Introduction

From 1985 to 1990, Japan experienced an asset bubble of unprecedented proportions. The Nikkei Stock Index surged in these five years from below 7,000 to over 39,000, while the price of other assets—and real estate, in particular—multiplied many times over. During this period, the central bank maintained an extremely loose monetary policy, holding interest rates at postwar lows. Japanese banks engaged in a lending frenzy and, in doing so, helped to fuel the surge in asset prices. They extended many loans for purposes of investment in the stock or real estate markets. They extended many more for the buildup of industrial capacity on a scale that could only be fully utilized if bubble-period consumption trends persisted.

From 1990, this bubble began to burst—first with a plunge in the Nikkei Stock Index, followed in early 1992 by a tumble in land prices. Both developments had a severe impact on the ability of corporate and individual borrowers to repay loans. The bursting of the bubble thus left banks throughout Japan—both large and small—in financial distress, burdened with massive amounts of bad debt. This bad debt, in turn, weakened bank capital ratios, sharply raising their likelihood of collapse and severely impairing the capacity of banks to extend credit to new borrowers.

History is replete with financial crises, however. In recent decades, many countries have experienced distress in their banking sectors, in particular. Since the 1980s, crisis has struck several major Latin American and African countries, Russia, and numerous countries in East Asia. Even advanced industrial nations with highly advanced financial systems and seemingly strong banking regulators such as the United States and the Scandinavian countries have experienced severe crises. So, why a book about Japan’s financial crisis? At least two features of the Japanese case stand out as distinctive; both are intimately related and pose important substantive and theoretical puzzles.

The first feature is the extraordinary delay by Japanese government officials before intervening to aggressively address the bad debt problem in the nation’s banking system. The resolution of banking crises typically requires the use of public funds to recapitalize banks, augment the depositor safety net, and establish a temporary agency to take control of failed banks and dispose of their assets. Since an injection of public funds is al-
ways politically unpopular, governments often delay before mustering the political will to allocate taxpayer money to this end. Nonetheless, mechanisms seem to exist in other countries to spur a more prompt response to financial crisis than that seen in Japan.

According to an International Monetary Fund (IMF) study, those countries that made the greatest progress in the wake of financial crisis took a little less than ten months on average before embarking on systemic bank restructuring while those countries making the slowest progress took, on average, approximately four years. In Japan, eight years passed from the onset of severe financial distress before the government initiated aggressive measures to tackle the bad debt problem and institute fundamental financial system reforms. As a result of this delay, what might have been relatively small costs of clean up in economic terms turned into staggering costs. By the time of this action, the amount of bad debt held by Japanese banks was estimated to total 1 trillion dollars or approximately 30 percent of the gross domestic product (GDP). Clearly Japan’s extraordinary delay places the country well outside even the upper bounds of normalcy.

A second distinctive feature of the Japanese case is the ineffectiveness of the government’s financial reform and recovery efforts, once initiated. As of this writing in mid-2003, thirteen years after the bursting of the bubble, Japan’s financial sector problems remain unresolved. Indeed, regardless of the metric one chooses to use, financial reform outcomes have been abysmal to date. This is the case whether we measure success by the speed and degree to which confidence is restored to the financial system, the fiscal costs incurred in restructuring the financial system, or the length of the crisis recovery period, with recovery measured in such terms as percentage of nonperforming loans in the banking system or health of financial institutions as reflected in capital ratios or profitability.

The elusive outcomes are particularly puzzling on the surface given the seemingly dramatic nature of reforms implemented since late 1998. In October of this year, Japanese legislators at last readied large amounts of public funds for use in recapitalizing the banking sector. At the same time, they established a new legal framework for dealing with ailing banks, enhanced the independence of a newly established Financial Supervisory Agency, set up a commission to oversee financial reconstruction, revised the Deposit Insurance Law, and strengthened the functions of the Resolution and Collection Corporation (RCC), a newly established government-backed asset management corporation (AMC) to aid in the disposal of bad debt. In the wake of these changes, new norms emerged concerning appropriate relationships between regulators and financial firms, and new expectations about standards of transparency were likewise estab-
lished. The creation since 1998 of numerous councils and committees in the Diet to deal with financial sector issues also seems to signal a political commitment to resolving the nonperforming loan (NPL) problem.

