to the degree that these banks choose (or are forced) to retrench their domestic lending. However, continued pressure on Japanese banks to shrink lending in order to raise capital ratios may slow lending in both Japan and Southeast Asia. How severe these pressures are and how long they continue will depend on how (and when) the Japanese banking crisis is finally resolved.

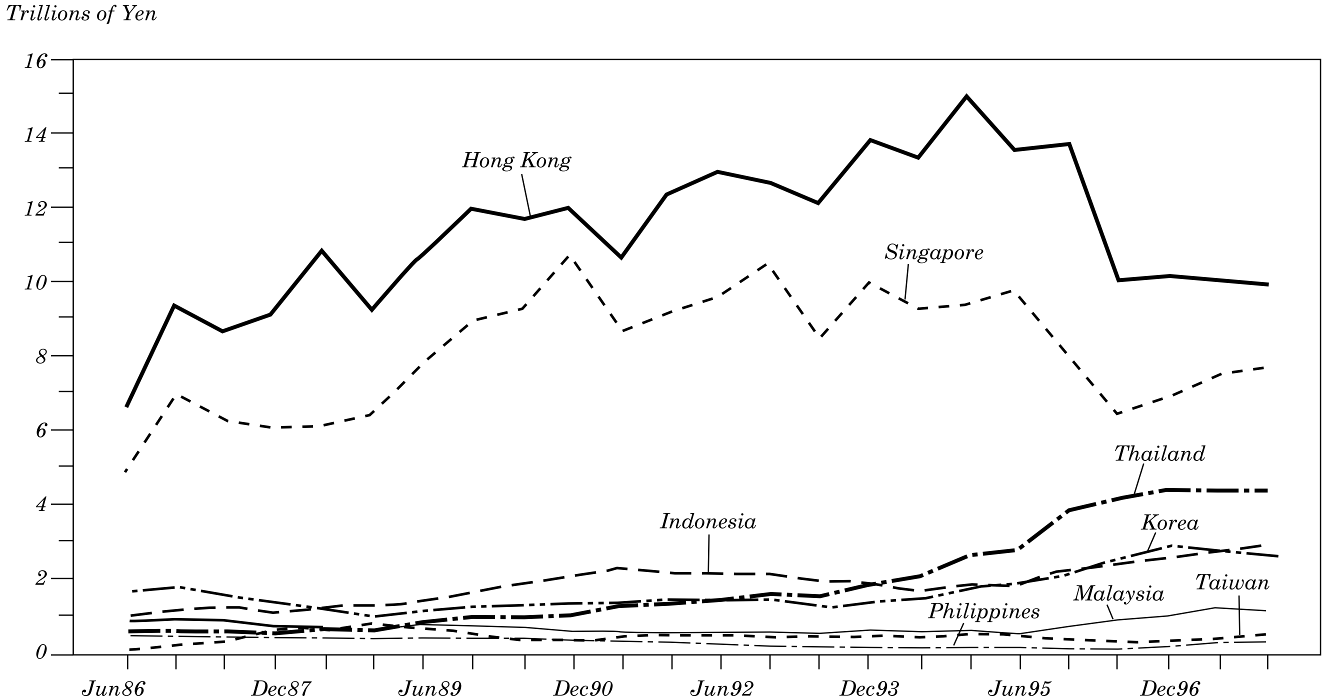
3. Impact of Southeast Asian Loans on Problems at Japanese Banks

Lending to Southeast Asia is also important to Japanese banks because of its contribution to their already sizable volume of nonperforming loans. The Asian exposure, as reported by Japanese banks as of March 1998, totaled almost 18 trillion yen, for which very limited loan-loss reserves have been set aside (table 4). Although many of these loans are to Japanese affiliates whose Japanese parent serves as guarantor, and the extent to which these loans will eventually be written off is difficult to determine, one might reasonably expect losses on these loans to greatly exceed such meager reserves.[11]

11. In their 1998 annual reports, some banks provided more details of their exposure in Southeast Asia. For example, Sanwa Bank, with one of the largest exposures, reported a $16 billion total exposure, $5 billion of which was to Japanese companies. Of course, the net exposure of $9.4 billion was much smaller than the total exposure. However, the annual report gave no specific description of which categories of loans were considered classified. To put the extent of the exposure in perspective, total assets and total equity capital of Sanwa were $431 billion and $14 billion, respectively.

