

## Politics After the Collapse of the Bubble Economy

## How Did Politics Respond To the Occurrence and Collapse of the Bubble Economy?

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### 1. Problem Identification: The *Essence of Failure* and the *Best and Brightest*

The occurrence and progress of a bubble economy is said to be difficult to recognize precisely. In general, a bubble is recognized in hindsight.<sup>(1)</sup> While recognition of a bubble economy's collapse can be shared relatively easily, unlike the recognition that a bubble is occurring, there are difficult questions regarding the response to the collapse of a bubble economy.<sup>(2)</sup> While judgement and response are usually left to individual companies and financial institutions, in some cases the government has to intervene. Also, it is a matter of macro-policy decisions regarding general fiscal and monetary policies, as well as micro-judgement on individual cases, which sometimes require the government to order companies and financial institutions to make their exit. How did politics respond to these problems? In other words, it should be asked now, twenty-five years after the collapse of the bubble economy, how politics responded to its occurrence, its collapse, and its management.

*Lost Decade* and *Lost Two Decades* are terms that have been used to describe

Japan over the years. It is possible that not only *time* and *assets*, but also *human resources* and *trust* were lost.

Another issue is that the Japanese economy and politics during these years were comparable to *the essence of failure*<sup>(3)</sup> which revealed the former Japanese forces' organizational flaws. Not only was it common to avoid taking responsibility for decisions, but also to postpone important decisions. Similar to organizational theory in *the essence of failure* before the war, the leading figures of financial institutions, the Ministry of Finance, and the government that were involved in making decisions during the collapse of the bubble economy were *the best and the brightest*,<sup>(4)</sup> just like those involved in *the essence of failure* and the Vietnam War. As they were considered elites according to their alma mater and career, one has to wonder what problem these elites could not deal with. In other words, from the perspective of the theory of decision making, why did they choose to *postpone* response (even if they did not do so consciously)? Also, from the perspective of epistemology, why did no one recognize the seriousness of the bubble economy's collapse?

While these are issues common among individual companies and financial institutions, this chapter examines these issues on a political level. This is because these should be dealt with as a matter of politics, including the process of decision making, rather than as a matter of the qualities of individual politicians alone.

Furthermore, did they remain idle spectators during the Lost Decade and the Lost Two Decades? In fact, it was the 1990s when various reforms were implemented one after another. It may well have been called the *Decade of Reforms*. However, it is necessary to examine the relationship between these reforms and the cleanup of the bubble economy. In other words, the question of whether this led to systemic reform that ensured the governance of finances.

Timewise, the world experienced the end of the Cold War in 1990 following the fall of the Berlin Wall the previous year. However, this also marked the end of the Japanese economy's continuous growth.<sup>(5)</sup> After all, as it was the period when the business model of a growth phase lost currency, there was a limit if one tried to deal with the collapse of the bubble economy using the conventional method of policy making.<sup>(6)</sup>

Following the drop of stock prices to their lowest at 7,670.88 yen on April 28, 2003, Junichiro Koizumi's cabinet decided to inject public funds on the scale of two trillion yen into Resona Bank on May 17, 2003. The author perceived that the response to the collapse of the bubble economy was settled then for the time being. In other words, in terms of periodical division, it took a long time between 1990 and 2003 to sort the bubble economy out.

In 2008, however, the Lehman's Collapse, similar to the collapse of the bubble economy in Japan, occurred on a global scale. In comparison with the period of bubble economy in Japan, while the methods of securitization and financial engineering have since developed spectacularly, ways of maintaining global financial order are still influenced by the Bretton Woods system (IMF system),<sup>(7)</sup> and *Bretton Woods II* has yet to be created. Established with the leadership of White from the US and Keynes from the UK, the Bretton Woods system, which was the *post-war regime* itself, ended its role when the conversion of the dollar to gold was stopped in 1971. The maintenance of financial order as international public goods and the establishment of a system that prevents a crisis *pandemic* from spreading globally are challenges yet to be addressed.

In this chapter, the author would like to describe how Japanese politics responded to the bubble economy<sup>(8)</sup> and its collapse, and, in addition, to discuss the shift of issues to be addressed over twenty-five years, based on the author's personal experience of being involved in dealing with the issues, approximately in the same period.

## 2. Were Politicians Unaware of the Occurrence and Collapse of the Bubble Economy?

In general, Japanese politicians are not well versed in monetary policy compared to finances (budgetary process) and individual industrial policies. They tend to leave it to experts not only because of the general factor of unfamiliarity, but also because it involves technically complex issues. However, politicians make the following remarks either as excuses or facts. In particular, they are resentful of the Ministry of Finance regarding housing loan companies.

Early in the aftermath of the collapse of the bubble economy, Koichi Kato

stated, "When I read it,<sup>(9)</sup> I became aware of monetary issues for the first time."