Nevertheless, by most conventional indicators Japan’s financial system looked worse in 2002 and 2003 than it did in any year since the bursting of the bubble. Amounts of nonperforming loans held by Japanese financial institutions surpassed amounts recorded in 1998, all of the major banks reported net losses, and these banks remained highly vulnerable to a multitude of “shocks”—such as a stock market downturn, adjustments to deferred tax accounting practices, the failure of financial interdependent insurance firms, or a significant rise in the interest rates of their massive holdings of Japanese Government Bonds (JGBs). Moreover, Japan’s financial sector problems today comprise only one component of a complex array of formidable problems that include prolonged deflation, industrial stagnation, and unprecedented levels of government debt. Why can’t Japan get back on track? The answer is of critical importance, for the costs to date of Japan’s elusive financial sector recovery have been huge.

Costs of a Delayed Response

There is no question that Japan’s banking crisis will be the costliest in history. The government’s delayed response to systemic problems in the banking sector has translated into lost output and enormous fiscal outlays. In the period 1992–2001, the nation’s average growth barely exceeded 1 percent. This performance placed Japan last among the Organization for Economic Cooperation and Development (OECD) countries in growth over the 1990s. Moreover, the second of the nation’s three economic contractions in this period represented one of the sharpest experienced by a developed country since the American Great Depression. The link between dysfunctional financial intermediation and poor economic performance has been particularly close in Japan due to the underdevelopment of capital markets and heavy reliance by most of the nation’s firms on bank loans as a means of capital procurement.

Litan and Posen (2001) assert that even if only half of the $600 billion of nonperforming loans they estimated to exist in 2001 were collected, the Japanese government faces clean-up costs of more than four times the share of GDP that the U.S. spent cleaning up its savings and loan debacle of the 1980s. Kashyap (2002), moreover, estimates current Japanese taxpayer liability for losses incurred but not yet recognized in 2002 to total at least 24 percent of Japan’s GDP. And, in January 2003, the Deposit
Insurance Corporation of Japan (DICJ) announced that it expected to spend a total of 11 trillion yen (approximately $91.7 billion) by the end of fiscal year (FY) 2002 to guarantee the repayment of deposits at failed Japanese banks alone. This sum represents approximately 100,000 yen ($847) of taxpayer money for every person in Japan.9

Japan’s financial crisis has also had important international and regional spillover effects. Depressed economic output, weak consumer demand, and slowed credit flows from Japan—all by-products of the unresolved banking problems—have profoundly affected other economies. The negative impact was felt in particular by Japan’s regional neighbors in the wake of the 1997–98 Asian financial crisis. Japan accounts for approximately 60 percent of the goods and services produced in Asia, and is an important export market for its regional neighbors. The country’s protracted downturn has left it unable to absorb exports as in the past. The inability to fix the banks—a prerequisite to reviving both domestic demand and sustained growth—has also led the government to support an export-oriented recovery and weak yen, policy choices that tend to generate trade conflict and foster resentment of Japan within East Asia.

As the second largest economy in the world, producing one-eighth of global GDP, Japan’s financial woes and protracted malaise also affect the operation of global capital markets, trade flows, and exchange rates. In 1998, in particular, the conjunction of acute domestic financial crisis with crises elsewhere in global markets generated widespread fear that Japan might collapse and take the rest of the world with it. The large-scale withdrawal of most Japanese banks from overseas business since 1998 alleviates some of this concern. Nonetheless, stagnation in Japan is clearly a negative for the global economy—particularly when its problems coincide with economic malaise in the United States.10

The government’s delay in dealing aggressively with the bad debt problem also extended the time required for crisis resolution and severely complicated the task. In August 2001, the State Minister for Financial Services, Yanagisawa Hakuo, estimated that a final resolution of bad debt problems would likely take up to seven years, even with aggressive actions.11 In 2002, following a further climb in amounts of bad debt held by Japan’s 129 banks, many financial analysts and government officials confided that even this estimate was optimistic.

The price tag associated with Japan’s financial crisis reflects more than the costs of government inaction. It also reflects the costs of policies pursued in lieu of tackling banking problems head-on in the 1990s. In an attempt to “grow out” of the bad debt problems in this decade, authorities carried out a series of massive fiscal stimulus measures. This spending...
spree led the government, holding an overall fiscal surplus of 3 percent of GDP in 1991, to shoulder by 2002 a deficit unparalleled in the industrial world at 140 percent of GDP. This by-product of institutional inertia now poses new and enormous political impediments to spending the massive amounts required to execute a final resolution of the non-performing loan problem.

