Towards True Revival of Small and Medium Enterprises: Moratorium is not the Answer

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Shizuka Kamei, the Minister of Financial Affairs of the new government, surprised the world by announcing a plan to force banks to provide a three-year moratorium for small and medium enterprise customers who are in financial trouble. The final bill that was submitted to the Diet and approved on Nov. 30 does not require banks to suspend debt collection but just encourage them to reschedule the loans when small and medium enterprise borrowers ask for it. Whether the decision to grant concession is given to banks or the FSA (Financial Services Agency) *de facto* requires such concession by strong guidance remains to be seen.

Problems in the Small and Medium Enterprise Finance Smoothing Act

Even when banks are not forced to reschedule loans against their wish, the new law will generate several problems. First, the law substantially expands the coverage of the government guarantee on SME loans. If SMEs default on their loans after those have been rescheduled, the government-run Credit Guarantee Association will pay for the loans. This extension of government credit guarantee reduces the cost of default on banks and exacerbates the moral hazard problem. Such moral hazard was one of the factors behind the failure of New Bank Tokyo, which was rescued by ¥40 billion recapitalization from its founder Tokyo Government.

Second, government credit guarantee can make loan rates insensitive to credit risk. Indeed the Bank of Japan’s *Financial System Report* (September 2009) points out that the expanding government guarantee has made it difficult for banks to charge high enough interest rates to compensate for the credit risk. Inability to charge appropriate interest rates can jeopardize the profitability and financial health of the banking sector.

Third, many SMEs may be hesitant to apply for the loan restructuring, fearing the stigma attached to it. As a result, only the firms in the deepest trouble would apply for restructuring, increasing the likelihood of defaults of restructured loans. Thus, the new scheme can just end up subsidizing the firms that eventually fail.

Fourth, under the new scheme, the FSA is reported to change the inspection manual so that the banks do not have to count the restructured loans as non-performing. Such opportunistic revision of the financial supervision will reduce its transparency and hurt its credibility.

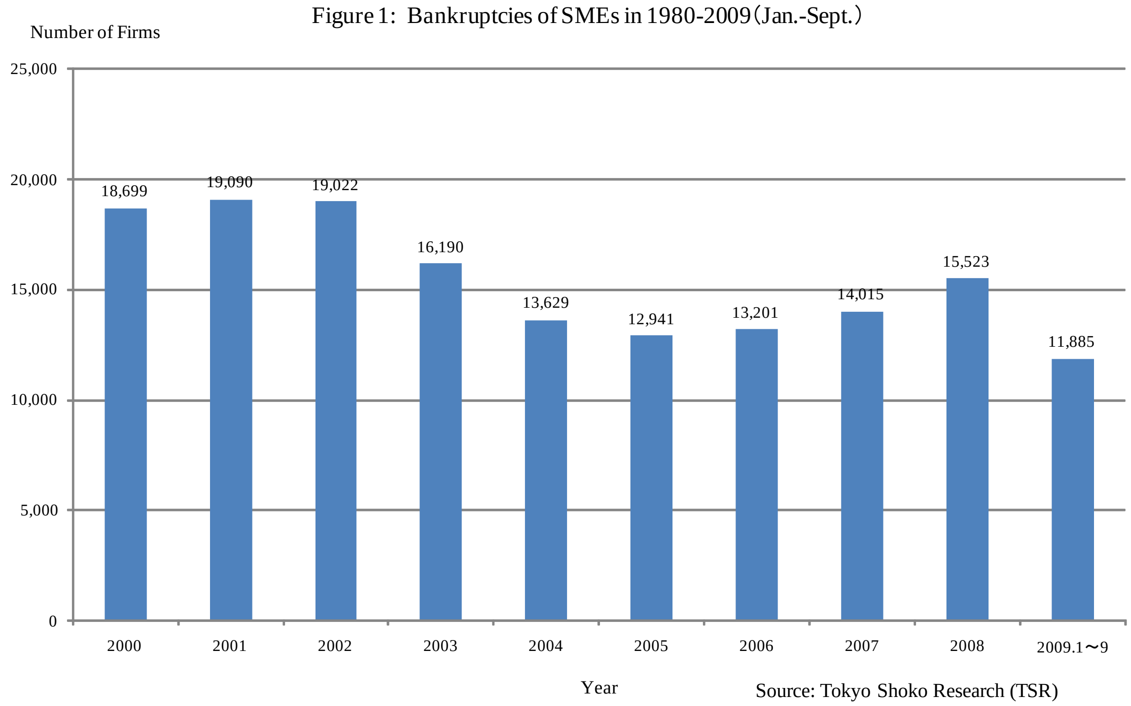
Finally, if the FSA ends up *de facto* forcing the banks to restructure SME loans, banks will become reluctant to extend new SME loans, fearing that those loans may be forced to be rescheduled in the future. Thus, the scheme to protect the current SME borrowers can increase the risk of new SME loans and end up hurting new SME borrowers. Since the law encourages banks to restructure mortgage loans as well, it can have a serious impact on the market for securitized loans, too.