Seiroku Kajiyama, the former Chief Cabinet Secretary said, "The Ministry of Finance explained to me that I didn't have to worry about anything as long as the issue of housing loan companies was dealt with. However, in fact, all messy stuff other than the issue of housing loan companies were postponed."<sup>(10)</sup>

Ryutaro Hashimoto came forward as a candidate in the April 2001 election for President of the LDP. While Junichiro Koizumi also announced his candidacy, the favorite candidate was Hashimoto. When asked about the responsibility of bad loans at a press conference, he answered, "My judgment was clouded because I didn't know the actual situation of bad loans," implying that the Ministry of Finance was to be blamed for not informing him properly.<sup>(11)</sup>

However, politics has to deal with issues at times in specialized areas such as nuclear power, energy, and gene therapy. In other words, it can be said that it is a matter of politicians' individual qualities as to what extent one can grasp a situation that changes every hour.

Let's have a look at an example. The following passages by Chief Cabinet Secretary Masaharu Gotoda allow us to examine what information politicians at the center of government possessed, including the Chief Cabinet Secretary.

"At the time of the Plaza Accord, participating countries appeared to have assumed that the yen-dollar exchange rates would be lowered from 250 yen per dollar to 220 yen per dollar. However, it didn't stop at 220 yen. I think it dropped to around 180 yen over a year. Ultimately, it further dropped to 150 yen. Of course, it would bring export to a halt. So Japan was internally driven into the recession due to a strong yen. Then the government had to turn to economic measures. Nowadays, Nakasone's cabinet is blamed for the bubble economy.

It is true that economic measures were first taken in the last years of Nakasone's cabinet, but I would say the problem was that successive cabinets after Nakasone's cabinet continued monetary easing, failing to recognize the time to turn to monetary tightening.

I was the Chief Cabinet Secretary for the last two years (Note: 1986-87) of Nakasone's cabinet. A year or so passed in the office, and it was when I was listening to monthly economic reports that I realized that M2 (currency in circulation) was increasing in double-digit percentiles for more than a year. It probably continued for about two years. So I asked about it only once during the meeting on monthly economic reports.

'I'm a novice in this matter, but it seems strange to me that prices are not rising, and economic growth is far below our expectations at around four percent, while prices are rising at a rate of less than two percent, despite there being so much money in circulation. What is happening with the money that has increased by ten-odd percent, and where is it going? It must be real estate financing, buying real estate and golf courses abroad and investing in domestic real estate. So could you please explain to me why you are not implementing a monetary squeeze?'

The governor of the Bank of Japan at the time was Mr. Satoshi Sumita who came from the Ministry of Finance. Mr. Sumita's reply was not clear. So I sent for the director of the banking bureau. It was Mr. Sadaaki Hirasawa, who later became an undersecretary and then the president of the Bank of Yokohama. He replied 'I agree with you completely.' I asked him to do something about it. So he issued a circular. The circular was probably issued a few times, whenever I pointed it out. However, they must have hesitated. The Ministry of Finance was not serious about it."<sup>(12)</sup>

The above quote suggests what the Bank of Japan should be monitoring. In addition, Gotoda claimed that when he sent for Sadaaki Hirasawa (the then director of banking bureau at the Ministry of Finance), as "Mr. Sumita's reply was not clear (Sumita was the then governor of the Bank of Japan)," and asked about it, Hirasawa replied "I agree with you completely."

These passages show the intuition and kind of analytical capacity politicians

should have towards general reports such as monthly economic reports.

Also, Gotoda intuitively realized the discrepancy between the money flow and stock statistics. In other words, he realized the difference between the stabilization of consumer prices and the occurrence of assets inflation (bubble).

From these passages, it should be noted that the Chief Cabinet Secretary is receiving quite accurate information. However, usually the Minister of State for Financial Services should be in charge of information about bad loans at individual financial institutions.

### **Prime Minister Kiichi Miyazawa's Argument for the Injection of Public Funds**

While it has been mentioned that politicians in general are not well versed in financial affairs, it is well known that Kiichi Miyazawa, being acquainted with this area, stated the *possibility of injecting public funds* as early as 1992. This is not a matter of awareness, but rather a good case to analyze why it was not implemented in the actual political process.

"At the end of August, a LDP seminar was held in Karuizawa. I remember that I made a speech there saying, 'Under the current situation of bad financing – as it was called then – by banks, in some cases the government may have to intervene officially.'"<sup>(13)</sup>

Regarding Miyazawa's remark, some praised it, saying, "That's like Mr. Miyazawa," while others questioned why he didn't push through the injection of public funds in reality. The quote is taken from Miyazawa's memoir, which is further quoted at length as follows:

"Miyazawa: Let me jump to another topic. When I became Prime Minister, I had to deal with the gradual collapse of the bubble. The Dow-Jones average dropped sharply in the summer of 1992. The Nikkei Stock Average also dropped to 14,309 yen in August 1992, despite the ongoing efforts to deal with the collapse of the bubble economy, such as the lowering of the official rate by the Bank of Japan and the front-loading of public works by the government. Yet

it dropped to 14,309 yen. I was thinking that I had to return to Tokyo and close the stock exchange for a day, if it fell below 14,000 yen. When I told Mr. Mieno, the then governor of the Bank of Japan, while talking over the phone, 'If it falls below [1]4,000 yen, I will return to Tokyo. I think if the prime minister returns, others will have to do something to deal with the issue,' then he replied, 'I understand. I'll do whatever is necessary when you return.'