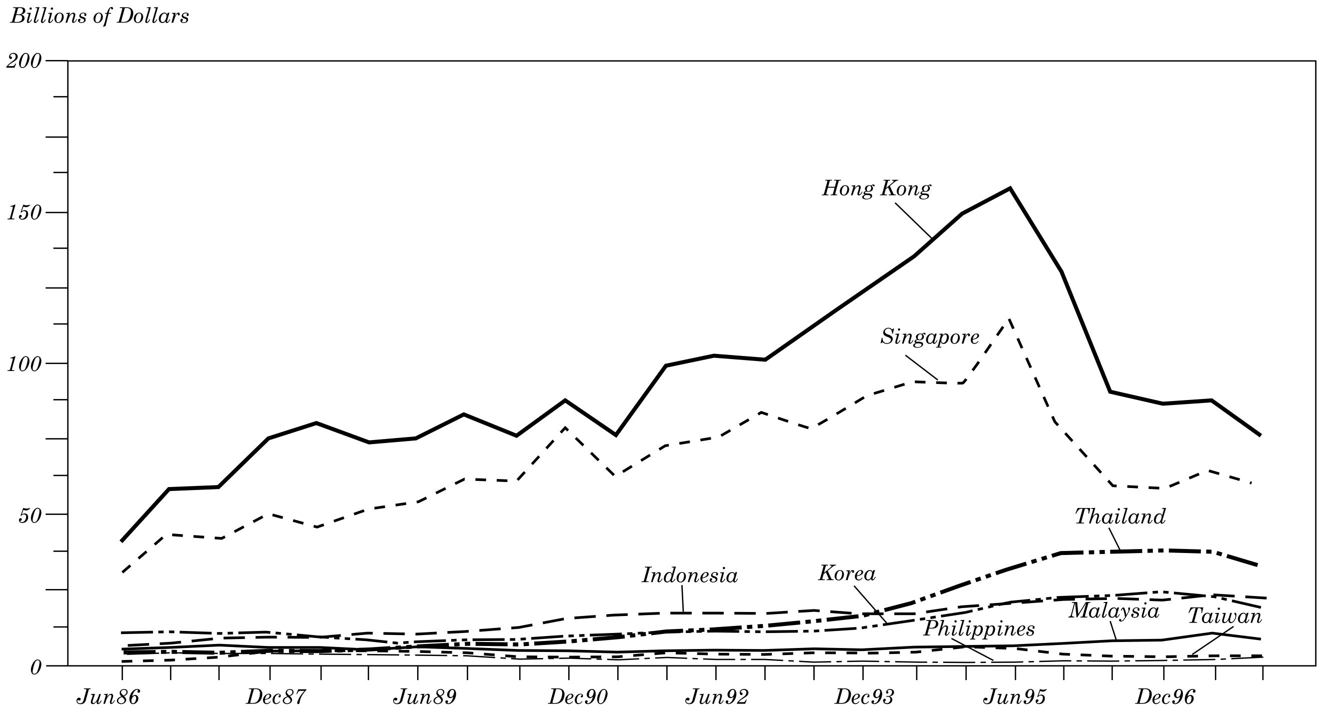
Figure 3. Japanese Bank Lending to Southeast Asian Economies

a. Yen-Denominated, June 1986-December 1997



Source: Bank for International Settlements.

b. *Dollar-Denominated, June 1986-December 1997*



Source: Bank for International Settlements.

To put the Southeast Asian exposure of 18 trillion yen in perspective, Japanese banks had 77 trillion yen in classified assets as of September 1997, according to the Ministry of Finance.[12] However, 65 trillion yen of the classified loans were considered to be in category 2, which refers to loans that are impaired but not expected to result in losses. It appears that Japanese banks included many of their Southeast Asian exposures in category 2, likely reflecting an overly optimistic view of the prospects for these loans.

The largest Asian exposures are held by Bank of Tokyo-Mitsubishi and Sanwa Bank. Both are among the healthiest of the major Japanese banks. The only banks to have announced significant loan-loss reserves against their Asian exposures as of September 1998 were Daiwa Bank, Nippon Credit Bank, and Mitsui Trust. Both Daiwa and Nippon Credit had relatively small Asian exposures, but Moody's placed them among the lower-rated banks.