Problems for the Small and Medium Enterprises in Japan

What motivated the law is the recognition that credit crunch and credit squeeze are hurting SME borrowers. Statistical and survey data, however, do not support such a concern.

Figure 1 shows the number of SME bankruptcies by year. In 2008, the year of the Lehman Shock, 15,323 SMEs went bankrupt, but this was much less than around 19,000 a year in the early 2000s. Moreover, the SME bankruptcies have been declining since April 2009. The total amount of bank loans for SMEs does not show any sign of sudden decline in recent years. Japanese banks did not have much exposure to sub-prime related products compared with the US and European counterparts and has not lost much capital. Thus, credit crunch caused by the capital shortage like the one in the late 1990s is not likely happening this time.

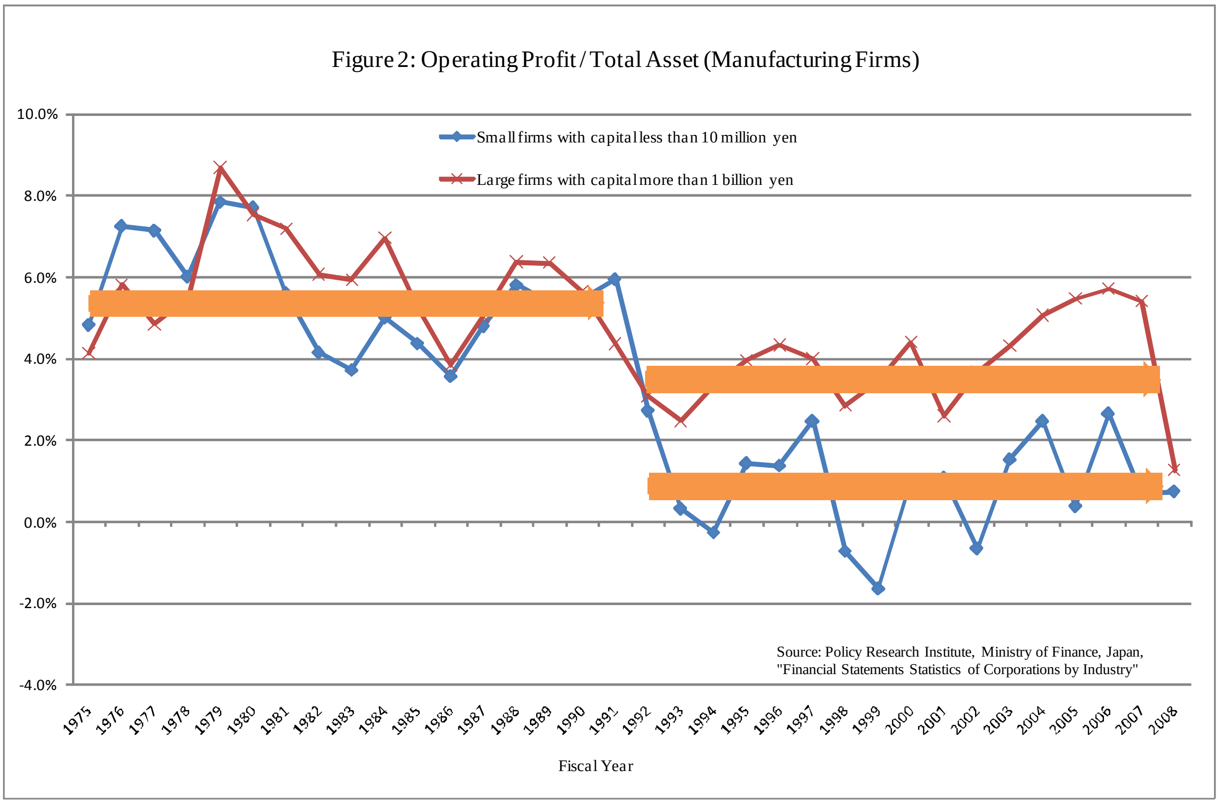
Figure 1: Bankruptcies of SMEs in 1980-2009（Jan.-Sept.）