In the meantime I talked to a secretary for the Ministry of Finance, and the Ministry issued the "Operational Policy of the Finance Administration for the Time Being" on August 18, which brought calm to the market.

Then, at the end of August, a LDP seminar was held in Karuizawa. I remember that I made a speech there, saying, 'Under the current situation of bad financing – as it was called then – by banks, in some cases the government may have to intervene officially.' This was the expression of my personal thoughts, not a text prepared by the government office, but it didn't get much support despite it being reported by the press on a large scale. This is a case often cited when the issue was discussed in the Diet in later years, and I was repeatedly asked why I wasn't able to execute the policy despite being so aware of the situation.

However, at that time, more than anything, the most irritating thing for the industrial world was that the government would support banks, and the majority of the financial world itself was against it, claiming, although it depended on individual banks, 'We are not in such big trouble. Indeed there are some banks struggling, but it is a matter for them. It is appalling that the government would intervene by giving money to banks.' The Federation of Economic Organizations, presided by Mr. [Gaishi] Hiraiwa at that time, also said, 'As a matter of course, the Federation of Economic Organizations does not agree with such a policy.' It eventually ended up being nothing but pie in the sky, as government officials did

not commit to the policy saying, 'It is not necessary to embark on such a policy, as property values will recover soon,' or due to the circumstances of work continuation. Such was the situation in the summer of 1992. Later I was often asked how it could have been done at that time, but in hindsight the situation was not ready for it. The actual situation was that, although I was aware of the issue and pointing it out, it didn't get to the point where everyone got on board to put the policy into execution."

Miyazawa's remarks are a denial of the theory that a policy can be executed as long as the Prime Minister is properly aware of the issue. It not only stated that politics cannot move forward without reconciliation of interests and agreements among the related parties, but also suggested the influence of bureaucracy that executes policies based on coordination.

In fact, the injection of public funds was opposed not only by the Federation of Economic Organizations, but also by the Japan Federation of Employers' Associations, the Japan Chamber of Commerce and Industry, and the Japan Association of Corporate Executives, as well as the industry and financial worlds.<sup>(14)</sup>

At that time, the author conducted a hearing with the president of a certain bank, who stated that they could not support the injection of public funds. Their reasons for opposing the injection of public funds were fears of stronger interventions from the Ministry of Finance or the Bank of Japan, as well as requests to accept golden parachuting from them.

The banks were also dreading that, in case of the injection of public funds, the real examples of bad loans, i.e. the fact that XX branch of YY bank arranged such stupid financing, could be brought to light. Hence, they hoped to resolve the issue of bad loans confidentially so far as possible.

Another influential reason why Prime Minister Kiichi Miyazawa only mentioned the injection of public funds but failed to implement it was that the Ministry of Finance had decided not to inject public funds hurriedly.<sup>(15)</sup>

### 3. Political Issues Regarding the Financial Crisis

As for the beginning of the financial crisis, some would think it was the case of the Toyo Shinkin Bank in October 1992, which didn't follow the precedent of its parent bank taking over as a whole, and others might say it was the case of Hyogo Bank which failed in August 1995. Or, some might have realized it when they watched the bank run of the Kizu Credit Union on television in August 1995.

However, the initial issues of bad loans had not yet attracted the nation's attention. The 1996 ordinary session of the Diet was called the *Housing Loan Companies Diet* as it deliberated on the injection of public funds for the disposal of bad loans for the amount of 685 billion yen. The opposition, New Frontier Party, used picketing tactics. In addition, Prime Minister Ryutaro Hashimoto agreed with the US government after negotiations over a month and a half to hand over the entire US Futenma base in April 1996. It was an irony of history that the general election held in October that year was fought over the issue of administrative reforms, rather than the issue of housing loan companies as expected by the opposition or the issue of Futenma as assumed by the LDP.

The issue of housing loan companies was merely a prelude,<sup>(16)</sup> and a full-blown crisis occurred during Japan's financial crisis between 1997 and 1998. At the same time, there was also the Asian financial crisis, and these two crises were sometimes put in the same category by foreigners despite the complete difference in their causes and characters.

#### The Total Amount of Bad Loans was Over 120 Trillion Yen

The calculation of the amount of bad loans might seem easy, but in fact it isn't. The amount of bad loans increases if one assesses it strictly. Stock and land prices fluctuate every day. Also, there were different methods for categorizing bad loans. The method of categorization by debtor uses the following categories: failed or failed in essence, concern of failure, require attention (management), and normal.

The categories of loans included No-Category, Category II, Category III, and Category IV. Furthermore, there was a uniform international standard.

The amount of bad loans affects the method of the disposal of bad loans.

For example, if the amount of bad loans is 20 trillion yen when the financial institution's net business profits is 5 trillion yen, the bad loans can be depreciated in four years with simple calculations. However, if the amount was 100 trillion yen, the ordinary method won't work.