It is likely that the extent of problem loans has remained underreported. Many of the loans are to Japanese affiliates, and Japanese banks assume that the Japanese parents will serve as a source of strength. Similarly, in countries with large local exposures, such as Thailand and Indonesia, many of the loans are to borrowers of significant size that have long-standing ties to the Japanese lender. However, the extent of possible underreporting of problem loans is impossible to estimate accurately using the information that is publicly available.

Figure 4 uses BIS and Bank of Japan data to calculate Japanese bank exposure in Southeast Asia as a percentage of total (domestic plus overseas) Japanese bank loans outstanding. Lending to Hong Kong and Singapore, which includes a high percentage of loans to blue chip companies and affiliates of major Japanese companies, haddeclined substantially by the end of 1997 and equaled roughly 3.5 percent of total Japanese bank loans. At the same time, the exposure of Japanese banks to the other Southeast Asian economies had increased to

12. "Classified" refers to the banks' own assessment of their loans, the preliminary results of which were released in aggregated form by the Ministry of Finance in September 1997. However, the individual bank data are not required to be disclosed. Banks were asked to classify their loans into four categories. Category 1 includes loans with no credit risk (this includes reserved portions of exposures). Category 2 loans require credit management if losses are to be avoided. Category 3 includes loans with serious concerns and loans that are likely to result in losses. Category 4 loans no longer have value. The banks use their own policies in assigning loans to categories, and so loans may not be classified consistently across banks. Furthermore, classified loans do not relate directly to the nonperforming loans classification.

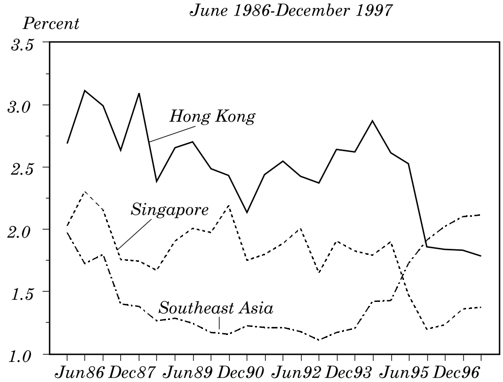
Table 4. Asian Exposure of Japanese Banks as of March 31, 1998

Bank	*Exposure (billions of yen)*	*Reserved (percent)*
Bank of Tokyo-Mitsubishi	4,401	2.1
Sumitomo Bank	1,760	3.0
Sanwa Bank	2,100	1.4
Dai-Ichi Kangyo Bank	1,600	2.8
Sakura Bank	1,553	1.9
Fuji Bank	1,470	2.0
Tokai Bank	959	0.5
Asahi Bank	463	1.0
Daiwa Bank	328	7.3
All city banks	14,634	2.4
Industrial Bank of Japan	906	1.2
Long Term Credit Bank	593	1.3
Nippon Credit Bank	41	5.6
All long-term credit banks	1,541	2.7
Mitsubishi Trust and Banking	517	0.8
Mitsui Trust and Banking	222	10.1
Sumitomo Trust and Banking	408	2.4
Yasuda Trust and Banking	223	2.5
Chuo Trust and Banking	44	1.6
Toyo Trust and Banking	223	2.4
All trust banks	1,637	3.3
All banks	17,811	...

Source: Moody's Investors Service, *Banking System Outlook—Japan,* July 1998, table 7.

Figure 4. Japanese Bank Lending to Hong Kong, Singapore, and Southeast Asia as a Share of Total Japanese Bank Loans

June 1986-December 1997



Source: Bank of Japan, Bank for International Settlements.

over 2 percent of total loans. By itself, this loan exposure to Southeast Asia should not pose a major threat to most Japanese banks. However, the low level of loan-loss reserves associated with these loans (table 4) and the size of some banks' Asian exposures, on top of the already well-established problems with nonperforming loans at home, may be particularly troublesome for some of the weaker Japanese banks.