Moreover, in lieu of a publicly funded and politically difficult recapitalization of the banks, the government strongly encouraged other private sector actors to privately recapitalize weak banks. The result was a deep intertwining of the fate of banks with those of other financial institutions. Insurance firms, in particular, deepened their interdependence with banks, and vice versa, by engaging in “double-gearing”—a practice involving the simultaneous issuance of new shares for mutual purchase. As a result, regulators would scramble in 2003 to assemble a scheme aimed to preempt the large-scale collapse of insurers, reeling under the weight of years of lower-than-promised yields, because of the disastrous implications such a development would have on banks.

The repercussions of policy delay in finance extend even to Japan’s foreign affairs and to its security alliance with the United States. The need for increased spending on the bad debt clean-up in the presence of a crisis in public finance has meant budget cuts in other important policy areas, constraining Japanese diplomatic initiatives. In 2002, Japan was displaced as the top provider of overseas development assistance (ODA) in the world, signaling the weakening of one of the nation’s key foreign policy tools. Likewise, defense spending has emerged as a target of spending cuts at a time when Japan faces unprecedented threats from North Korea and corresponding pressure to boost spending to develop a missile defense system.

Japan’s financial crisis has also had enormous social consequences. According to Japan’s National Police Agency, the number of suicides rose sharply in Japan over the past decade. Beginning in 1998, in particular—the first year following a sharp escalation in the financial crisis marked by the collapse of major financial institutions in Japan—the number surged to over 300,000 a year. The year 2002 represented the fifth consecutive year in which the number of suicides topped this mark. This figure represents more than double the number of suicides in 1970 and represents a rate of roughly eighty deaths per day. According to the Police Agency, a major portion of this increase is accounted for by a rise in the number of incidents related to financial problems, such as bankruptcy or the inability to repay loans. To Japan’s life insurers, the connection appears clear: today insurance firms require a financial profile as part of the screening process of new policyholders.
The suicide epidemic, as it relates to the country’s financial woes, extends beyond middle-aged salary workers facing job losses, small business owners unable to repay loans, or youth facing unprecedented challenges finding work. At the peak of financial crisis in 1998, its reach extended into the once vaunted Finance Ministry, the Bank of Japan, and into the national legislature, claiming the lives of three career bureaucrats, a central banker, and a prominent politician. Social costs of unresolved financial crisis are also manifest in the rising number of the homeless—once a rare sight in Japan but now more commonly observed due to the prolonged economic stagnation and postwar high unemployment rates. Financial turmoil has clearly affected the social fabric of the nation.

**The Enigmatic Character of Japan’s Crisis Response**

Understanding the political dynamics underlying the delayed response by Japan’s financial authorities is also vitally important because the government’s delayed response to this crisis challenges the conventional wisdom of Japanese political analysis. While most scholars emphasize the incremental nature of policy change in Japan in regular times, they have tended to evaluate this incrementalism as fairly effectual on balance. And, most do see crisis as spurring significant policy change. Examples of adept Japanese government response to past crises make the mismanagement of the banking sector woes in the 1990s all the more enigmatic. The response to potentially destabilizing problems in the financial sector in the mid-1960s was swift and decisive. In this period, a cyclical downturn in the economy combined with a depressed stock market to lead a number of brokerages including Yamaichi Securities to the brink of collapse. The government extended extraordinary assistance to the financial industry via the central bank and all of these loans were later repaid in full. Similarly, the nation’s response to the oil crises of the 1970s was widely appraised as a success. When the oil crisis exposed the deficiencies of local energy supplies in 1973, the government and private industry responded in such a way that Japan was a world leader in energy saving technology by the time of the second oil crisis in 1979. Consider that in 1984, OECD went so far as to declare that Japan “weathered the second oil shock and protracted international recession better than any other country.” The OECD noted, moreover, that the nation’s distinctive performance “owed much to the timely and appropriate response of policies . . .” (emphasis added). Yet, when historians review Japanese postwar history in the decades to come, no other event—with the exception of the Allied Occupation—is likely to receive more attention than the government’s inept response to financial crisis in the 1990s.
How do we explain this puzzle of extreme variance in the state’s capacity to manage crisis across time?