So, what was the estimated amount of bad loans at that time?<sup>(17)</sup> Seiroku Kajiyama, Chief Cabinet Secretary of the Hashimoto's cabinet, explained in the *Weekly Bunshun* in 1997 as follows:

“For the present, the official amount of bad loans held by Japanese banks is said to be 16 trillion yen among the twenty major banks (as of March this year). However, in reality, it is obvious that the actual amount of bad loans is manifold more. ... In Japan, dominated by the *land standard*, for good or bad, according to the System of National Accounts published by the Economic Planning Agency, the total amount for land prices in Japan as of 1990 at the climax of the bubble economy was 2,365 trillion yen, which dropped to 1,767 trillion yen just five years later in 1995. Indeed, as much as 600 trillion yen in assets were lost.

As the financial institutions, including banks, were lending to real estate agents on the security of land as much as possible at that time, even if it is estimated at the lowest that twenty percent is bad loan, the actual amount of bad loans was expected to reach more than 120 trillion yen.

Furthermore, as land prices have dropped sharply, bad loans are also created through lending after the collapse of the bubble economy (lending that strictly observes the assessment rate of collateral).<sup>(18)</sup>

Although the fact that the total amount of bad loans in Japan is over 100 trillion yen, as pointed out for some time by experts including David Atkinson who was working at foreign financial institutions, this was the first time that a Japanese politician officially admitted it.

### Soft Landing vs Hard Landing

Along with the discussion about the amount of bad loans, it is well known that there was also a conflict between the *soft landing* line and the *hard landing* line.

The first round of the debate was fought between Kiichi Miyazawa and Seiroku Kajiyama.

Toru Hayano, Senior Staff Writer of the Asahi Shimbun stated, “Contrary to the soft landing line which aims at gentle financial reconstruction so far as possible, the hard landing line which intends to force through reconstruction at the cost of bank failures if necessary is characteristic with Seiroku Kajiyama, as well as Ichiro Ozawa of the Liberal Party and others,” and introduced the following exchange from the Obuchi-Miyazawa meeting.<sup>(19)</sup>

“Obuchi: ‘I’d like to enact the bill regarding the disposal of bad loans. I don’t think hard landing works better.’

Miyazawa: ‘I agree. To prefer hard landing is amateurish. ... It is important to deal with the situation without falling into a catastrophe.’

Contrary to the soft landing line which aims at gentle financial reconstruction so far as possible, the hard landing line which intends to force through reconstruction at the cost of bank failures if necessary is characteristic of Seiroku Kajiyama, as well as Ichiro Ozawa of the Liberal Party and others. Then, what is the political meaning of Miyazawa’s harsh remarks on ‘amateurish’ policy?

Now, Nonaka is trying to eliminate the power of Kajiyama, who came out of Obuchi’s faction and fought Obuchi over the presidency of the LDP. The ministerial appointments of Kaoru Yosano and Seiko Noda who supported Kajiyama can be perceived as an attempt to weaken Kajiyama’s power. There has long been a rivalry between Nonaka and Ozawa. Before his appointment as Chief Cabinet Secretary, Nonaka must have made Obuchi promise that he wouldn’t team up with Ozawa.”

Why did Kajiyama argue for a hard landing? Why did Obuchi and Miyazawa try to avoid a hard landing and think that a soft landing was possible? If asked which is preferable at the time of landing, either hard landing or soft landing, most would naturally answer “soft landing.” However, when an airplane is unable to put down its wheels due to an accident, it needs to make a belly landing on the runway, and, in an emergency with no time for a belly landing, landing on sea water must be considered. Although it is difficult to interpret the situation correctly due to the entanglement with the political situation, it needs to be inquired once again if it really was a choice between two alternatives, hard landing and soft landing.

The second round came when Heizo Takenaka replaced Hakuo Yanagisawa as the Minister of State for Financial Services in the cabinet reshuffle on September 30, 2002. It appears that Prime Minister Koizumi appointed Heizo Takenaka with a determination to resolve the issue of bad loans at once.

Heizo Takenaka approached banks with three principles set by himself, namely 1. Stricter asset assessment, 2. Securing owned capital, and 3. Stronger governance of bank management.

As for the stricter asset assessment in practice, he set forth a policy to apply individual allowance based on the DCF (Discounted Cash Flow) method in principle with large debtors which require attention (with credit amount over 10 billion yen). The DCF method is to calculate the current value of debt from the future cash flow, such as repayment of the principal and interest generated from the finance receivable, using a “discount rate” which takes the risks of irrecoverable debt and interest rates into account. It would be more appropriate to say he forced a hard policy, rather than a hard landing, on the financial institutions.

### Policy and the Political Situation

Policy is often entangled with the political situation. The insistence on policy itself could be the political situation, making it difficult to find clear a distinction in most cases. The Hashimoto administration was replaced by Keizo Obuchi’s cabinet after the defeat in the House of Councilors election in 1998, which



resulted in a divided Diet. A political solution in such a situation was to delegate bills to the opposition entirely. In the so-called Financial Diet, the so-called “New Breed of Policy-Makers” (LDP’s Nobuteru Ishihara, Yasuhisa Shiozaki, and Yoshimi Watanabe, as well as DPJ’s Yukio Edano, Motohisa Ikeda, and Motohisa Furukawa (then)) played an important role. The ruling and opposition parties consulted on the disposal of bad loans and the liquidation procedure of financial institutions, enacting the Financial Reconstruction Act.