4. Were Japanese Bank Lending Patterns Different from Those of U.S. and European Banks?

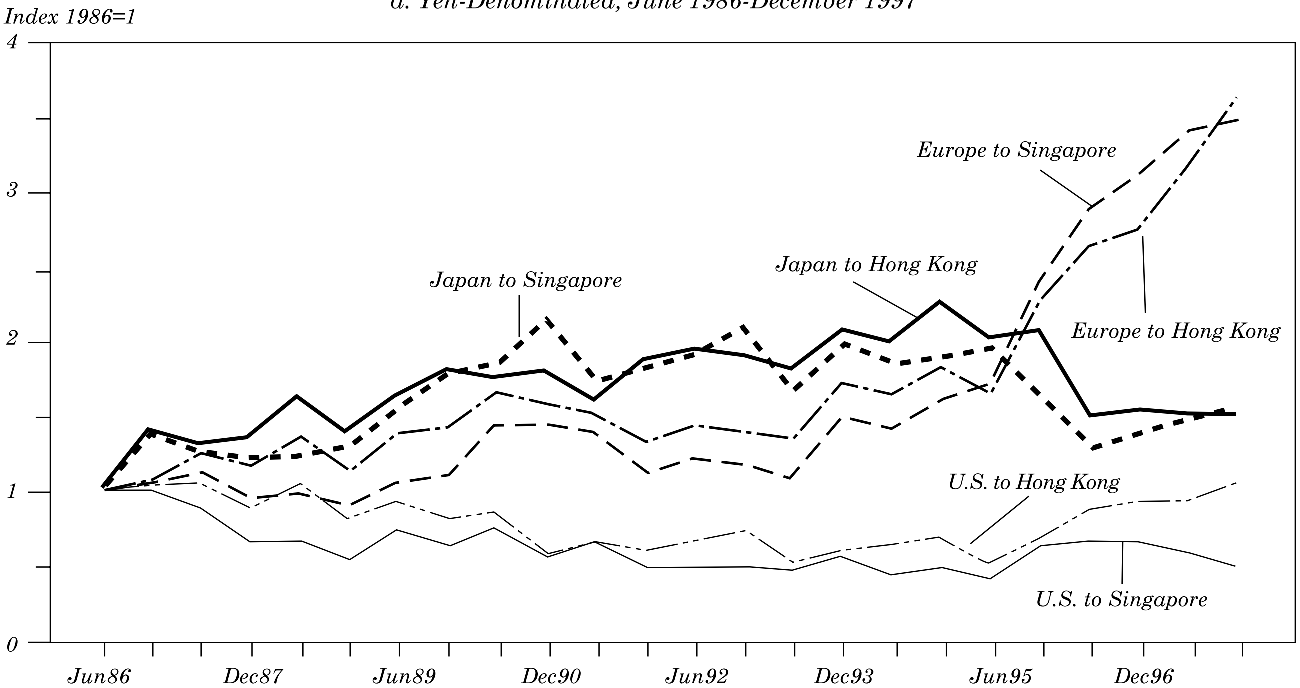
Although all foreign banks faced the same economic environment of growth and subsequent slump in the Southeast Asian economies, the financial conditions of the foreign banks varied considerably. During the late 1980s, Japanese banks were well capitalized, while U.S. banks were rebuilding their capital. More recently, Japanese banks have been constrained by low capital ratios, while banks in the United States and Europe have been well capitalized and better positioned to continue to lend. Thus, examining the differences in lending behavior may help identify the extent to which Japanese lending patterns are being driven by home-country problems, and the extent to which the patterns reflect concerns with economic prospects in Southeast Asia.

Figure 5 shows cross-border lending to Hong Kong and Singapore by Japanese, European, and U.S. banks over the decade ending in 1997. The behavior of the Japanese banks is quite different from that of their European and U.S. competitors. Figure 5a shows that Japanese banks steadily increased their exposure until late 1994, when they began to substantially decrease their lending in Hong Kong and Singapore. Much of this decrease was offset by European banks, which sharply increased their lending in both Hong Kong and Singapore beginning in 1994. On the other hand, U.S. lending in Hong Kong and Singapore remained relatively flat over the past decade, declining steadily until 1995 before rebounding somewhat.

The story is much the same when lending is denominated in dollars rather than yen (figure 5b). However, the rise and fall of Japanese bank lending to Hong Kong and Singapore in the 1990s is much more pronounced. Furthermore, the acceleration in lending by European banks occurs sooner, and the series shows a slowdown for Hong Kong and a decline for Singapore in 1997. Finally, recent lending by U.S. banks to Hong Kong shows more of an upturn, and that to Singapore shows less of a downturn, when stated in dollars.

