Bailing out the Bankers or the Banking System? Comparing Sweden and Japan's Responses to Financial Crisis

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In this paper[1] we examine the divergent policy responses of the Swedish and Japanese financial crises in the early 1990s. We will demonstrate below that these crises had similar causes, including financial deregulation, credit expansion and massive asset bubbles. They initially also had similar fallout, with sharp declines in asset prices and massive increases in non-performing loans leading to a full-blown solvency crisis. But Swedish and Japanese responses to their quite similar crises were very different. The central aim of this study is to explore the classic comparative politics question: Why do governments do such different things - even when faced with similar problems?

It is almost impossible to overstate the extent to which the Japanese and the Swedes diverged in handling their respective financial crises in the early 1990s. The Swedes organized a coalition in support of intervention and quickly stabilized the banking system along with the larger economy. The intervention was also transparent, reassuring domestic constituencies and foreign investors and was deliberately structured to minimize moral hazards. The intervention imposed objective rules and clarified that the intention was to save the banking system rather than the bankers and shareholders. Where necessary, the bankers' jobs and investors' capital were made forfeit. Moreover, new and robust regulatory measures were swiftly adopted and a renovated institutional structure managed the aftermath. These policies have been subsequently heralded as a model for others to follow as they faced financial difficulties in subsequent years.

1) The present paper is a revised version of Steinmo, et al, 2014.

In contrast, Japan's policymakers chose to conceal the fundamental problems in the financial system, bailed out the bankers and chose to deal with the crisis as one of liquidity. They therefore extended a raft of fiscal, monetary and regulatory supports without fundamental restructuring of the financial sector, treating the problem as serious but temporary. The Japanese authorities' policies of forbearance and wait-and-see largely denied the existence of a solvency crisis until the second half of the 1990s. Japan essentially gambled that hiding the bad-loan problem would prevent a panic and then be resolved by a return to growth and a recovery of asset values. The Japanese lost the gamble, as well as an enormous amount of wealth and economic opportunity[2].

The question we seek to answer is why the Swedish authorities were able to aim at stabilizing the banking system, taking bold measures and establishing new institutions, whereas their Japanese counterparts sought to conceal the facts and deploy ad hoc measures to save their bankers. Our analysis emphasizes both the institutional differences between the Japanese and Swedish political economies *and* differences in what we call the 'cognitive frames' of the relevant policy makers. We submit that understanding the institutional variation gives insufficient purchase on the question of why different choices were in fact made. As Mark Blyth has argued, "[i]nstitutions do not come with instruction sheets." Particularly in eras of great uncertainty, such as financial crises, actors must first interpret their current situation before deciding what must or can be done. As we shall show, this interpretation has a powerful effect on the ultimate decision taken.

In the following pages we demonstrate that in the early 1990s Swedish elites on both the political left and the right had become highly critical of the Swedish political economy and were thus predisposed to take bold measures, even when these entailed significant losses and outright bankruptcies for bankers. In contrast, Japanese elites at the outset of the 1990s possessed an undue optimism and thus perceived their financial crisis as a temporary shock. They were thus cognitively trapped in the status-quo bias. To put this in terms of Tversky and Kahneman's *Prospect Theory*, Swedes were predisposed to accept losses because they already perceived they were in a losing

2) Svensson, Mabuchi and Kamikawa 2006 focus on the same puzzle.

game[3]. Japanese elites, in contrast, were not inclined to see the disruptions caused by the collapse of the financial economy as a challenge to their basic model. They instead saw their crisis as something that they would overcome through maintaining the model largely intact.

Decision Making In Times of Uncertainty

Governments not only wield power, but also puzzle over collective problems[4]. Their puzzling over policy options is most important in times of crisis, when established institutions and ideas fail to yield effective solutions to new challenges[5]. But the human mind is not a neutral calculating machine. It is well understood by social psychologists that the past frames our perceptions and choices available today[6] - especially when decisions have significant implications and the uncertainty is high[7]. We argue that financial crises represent extreme cases of this phenomenon, combining the need for urgent and right action with high public visibility and a belief that wrong choices could lead to economic ruin. Because of these features, financial crises provide us with something like a natural experiment wherein we can trace how political elites puzzle over alternative policy responses as well as elucidate why certain responses are favored over others.