However, the composition of the ruling and opposition parties changed for the next bill. In short, the Financial Functions Early Strengthening Act was enacted with the cooperation of the Liberal Party. This was the turning point which led to the so-called three-party coalition (LDP, Liberal, and Komeito) then LDP-komeito two party coalition has continued till today.

On the other hand, there were various acts and policy plans whose contents are difficult to differentiate upon first glance, such as the Financial Reconstruction Total Plan, the Three Financial Acts, other than the Financial Reconstruction Program. Although each act and plan had its own policy-making process and political situation, the individual process will not be discussed here.

### ***The Lost Decade and the Decade of Reforms***

Also, as a problem inherent in politics, interest tends to shift according to the policy issues of the time. For example, when the focus was on the issue of housing loan companies, it became the focal point in disputes. As an extension of this argument, there is a theory that the response to the collapse of the bubble economy was delayed because politicians were hooked on political reforms in early 1990. Those criticizing the political reforms often claim this, but it would generally be easier to understand the failure as a lack of knowledge about financial issues, rather than as an issue inherent in political reforms. Namely, Koichi Kato, Seiroku Kajiyama, and Ryutaro Hashimoto, etc. were not political reformists, but it does not necessarily mean they knew more about financial issues than others. On the other hand, those promoting the political reforms,<sup>(20)</sup> such as Ichiro Ozawa, Tsutomu Hata, and Morihiro Hosokawa, were not well versed in financial issues either. Although the author himself has argued since 1990 that

the disposal of bad loans is an important political task, it cannot be said that Japanese politicians were unanimous in recognizing it was the most important issue.

For example, when Japan faced the financial crisis during Ryutaro Hashimoto’s period in office as Prime Minister (January 11, 1996 to July 30, 1998), the reforms proposed by Hashimoto were extremely wide-ranging. Hashimoto’s six major reforms included (1) the administrative reform, (2) the fiscal structural reform, (3) the social welfare structural reform, (4) the economic structural reform, (5) the financial system reform, and (6) the education reform. Although the financial system reform was included, it was mainly about the financial structural reform to carry out a *financial big bang* under the principle of *free, fair, and global*. It was neither concerned with the method of response to the collapse of the bubble economy nor dealt with the disposal of bad loans. When the author said, “It is a problem that Hashimoto’s six major reforms do not include the disposal of bad loans,” as the author was greatly dissatisfied with it, during a dialogue with Karel van Wolferen who was often very critical about Japan, he appeared not to be so concerned about the issue of bad loans.<sup>(21)</sup> The author remembers wondering why Wolferen could be so optimistic about it, despite being so harsh about Japan.

At the final stage of compiling Hashimoto’s administrative reform report, the Sanyo Securities Company went bankrupt in November 1997,<sup>(22)</sup> the Hokkaido Takushoku Bank failed on November 17, and the Yamaichi Securities Company announced its voluntary business closure on November 24. When the final report was submitted on December 3, 1997, people could not think of the administrative reform.

## **4. The Evaluation of Policy**

### **The Postponement of the Disposal of Bad Loans as a Political Method**

From a political perspective, *postponement* might have been a rational choice in a sense. Politicians tend to avoid taking responsibility. For bureaucrats, it is a solution based on the traditional mechanism to “respond systematically and

gradually, within the limit of physical strength.”<sup>(23)</sup>

If a gradual response is possible, it means there is unrealized gain, whose large size is a factor in delaying the response in Japan. It was in contrast to the sudden foreign currency shortage as foreign capital started fleeing during the Asian financial crisis, which forced governments to take emergency measures.

Also, there was no scheme to dispose of bad loans with the size of the Long-Term Credit Bank of Japan or the Nippon Credit Bank. Although the case of S&L was often mentioned as a foreign precedence used by bureaucrats, it was not helpful due to difference in size. The purchase of bad loans by the Federal Deposit Insurance Corporation in 1984, the rescue of the Continental Illinois National Bank and Trust Company with additional investment, etc., and the failure of the Bank of New England in 1991 were rarely mentioned.

However, the fixation on postponement was extremely unfortunate for Japan as a whole. At that time, the author consistently claimed to “inject public funds in volume” to the financial institutions holding a large amount of bad loans “at an early stage and in the short term, under the government responsibility, to dispose the bad loans at once, and call the financial institutions to account for the management responsibility so that there will be no moral hazard.”<sup>(24)</sup> However, the reality was “the shortage of allowance for uncollectable accounts, the postponement of decisions, the responsibility avoidance, the unsatisfactory injection of public funds, the response in the long-term, rather than the short-term.” It must be questioned why the general method of disposal of bad loans was not used.

As mentioned already, one reason was the amount of bad loans. In addition, for the disposal of bad loans held by failed banks, these banks had to be nationalized or announce their failure, which the politicians couldn’t decide on as it was a death sentence to the financial institutions.

Another reason was the difference between the inflation and deflation periods. During the inflation period, bad loans would be disposed of naturally as land and property prices rose. For example, when Ataka & Co. went bankrupt in the late 1970s and the Heiwa Sogo Bank failed in the middle of the 1980s, the issue of bad loans was resolved earlier than expected, because these failures

happened during the inflation period and the bubble economy.