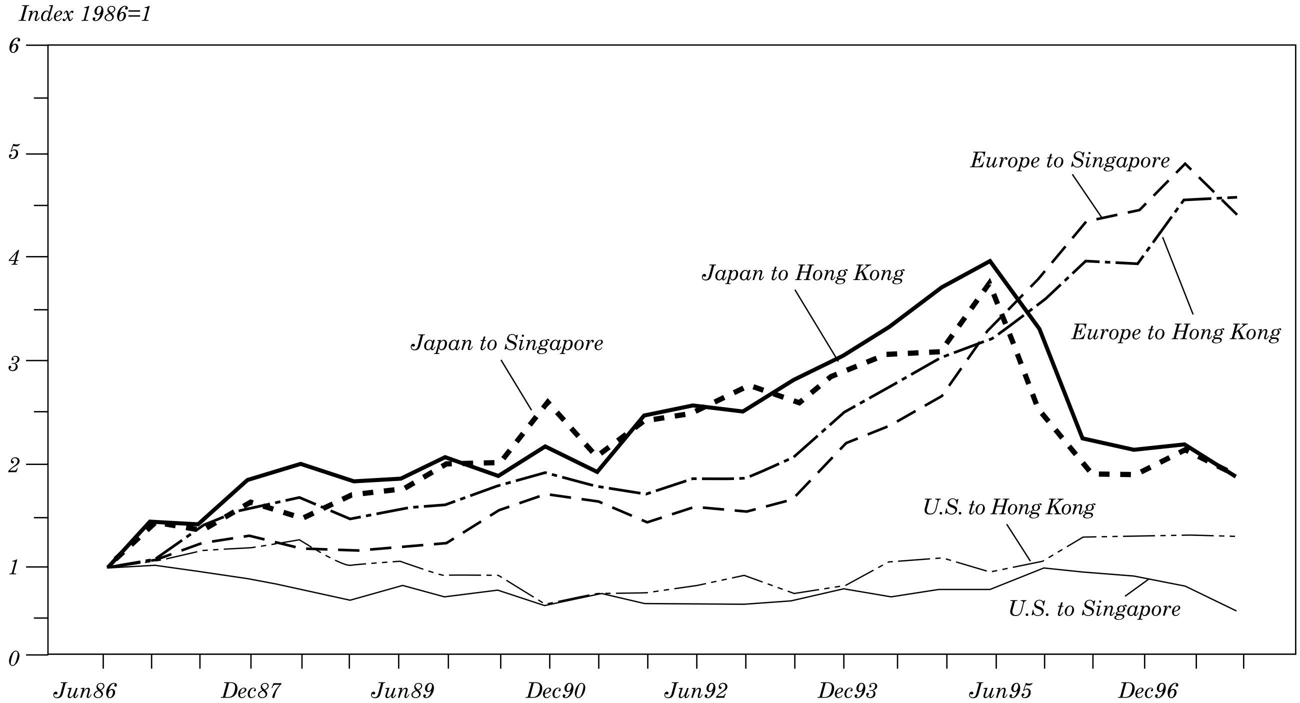
Figure 5. Cross-Border Bank Lending to Hong Kong and Singapore from Japan, the United States, and Europe

a. Yen-Denominated, June 1986-December 1997



Source: Bank for International Settlements.

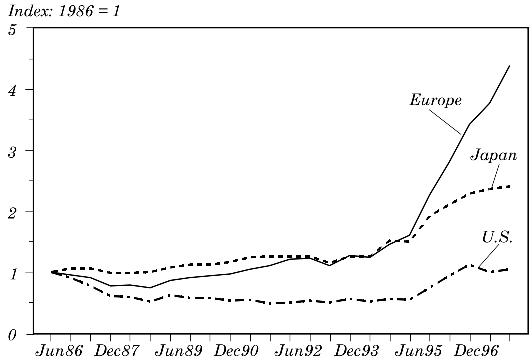
b. Dollar-Denominated, June 1986-December 1997



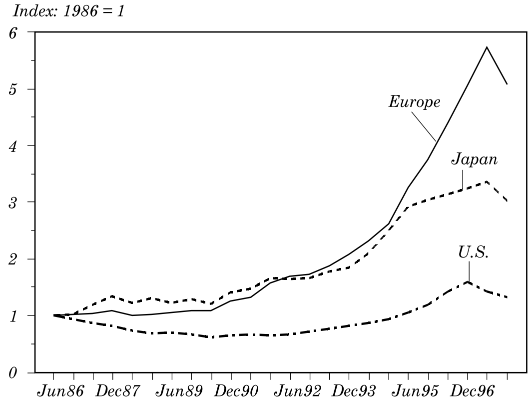
Source: Bank for International Settlements.