First, we show that Swedish and Japanese political elites' interpretations of their respective financial crises were fundamentally shaped by their perceptions of the health and viability of their national economic models. History matters directly in this sense because it frames the perceptions of key actors. As we shall see below, Japanese policymakers were unduly optimistic in the face of their crisis. They perceived the early 1990s drops in real estate and stock market values as a temporary shock, one that *did not* challenge their understandings of the viability or health of their political-economic model. To be fair, they had good reason to be confident about the "Japanese Model." The Japanese economy of the late 1980s, and even into the 1990s, was not only prosperous, but was also deemed the reference model in comparative political economy and in-

3) Tversky and Kahnemann 1979; Kahneman, Slovic et al. 1982.
4) Heclo 1974; Hall 1993.
5) Blyth 2002.
6) Tversky and Kahneman 1974; Kahneman 2011.
7) Tetlock 2005.

dustrial policy studies[8]. Japan successfully managed the oil shocks and other crises in the 1970s and 1980s. This performance further strengthened Japanese policymakers' confidence in their political economy model, especially in contrast to the European welfare states that seemed hopelessly sclerotic[9]. Furthermore, no Japanese financial institutions had gone bankrupt in the entire postwar period. Small wonder, then, that Japanese elites were convinced they could weather the post-bubble turbulence by bailing out a few of the banks and bankers while avoiding fundamental reform of the overall banking system.

Swedes saw a very different terrain at home. By the early 1990s, Sweden's reputation as a model for the world was long gone, and Swedish elites themselves doubted their system's efficiency and even its efficacy. Across the Swedish political spectrum, a consensus appeared to be emerging which held that Sweden suffered deep structural problems. And there were solid empirical reasons for concern: the symbiotic relations between Sweden's labor and business had begun to erode; productivity was lagging; and wage-push inflation forced Swedish authorities to repeatedly devalue the Swedish Krona, which only afforded short boosts to Swedish export competitiveness[10]. These problems were 'common knowledge events' that underpinned a gloomy consensus among the Swedish political elite. They believed that the current political economy model was not working and needed reform[11]. In consequence, the Swedish elites were cognitively in the right place, and ready to reform the banking system completely when its crisis erupted.

We argue that institutions also matter. But this comparison reveals that it is sometimes less the formal institutions that matter, and more what Adler and Pouloit call "practices[12]." We argue that institutional practices shaped the mindset of political and economic elites and thus ultimately contributed to their taking quite different policy choices. Swedish-Japanese elite institutions both foster close-knit relations among the central actors in policymaking and regulation. Both countries have relatively con-

8) Vogel 1979; Zysman 1983.
9) Kato and Rothstein 2006.
10) Steinmo 2010.
11) Culpepper 2008.
12) Adler and Pouliot 2011, 5.

centrated political, economic and bureaucratic elites who share similar social and educational backgrounds. These elites tend to know each other well, have ample accumulated experience of cooperating to solve policy puzzles, and indeed inhabit a kind of cooperative neo-corporatism. But Swedish and Japanese 'corporatist' institutions evolved in different directions. The result was that the actual "practices" within these neo-corporatist institutions were quite different. In Sweden, the longstanding pattern had been to bring in outside experts to aid policy makers, broaden the scope of the issue under examination and, if possible, bridge across partisan lines. In Japan expertise was exclusive and internalized. Policy-making was anything but transparent. Whereas Swedish neo-corporatist practice was inclusive, Japan corporatism developed "without labor" into various "Iron Triangles" that eventually became a collusive structure with non-transparent interaction between the Ministry of Finance (MOF), the Bank of Japan (BOJ) and individual financial institutions[13]. These opaque and collusive institutional practices encouraged Japanese elites to focus on saving the bankers and concealing their losses.