In short, during an inflation period, the issue of bad loans would be resolved earlier than expected as the market recovers, for real estate and assets won’t be bad loans any longer as land and asset prices soar. However, during the deflation period in 1990s after the collapse of the bubble economy, land and real estate prices continued to drop. The assumption that the economy would recover sooner or later was proved wrong, which worsened the situation as the issue of bad loans that should have been resolved sooner was prolonged. In addition, there was no scheme to dispose of bad loans. Although financial institutions settled their accounts with unrealized gains by selling stocks at the term end, even unrealized gains eventually depleted, which coincided with the period of Takenaka’s reforms in 2002.

### The Standard Measures Afterwards

In 2002, under the Koizumi administration, standard measures to dispose of bad loans were implemented with the *Financial Reconstruction Program* by the Minister of State for Financial Services Heizo Takenaka. It was based on the scheme of response to the financial crisis, which included (1) maintaining sufficient circulation of money to avoid financial panic such as bank runs, (2) protecting depositors, (3) purchasing bad loans, and (4) injecting funds to financial institutions. After the Lehman’s Collapse, similar measures were taken globally for the financial institutions holding bad loans.

Among the standard measures, while the maintenance of circulation and the protection of depositors meet with general approbation, the purchase of bad loans and the injection of public funds are problematic. There is considerable difficulty in purchasing bad loans and collect debt by selling them. Also, the injection of public funds was more difficult as the size and method of injection had to be taken into account to avoid moral hazard. As a matter of fact, as the funds used to dispose of bad loans would be recovered ex post facto through the selling of bad loans and stocks, the real deficit was not so big. Hence, from a long-term perspective, in terms of the national economy as a whole, the national burden was not too heavy even if the public funds were injected.



Even so, the disposal of bad loans is a large-scale operation, which is impossible to execute quickly and without any discontent. The patient (financial institutions) would cry, “It hurts!” and interested parties would try to be involved as much as possible.

## 5. An Overview of the Twenty-Five Years After the Collapse of the Bubble Economy

### Political Overview (The Issue of Governance and the Crisis Management)

When probing the question of why the disposal of bad loans was postponed, one encounters the issue of governance. While some within the individual financial institutions must have objected to lending, the brake was not applied in the middle of the bubble economy. Also, although there should have been some who motioned for the disposal of bad loans at once after the collapse of the bubble economy, they were not in the mainstream (many were relegated). In short, postponement was the only answer in reality. In the field of politics, there were systematic problems to be overcome in creating a persuasive plan and executing it before materializing the disposal of bad loans. It was an issue of governance as to whether the mechanism to modify an erroneous policy was inherent in the system.

### Crisis Management

Another challenge was *crisis management*. One purpose of Hashimoto’s administrative reform was to strengthen the function of the cabinet. It was pursued in the context of improving the issue of crisis management revealed in the Great Hanshin/Awaji Earthquake (1995) by strengthening the cabinet’s function. As a result, the significance of Hashimoto’s administrative reform was to create a commanding height function in the center of government, in the form of the Council on Economic and Fiscal Policy. While Hashimoto’s administrative reform had two aspects, namely the restructuring of the central government and the strengthening of the cabinet function, the latter aspect was more important than creating various large ministries and agencies.

While the National Security Council was established regarding crisis management, economic crisis management is also a significant challenge. At a symposium held in the US in 1998, David Sanger of *The New York Times* cast doubt on the IMF’s former crisis management system, for when an local official phoned the IMF as the financial failure happened on Friday evening in Latin America, only the guard answered to no avail, and the IMF’s response was delayed until the following Monday.

For *crisis management*, information must be exchanged 24/7. In Japan, the fire department, the police, the Self-Defense Force, and part of the press all work 24/7. In the world of finance, however, it is common to take a break starting Friday evening.<sup>(25)</sup>

In short, a lesson from the twenty-five years after the collapse of the bubble economy is that, while crisis management is often considered a matter of military national security in most cases, crisis management in the sense of how to transmit, analyze, and process information when faced with economic panic has become extremely important.

### The Response to Failures and the Injection of Public Funds

The third lesson was that response to failures is difficult. For example, while it might be easier to respond to the failures of financial institutions on the scale of S&L in the US, the same scheme could not be applied to the disposal of bad loans and financial failures on a larger scale. From the experience of the twenty-five years after the collapse of the bubble economy, the initial financial failures of the Toyo Shinkin Bank and the Hyogo Bank were not the same as the disposal of bad loans of the Long-Term Credit Bank of Japan and the Nippon Credit Bank which were larger. Also, if a financial institution with a clearing function fails, it would lead to the failure of the entire economic system. Hence, public funds would be injected with the logic that financial institutions are special. In other words, that’s why the response is different to the failures of private companies in general, which might gain consent to some extent.

However, there are issues of what to call financial institutions that receive public funds to account for management responsibility, and the issue of moral

hazard. In particular, the issue of moral hazard typically surfaced with the AIG (American International Group, Inc.) in the US which faced a management crisis following the problem of subprime loans between 2007 and 2008. Although a huge amount of public funds were injected, a bonus of 165 million dollars in total was paid to about 400 AIG executives, with 70 executives pocketing more than a million dollars each.