Figure 6. Cross-Border Bank Lending to Southeast Asia from Japan, the United States, and Europe

a. Yen-Denominated, June 1986-December 1997



b. Dollar-Denominated, June 1986-December 1997



Source: Bank for International Settlements.

Figure 6 shows cross-border lending by European, Japanese, and U.S. banks in Southeast Asia over the same decade. The expansion in exposures to Southeast Asia was quite similar for European and Japanese banks during the first half of the 1990s. However, the recent acceleration in European bank lending greatly exceeded that by Japanese banks. U.S. banks also expanded lending to Southeast Asia, but the increase was much more muted. Furthermore, U.S. banks began reducing their lending at the end of 1996, whereas Japanese banks only slowed the rate of increase in their yen-denominated lending, although their dollar-denominated lending declined in 1997. In contrast, European lending rapidly increased through 1997 when denominated in yen, whereas the dollar-denominated series exhibits a sharp decline in that year.

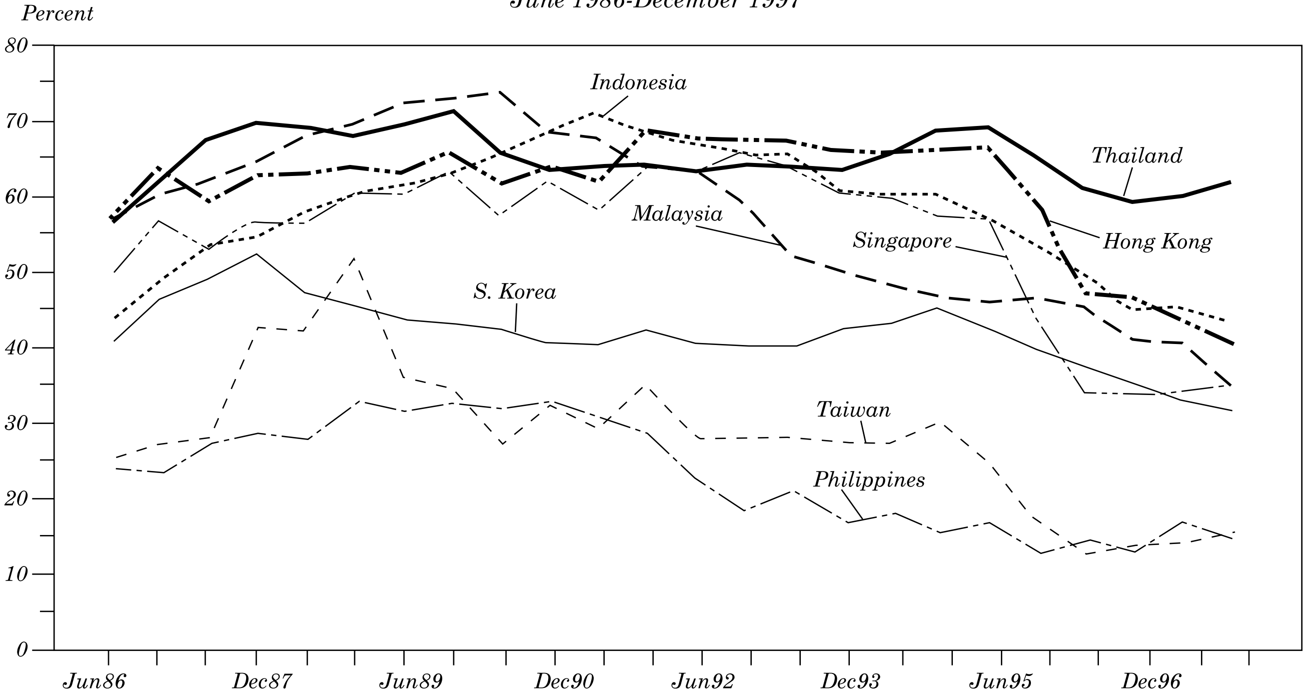
5. Southeast Asian Penetration by Japanese Banks

Japanese banks had the largest foreign banking presence in most Southeast Asian economies over the decade from 1986 to 1997. Figure 7 shows Japanese bank cross-border claims for individual Southeast Asian economies (measured relative to the total for all BIS reporting countries) from June 1986 through December 1987. Thailand, a major recipient of Japanese foreign direct investment, consistently had roughly 60 to 70 percent of its BIS claims from Japan. Indonesia and Malaysia had substantial Japanese shares in the 1980s, although that share declined substantially for both countries in the 1990s. Hong Kong and Singapore also show major declines recently, as Japanese banks have sought to reduce their wholesale lending activities in those economies. The Japanese bank share in Korea declined from roughly 50 percent in the late 1980s to about 35 percent in 1997. The Philippines and Taiwan historically have been less dependent on Japanese financing, and that has been the case recently, with Japanese claims accounting for less than 20 percent of total BIS claims to those economies.