THE SWEDISH FINANCIAL CRISIS AND ITS MANAGEMENT

Background

By the mid-1980s Sweden had the world's largest and most extensive welfare state as well as the heaviest tax burden. In the context of an increasingly competitive and open world economy, these facts presented Swedish policy makers with acute dilemmas. The Ministry of Finance, in particular, was acutely attentive to the Swedish economy's vulnerability to competitive pressures, and pressed their government for a series of deregulatory reforms designed to improve the competitive position of Swedish enterprises. In response to these perceived dangers they introduced a series of regulatory reforms intended to bring more competition into the Swedish financial system. This deregulation was aimed at making the economic system more dynamic, to meet the needs of an increasingly flexible and competitive world economy[14].

Prior to the 1980s, Sweden's financial system had been strongly regulated with interest rate ceilings, reserve requirements, taxation on bank issues of certificates, as

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13) Pempel and Tsunewaka 1979.

14) Feldt 1991.

well as strict controls on international capital movements. Given the very strict regulatory framework that prevailed prior to the 1980s, banking was more like a staid administrative endeavor than a business per se. Virtually all aspects of banking were prescribed, including to whom banks could lend, their interest rates, and their particular capital requirements under specific conditions. Most large loans had to secure the approval of government regulators. Beginning in the mid-1980s, however, these kinds of restrictions were gradually eliminated to accord with international financial markets and domestic concerns such as financing large budget deficits[15]. The changes in the financial system included eliminating the ceilings on interest rates as well as the removal of taxation on issuance of bank certificates and turnover at the stock exchange. The removal of interest rate ceilings allowed financial institutions to operate liberally and encouraged risk-taking. Furthermore, the tax system with full deductibility of interest payments encouraged excessive borrowing by effectively reducing interest rates to zero or even into negative territory. Finally, restrictions on the international transactions were gradually abolished, foreigners were allowed to buy Swedish shares, and the subsidiaries of foreign banks were permitted to operate in Swedish financial markets[16].

These regulatory changes came as a gradual evolution in the structure and behavior of the Swedish banking industry itself. Like most banks around the world, Swedish banks had once been largely conservative institutions with close and detailed knowledge of the individuals and enterprises in which they invested or to whom they lent money. Each of Sweden's different banking institutions tended to focus on different segments in the Swedish market: Nordbanken dominated public investment and projects, Wallenberg's SEB dominated the large investments in traditional industries, while Handelsbank focused on high profit investments often of smaller volume. As deregulation unfolded in the 1980s, however, opportunities for risk-taking increased. Competition expanded immensely within the traditionally rather staid industry, with new entrants driving a hitherto unseen, and increasing, competition for borrowers as well as investment products. Concomitantly, the management style of traditional Swedish banks also changed. Some of these changes arose from new managers being

15) Englund 1999 and Jonung 2009 provide the best accounts of Swedish financial liberalization and crisis management.

16) Drees and Pazarbasioglu 1998.

brought into the banks, and some through formerly conservative bankers now being able to invest outside their local communities.

These regulatory changes also led to a fundamental change in the industry's incentive structure. Banks had essentially been the sole source of consumer and industrial finance in Sweden, but the system was quickly evolving to a new environment in which traditional banks had to compete for borrowers with very aggressive companies who had little or no experience as lenders. "I remember one time in particular when I was asked by the director of a local savings and loan from a small town in rural Sweden to buy three apartment buildings in Hamburg, Germany," recalls Enrique Rodriquez, a director in the Swedish Savings and Loan Association. "Hamburg was gaining the reputation as a booming market, and the bank director didn't want to be left out[17]." As new institutions with little traditional banking experience began to enter the finance marketplace the traditional institutions began to take ever more risk in distributing loans to extend their market share. At first, at least, this competition worked to significantly increase the flow of capital into the private economy and was thus viewed as a boon to the Swedish economy.

On the consumer side, negative after-tax real interest rates encouraged borrowers to consume or invest in real estate markets with the help of the loans distributed by these financial institutions. Deregulation of the financial markets therefore drove credit expansion and a rise in rates of private sector borrowing that led in turn to higher asset prices and expanded consumption. Lending by private actors increased by 136 per cent between 1986 and 1990[18]. In the same period, private sector debt rose from 85 to 135 per cent of GDP while real-estate prices increased by 125 per cent[19]. These trends were accompanied by a 4 percent per annum increase in household consumption[20].