As those working on Wall Street have become the target of criticisms and a symbol of one percent vs 99 percent of the wealth in the US, it was a huge problem that great sums of retirement money were paid despite public funds being injected into failed companies holding bad loans.

### **The Lack of an International Financial Institution Equivalent to the WHO**

The Lehman's Collapse was indeed a globally spreading pandemic, triggering a chain reaction. This was because the financial crisis triggered by the issue of subprime loans which surfaced after July 2007 extended unexpectedly to BNP Paribas, etc., drove the Lehman Brothers Holdings into failure in the US in September 2008, and further spread to European financial institutions, creating a maelstrom for global economy.

The WHO (World Health Organization) is to respond in case of a pandemic of influenza, etc. However, an international institution has yet to appear to respond to a pandemic in the financial world. This is the fourth lesson of the twenty-five years after the collapse of the bubble economy.

Although the then UK Prime Minister, Gordon Brown, appealed for international cooperation at the G20 meeting after the Lehman's Collapse, there is still no international financial institution equivalent to the WHO, due to the opposition by hedge funds and US financial institutions.<sup>(26)</sup>

### **Economic Overview and the Possibility of the Recurrence of Financial Crisis**

Finally, let's get an overview of the twenty-five years after the collapse of the bubble economy from an economic perspective.

First of all, the issue of appropriateness of the *zero-interest* policy and the *quantitative* easing policy has yet to be solved. As money increased through monetary easing would naturally flow into real estate, stocks, and bonds, there is still a possibility that the bubble economy will recur in that sense.

Also, inflation targeting has now become the policy pursued by the Bank of Japan, which is attempting to continue increasing the supply of money, observing the CPI (Consumer Price Index), until the inflation rate reaches two percent. However, the author believes more attention should be paid to the market's expected inflation rate with the focus on the relationships between flow and stock, rather than the CPI. While the Bank of Japan, etc. observes the expected inflation rate specifically using the BEI (Break-Even Index, calculated as the straight government bond yields minus the index-linked bond yields), the question is whether that's enough.

Moreover, the financial *risk hedge* means just hedging risks locally, leading to the accumulation of *waste* in the world as a result. Similar to the creation of a Financial WHO, the issue of how to hedge risks in the international market has yet to be addressed. The fact that central banks are searching for the macroprudential approach shows that this is an issue of global financial order.

It is natural to gamble on Wall Street. To some extent, price mechanisms work normally thanks to gambling. However, Wall Street gambles differ in significance from losing all money personally through gambling in Las Vegas. While Las Vegas gambling only ends in personal failure, negative influence spreads globally when a gamble on Wall Street fails.

As there is no global firewall, it is quite possible that a financial crisis will recur in the future. Even if a global financial crisis occurs again, there is no way to prevent it now. As methods for softening financial crises have not yet been well developed, it is only possible to mitigate their influence to some extent, at best. To prevent the spread of influenza, one can only chant the simple words of advice, "Wash your hands and rinse your mouth."

(1) The Nikkei Stock Average peaked at 38,915 yen at closing on the last day of trade in December 1989, and then dropped by 202.99 yen on January 4th, the first day of trade in 1990. This was the beginning of the collapse of the bubble economy. Although many think full-scale collapse of the bubble economy started in 1992, the author

considers it to have collapsed in 1990. As a side note, the stock price fell below 20,000 yen in October 1990. The decline in land prices started in the same year.