Japanese banks now have at least four incentives to reduce their exposure in Southeast Asia. First, their problems with domestic loans have resulted in a significant level of classified loans, which, along with continued weakness in the Japanese stock market, is likely to keep most Japanese banks close to the BIS capital ratio threshold. And this pressure on capital ratios will be even stronger if Japanese banks are forced to fully disclose all the problems on their balance sheets. Second, the increase in the cost of funds that Japanese banks have experienced will make them less able to compete in world credit markets. Third, the continued low returns on assets posted by Japanese banks will force them to refocus their activities from attaining market share to improving profitability. And finally, the Asian currency crisis and associated political risks have substantially increased the risk premium required for bank loans to firms located in Southeast Asia.

Figure 7. Cross-Border Bank Lending by Japanese Banks to Southeast Asian Economies Measured as a Share of Lending by All Reporting Countries

June 1986-December 1997



Source: Bank for International Settlements.

Despite the substantial declines in its share of cross-border lending, Japan remains the single largest foreign lender in most of Southeast Asia. And to the extent that Japanese banking problems further inhibit lending, any additional retrenchment is likely to weaken firms whose access to external credit is already impaired. Thus the internal capital market decisions of Japanese banks may have important ramifications for Southeast Asia.

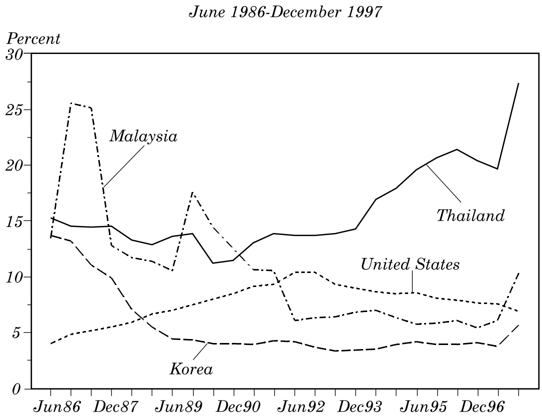
Figure 8 provides a crude measure of the penetration of Japanese banks into each of several Southeast Asian economies. The figure shows Japanese bank cross-border BIS claims as a percentage of total loans in the country, as approximated by the international financial statistics produced by the International Monetary Fund (IMF). We exclude Hong Kong and Singapore because of their extensive offshore banking operations. We also exclude Indonesia because of missing data and the Philippines because of data inconsistencies.[13] For comparison, we include Japanese penetration into the United States, although this requires the use of U.S. call report data, which are not directly comparable to the BIS and IMF data.[14] Nonetheless, the comparison does provide a benchmark for measuring the degree of penetration of Japanese banks into Southeast Asia.

To calculate Japanese penetration, we use BIS data on Japanese lending to a particular country divided by total nonfinancial claims as reported by the IMF. This calculation is fraught with difficulties in obtaining a consistent series. The BIS data are focused on the cross-border claims of the lending country, and so they include Japanese lending to a particular country regardless of whether the funds are lent directly from the parent bank in Japan or from affiliates in the host country. The IMF data focus on total bank credit in the host country, and so they generally include lending by foreign branches located in the host country, but not lending on the books of the parent bank in the home country. Thus the denominator will be

13. For Indonesia the IMF data have missing observations in 1993, 1994, and December 1997. For the Philippines the ratio of total BIS claims to total loans in the Philippines exceeds 100 percent for the first three years of our sample. Since the foreign share obviously cannot exceed the total, the comparability problems were so severe that we omitted these data from this analysis.