Japan’s recent economic performance is particularly shocking when viewed in the context of its own past record-breaking performance and extraordinary financial sector stability. From the mid-1950s through the mid-1970s, Japan’s financial system provided a safe means of payment, encouraged and facilitated real savings, and mobilized and allocated this savings relatively effectively to finance investment. The Ministry of Finance (MOF)’s regulatory policies, informal industry guidance, and heavy influence over monetary policy were widely seen as establishing a framework for financial system stability and prosperity. Despite a number of recessions and exogenous shocks to the financial system, the government responded to emerging problems in a way that maintained financial sector stability and facilitated economic recovery. Not a single bank collapsed and the system seemed to work well—so well that the pace of the nation’s postwar economic progress was dubbed “miraculous.” Developing nations across the globe—and particularly in Asia—sought to emulate the Japanese model.

While Japan’s economic growth slowed after the oil shocks, the nation continued to record growth rates of more than 3 percent per annum from 1981 to 1991, outpacing those of other large advanced industrial countries. When the asset bubble inflated in the latter half of the 1980s, no one predicted the severity of its consequences. On the contrary, many pointed to the size and international presence of major Japanese financial institutions at this time as a sign that the nation’s economic model—with its emphasis on bank-centered financial intermediation—was in its prime. Some even perceived Japanese financial and economic might to be so formidable as to pose a threat to U.S. dominance.18

The crisis of confidence that erupted in the next decade was in stark contrast to the self-assurance that oozed from the Japanese financial sector, the business community, and the MOF in the “bubble” era. Once the centerpiece of public adulation and hailed as the most competent bureaucratic organization in the world,19 the Finance Ministry became the target of public fury in the 1990s. Simple regulatory incompetence might have been forgiven but the revelation of numerous scandals accompanied the collapse of major financial institutions—including the nation’s tenth largest bank and fourth largest securities firm. These suggested that sector instability might be attributed at least partially to cozy relations between Finance Ministry officials and the institutions they were to regulate. Moves by the national legislature in this period to “dismantle” the ministry would have been unimaginable a decade earlier. How could institutional arrangements for financial policymaking and regulation work so well for so long and yet also be guilty of leading the nation into such a deep economic and financial abyss?
Understanding the Japanese Government’s Response to Financial Crisis

The chapters that follow try to solve the puzzles outlined above by examining the operations of policy networks in Japanese finance. During the 1980s, in particular, many argued that Japan was an unusually flexible and efficient “network state” that posed an alternative to the more arms-length, rules-based approach to policy favored in the West. Since the onset of Japan’s recession in the early 1990s, opinion has become far more critical, emphasizing the restraining and collusive aspects of network operations. By engaging in a systematic analysis of policy networks in post-war Japanese finance, this book seeks to provide a consistent intellectual framework for understanding the over four decades of apparent success in Japanese financial regulation, the large-scale regulatory breakdown in the 1990s, and the nature, process, and limits of change in regulatory arrangements since late 1998.

The analysis of policy networks in Japanese finance produces two main contentions. First, the book argues that the same network variable that helps explain earlier success plays a critical role in the explanation for the unprecedented degree of financial regulatory and policy breakdown in Japan over the past two decades. The study identifies two intervening variables that upset the political economic system, bringing about a functional shift in Japan’s financial policy networks: heightened fluidity in party politics accompanying a shift from uninterrupted one-party rule to rule by coalition government; and, a dramatic rise in information requirements for effective financial regulation. As a result of change in these variables, networks once enhancing policymaking capacity in Japanese finance were transformed into “paralyzing networks” by the 1990s, with disastrous results. The study exposes why and how these networks perpetuated themselves over time, even when utilitarian calculations would suggest they were dysfunctional.

Second, the book argues that the challenge of system transformation varies significantly across political economies and that the degree to which institutions are embedded in the larger political economy affects the cost and process of system change. By uncovering ways in which the embeddedness of Japan’s Finance Ministry in the political and financial worlds was similar to and different from its counterparts in other countries, the study contributes to a better understanding of why Japan’s financial system reform and recovery process has proven so difficult. Specifically, the analysis reveals that the particular structural and agency characteristics of Japan’s policy networks produced institutional legacies and linkages across policy domains that present particularly high barriers and costs to change.
The above findings, it is hoped, shed light on the determinants of Japanese state capacity across time, enhance our understanding of the complex challenges facing Japanese government and business leaders today, and point to the types of further institutional reforms required if Japan is to revive its troubled economy. It is further hoped that this case study of Japan’s financial crisis will enhance our understanding more generally of the potential role played by political institutions in mediating market forces, and of why some institutional forms are simply more difficult to change than others.