- (2) The author and his colleagues have been dealing with the issue of the occurrence and collapse of the bubble economy since the early period. See Yasunori Sone Study Group, *Seisaku teigen: baburu to fukyo wo koeru michi* [Policy recommendation: the path to overcome the bubble economy and recession] (1993).
- (3) Ryoichi Tobe, et. al., *Shippai no honshitsu: nihon gun no soshikiron teki kenkyu* [The essence of failure: the organizational study of the Japanese forces] (Diamond Inc., 1984).
- (4) David Halberstam, *The Best and the Brightest* (Random House, 1972).
- (5) Yasunori Sone, "Still the Decade of Japan's Growth Economy?: Post-Cold War, the Bubble, and the Recession," Prepared Paper for Roundtable of the International Political Science Association (IPSA), Kyoto, March 26-27, 1994.
- (6) Yasunori Sone, "Seiji keizai shisutemu no hendo to seiji shisutemu [The change of politico-economic system and the political system]," paper presented at Japan Economic Policy Association (JEPA), Aichi Gakuin University, May 28, 1994, published in JEPA ed., *Nihon no shakai Keizai shisutemu* [The Japanese socio-economic system] (Yuhikaku, 1995).
- (7) Yasunori Sone, "Inter-Institutional Governance: Global and National Financial Architecture," March 2, 1999, Program on US-Japan Relations, Harvard University.
- (8) The author does not discuss the following issues in detail here, as these are important and independent topics by themselves: The low interest rate long deferred by the Bank of Japan at the beginning of the bubble economy; the repeated increase of the interest rate, in total reversal, during Governor Mieno's term; and methods of *exterminating the bubble economy* including ceilings on land financing announced by the Ministry of Finance.
- (9) Report by Nomura Research Institute, July 31, 1992. Cf. Tomohiko Nishino, *Kensho keizai anun* [Inquiry on economic dark clouds] (Iwanami Shoten, 2003), p. 30.
- (10) Seiroku Kajiyama, *Asahi Shimbun*, September 17, 1999, morning edition.
- (11) Ryutaro Hashimoto (The election for the LDP presidency, April 2001).
- (12) Masaharu Gotoda, *Jo to ri: gotoda masaharu kaikoroku* [Emotion and logic: a memoir of Masaharu Gotoda], vol. 2 (Kodansha, 1998), p. 122.
- (13) Kiichi Mayazawa, LDP Karuizawa Seminar, August 30, 1992. "It is a natural duty for the government and the central bank to seek suitable solutions when the market economy is not functioning properly. While it would be the most preferable if the financial institutions brought knowledge and money together to liquidize the real estate held by banks, we would not rule out providing public support if necessary," cited in Nishino (2003), p. 44.
- (14) Gaishi Hiraiwa (Federation of Economic Organizations) said, "The banks are reluctant [to receive the injection of public funds]," while Takeshi Nagano (Japan Federation of Employers' Associations) requested, "the release of management information in case of the injection of public funds," to which Rokuro Ishikawa (Japan Chamber of Commerce Industry) and Masaru Hayami (Japan Association of Corporate Executives) agreed. See Nishino (2003), pp. 39-40, 45.
- (15) Director of Banking Bureau Nobuyuki Teramura stated as follows on August 15, 1992: "On this occasion, while financial institutions should deal with the issue of the stabilization of the financial system and the smooth circulation of funds with all capabilities as a matter of course, the authorities intend to put the maximum effort into it so that the nation's long-lasting trust towards the financial system won't be damaged at all." See Nishino (2003), p. 36. Director Teramura's later explanation that he put the idea of the injection of public funds to an expression in this sentence, "the maximum effort," is not convincing, for "The policy not to inject public funds for the time being had been agreed upon at the discussion within the Banking Bureau" in July that year (Nishino (2003), p. 33).
- (16) The author published an article in the *Weekly Toyo Keizai*, to which he was contributing a column, pointing out that the issue of bad loans was not a simple matter to be solved by the injection of 685 billion yen. See Yasunori Sone, "Jusen mondai' no honshitsu wo tou [Questioning the essence of the 'issue of housing loan companies'],"

*Weekly Toyo Keizai*, March 23, 1996.

- (17) The author and his colleagues estimated the amount of bad loans using the number of bankrupt companies published by Teikoku Databank, defining "bad loans" as the difference between book value and market value, as documents prepared by the Financial Services Agency were not available. As a result, it became known that the total amount of bad loans held by major banks was approximately 15 trillion yen. It was double the figure generally known. The result was published in a Korean magazine. See Yasunori Sone, "Nihon no furyo saiken ha naze souki ni kaiketsu shinainoka [Why can't the issue of bad loans in Japan be resolved soon?]," *Jiji Journal* (Korean magazine), November 28, 2002.
- (18) Seiroku Kajiyama, "Waga nihon keizai saisei no shinario [The scenario of the recovery of Japanese economy]," *Weekly Bunshun*, December 4, 1997. This is not incorporated in Seiroku Kajiyama, *Hakai to souzou: nihon saikou heno teigen* [Destruction and creation: proposals for the revival of Japan] (Kodansha, 2000).
- (19) Toru Hayano (Senior Staff Writer), *Asahi Shimbun*, August 1, 1998, morning edition.
- (20) The reformists who created the LDP's "The Fundamental Principles of Political Reform" included Masaharu Gotoda and Okiharu Yasuoka. As already mentioned, it cannot be said that Gotoda was unfamiliar with the finances.
- (21) A dialogue with K.V. Wolferen, "Gosei kaikaku: kaikaku wo motomeru enerugi- wo seijika ni mukeyo [The administrative reform: direct reform-seeking energy towards politicians]," *Ø [Fai]*, March 1997.
- (22) It was a default in the call money market without collateral. It sent shock waves through the call money market, as it was perceived as a policy change in the Ministry of Finance's policy of protecting interbank trading.
- (23) Nishino (2003), p. 27.
- (24) Yasunori Sone, *Nihon gabanansu* [Japan's Governance], (Toshind, 2008) p. 170.
- (25) As a matter of course, it appears that the IMF has changed its system to enable information exchange 24/7.
- (26) "Designing a 'Financial WHO' for the 'Market Pandemic': A Macroprudential Approach to Global Governance," The International Conference on Public Management in East Asia, School of Government of Sun Yat-sen University, Guangzhou, China, December 20-21, 2008. This paper was translated into Chinese (published in *Reviews on Public Administration* (2009, No. 2)). Just after the author published the English paper, there was a flu pandemic. On the occasion of the G20 meeting in London, the author contributed an article which pointed out the necessity of hedging risks in case of a financial pandemic on the online edition of *The New York Times* (Yasunori Sone "Push for a New Global Financial System," *The New York Times*, online edition, April 1, 2009), but the editor didn't use the term "pandemic" in the title.

Translated by Joe Matsui