14. We use total loans as reported in the call reports. However, Japanese banks have a much greater penetration in U.S. markets for commercial and industrial loans and for commercial real estate loans than for total loans. Peek and Rosengren (1997) note that, at the peak in 1990, Japanese banks accounted for 18 percent of all commercial and industrial loans to borrowers located in the United States. Peek and Rosengren (1998) find that Japanese banks accounted for one-fifth of all commercial real estate loans in the United States.

Figure 8. Japanese Bank Loans as a Share of Total Loans in Selected Countries



Source: Bank for International Settlements, International Monetary Fund.

understated to the extent that foreign banks lend from home as well as from their foreign branches and subsidiaries, causing this measure of Japanese penetration to be overstated.

Because individual countries collect data differently, the series are not necessarily consistently defined across countries. In addition, the BIS data include deposits of Japanese banks in host-country financial institutions, in effect treating these as loans. We have excluded the IMF data on financial institutions' claims, to avoid the double counting that can occur when a financial institution has a deposit at another institution, which then lends the funds to the private sector. We treat this transaction as if the depositing institution had instead lent directly to the private sector; this is consistent with the BIS treatment intended to avoid double counting.

Figure 8 shows, albeit somewhat crudely, that the penetration by Japanese banks is substantial. For example, Japanese banks held between 11 and 15 percent of claims in Thailand in the early 1990s. In the last three years of the period their penetration became much greater, accounting for 27 percent of claims as of December 1997. For Malaysia and Korea, the share of loans provided by Japanese banks has generally fallen since the mid-1980s but accounts at the end of the period for a still-sizable 10 percent of loans in Malaysia and 6 percent of loans in Korea. However, as was the case for Thailand, the Japanese penetration recently has increased.

This degree of penetration poses potential problems if Japanese banks should decide to pull back from Southeast Asian credit markets. For example, the penetration by Japanese banks in the United States, included for comparative purposes, was also quite substantial: as high as 10 percent in the early 1990s before falling to 7 percent by the end of 1997. Peek and Rosengren (1998) have shown that the withdrawal from U.S. commercial real estate lending by Japanese banks resulted in an economically significant reduction in construction activity in those U.S. states with a large Japanese bank presence. If withdrawal by Japanese banks can affect real activity in the United States, with its far deeper and better-developed credit markets than those in Southeast Asia, this suggests that the effect of a Japanese withdrawal on economies much more dependent on bank financing could be substantial.

6. Conclusion

It is too soon to assess the full impact of the evolving problems in Southeast Asia, or to know the full reaction of the Japanese banks to their problems at home and abroad. Thus any conclusions must be preliminary and will likely evolve as the problems continue to unfold. However, this paper has highlighted some trends in Japanese lending to Southeast Asia that make it different from Japanese lending to other parts of the world and different from lending by non-Japanese competitors in Southeast Asia.

Japanese banks have been refocusing their global operations toward Southeast Asia. Both the locations of their branches and their lending patterns reflect expansion in Southeast Asia and retrenchment in most other parts of the world. Despite often-binding capital constraints, Japanese banks appear to have decided that loans to customers in Southeast Asia will provide longer-run profitability, even given the current difficulties. Japanese banks also appear to be withdrawing from wholesale operations in both Singapore and Hong Kong, much as they have withdrawn from many wholesale operations in the United States. This may reflect a need to use scarce capital for more profitable lines of business. It may also reflect the less competitive position of Japanese banks as their cost of funds has increased, both because of the substantial premium they have had to pay to borrow in interbank markets, associated with their weaker financial position, and as a result of the opening of Japanese domestic financial markets to foreign competition.

Japanese banks' underreserving for potential loan losses and their failure to fully disclose the extent of the problems in their Southeast Asia portfolios likely will result in greater reported loan losses in the future. Nonetheless, the losses from these loans probably will be dwarfed by the problems created by the nonperforming loans in their domestic portfolios.

Any further pullback by Japanese banks would pose significant problems for the Southeast Asian economies. Japanese penetration into these markets is still large, and retrenchment would make external financing quite difficult for firms that are now viewed as far riskier than they were before the crisis. Some of the retrenchment that has already occurred has been partially offset by the willingness of European banks to enter the market. U.S. banks, however, have continued to hold relatively small positions in Southeast Asia. To date, it appears that Japanese banks will retain a major presence in Southeast Asia, but with a diminished role in the wholesale loan market. However, the future path of Japanese bank lending in Southeast Asia depends on the financial condition of the economies in the region as well as on the banking and regulatory policies undertaken as Japan restructures its banking industry.

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