Source: Tokyo Shoko Research (TSR)

Indeed, banks have already been rescheduling SME loans. For example, a survey by The Research Institute of Economy, Trade and Industry (RIETI) in February found that about 9% of small and medium enterprises (sales less than ¥1 billion) received moratorium for their loan repayments after the Lehman Shock of September 2008. The survey also shows that smaller firms are more likely to receive moratorium.

In the *Survey on Small and Medium Enterprises* conducted by the FSA in August, more than 70% of SMEs listed "deteriorated business conditions" as the primary cause of their financial difficulty. Few firms outside the construction and real estate industries chose "tighter lending attitude of banks" as the primary cause. The trouble of many SMEs does not come from credit crunch but from low profitability of their business. Figure 2 shows the average profit rates for small manufacturers (capital less than ¥10 million) and large manufacturers (capital more than ¥1 billion). Profit rates for both types of firms fell in the 1990s, but the drop was more dramatic for small firms. Thus, the SMEs have to restructure not only their liability side but also their business to restore profitability.



New entry of profitable firms would also help restoring the profitability of the SME sector, but the entry rate remains much lower than that of other developed economies.

Reviving the SME Sector

As we discussed, the new law is likely to generate many problems. If the FSA forces banks to reschedule the SME loans by strong guidance, the problems would become even more serious.

What is necessary for revival of SMEs is not the expansion of government guarantee and more government intervention, but economic restructuring at both firm level and industry level. There are several government policies that may help the process. The first and foremost is a policy to keep the banks well capitalized. Well capitalized financial institutions will actively seek for new customers with profitable prospects. Although the capital shortage is not yet a serious issue for many Japanese banks now, the continued global financial turmoil can still make some of them short of capital in the near future.

Second, institutions like the Industrial Revitalization Corporation in Japan (IRCJ) may be helpful in resolving the collective action problem among multiple creditors of distressed firms. Unlike the early

2000s when the IRCJ was established, however, Japan now has many private equity funds for corporate restructuring and improved court-supervised bankruptcy procedures. A government sponsored entity like IRCJ is probably not necessary at this point.

Third, there are policies that can encourage new entry more directly. The government may consider expanding the preferential tax treatment for individual investors for startup companies to other financiers of such companies. Financial institutions can be encouraged more to explore SMEs with new technologies. It is important to note that a policy to protect incumbent firms often ends up discouraging new entries and is counterproductive.

Finally, it is very difficult for the SMEs to improve their profitability under deflationary environment. Bolder macroeconomic policy to fight deflation is a necessary condition for the revival of the SMEs and the Japanese economy.