In the late 1980s, it became increasingly evident that the economy was overheating. In 1989, the unemployment rate declined to 1.4 per cent just as the stock and real estate markets peaked. The boom eventually elicited a fall. Unsurprisingly, this precarious decline in asset values put Swedish banks under enormous pressure. The

17) Author's interview with Enrique Rodriguez, Stockholm, 25 February 2011.
18) Englund 1999, 84.
19) Backstrom 1997, 131.
20) Englund 1999, 84-5.

construction and real estate stock price index declined by 25 per cent in 1989[21], a decline in part due to a rise in international interest rates in the wake of German unification. Changes in tax policy in 1990–91 also reduced the previous tax deductibility option and the ability to borrow at zero effective rates. This change helped undermine asset prices because borrowing became less attractive for Swedish households[22].

The decline in real asset prices also led to an increasing frequency of non-performing loans. This was seen in 1990 when Nyckelin, one of the non-bank finance companies that had recently entered the market often offering increasingly risky real-estate loans, found itself unable to roll over its maturing debt. The problems in the non-bank finance institutions quickly spread throughout the banking system. In autumn 1991, two of Sweden's large and more traditional financial institutions, Första Sparbanken and Nordbanken, were facing solvency crises. Shortly thereafter, in the spring of 1992, Götabanken found itself on the precipice of bankruptcy[23].

To make matters worse, Sweden's banking crisis coincided with the European exchange rate mechanism (ERM) crisis in the summer of 1992. In what proved to be a rather bad choice, Swedish authorities decided to protect the pegged exchange rate mechanism and the value of SEK instead of moving to a floating exchange regime[24]. On 16 and 17 September, Britain and Italy left the ERM. On the same day, for the purpose of defending SEK, the Riksbank raised over-night interest rates to 500 per cent and provided liquidity to the financial markets. Swedish authorities eventually reversed course and let the SEK float on 19 November. Its value fell 20 per cent by the end of the year. The depreciation further eroded financial institutions' balance sheets, as they had borrowed much in foreign currencies but distributed funds in SEK.

All of these problems took their toll. Between 1990 and 1993, Sweden's GDP dropped by a total of 6 per cent, aggregate unemployment increased from 3 to 10 per

21) Englund 1989, 89.
22) Jonung 2009, 4.
23) In contrast, Handelsbanken overcame the crisis with less trouble and no government support because it had the lowest fraction of real-estate loans. See Englund 1999, 90-91.
24) Jonung 2009 argues that there was a consensus among economists and policy-makers that previous devaluations had not resolved the long-run economic problems but only postponed them over the short-run.

cent and public sector deficit rose to 12 per cent[25].

Response

On September 15, 1991 the Swedish electorate moved to the right. For only the second time since the 1930s, the Social Democratic Party (SAP) found itself unable to form a government. And in a first in Swedish modern history, a new 'right wing' party, New Democracy, received enough votes to enter parliament. This unusual turn of events put the Swedes into a position where no one could form a majority government without this new, allegedly racist, party included. Eventually, the center-right Moderate Party, led by Carl Bildt, formed a minority government despite the fact that the Moderates had only received 80 mandates and were in fact only the third largest party in the Riksdag. This was not an auspicious beginning for a government about to face one of the most dramatic economic crises in modern history.

Almost immediately upon entering office, the new government found itself tested. As we saw above, by late 1991 the deflating asset bubble had already been undermining major financial institutions' balance sheets. In autumn of the same year, Första Sparbanken and Nordbanken ran into serious solvency problems. The crisis spread throughout most financial institutions in 1992. But the new government was quick to diagnose the problems. In the spring of 1992, the Swedish government injected capital in Första Sparbanken, but allowed the insolvent Götabanken to go bankrupt. As will be explained in detail, this selective intervention at this stage played a key role in the success of the Swedish crisis resolution. However, problems in the property markets and financial institutions were exacerbated by the ERM crisis and international financial instability in the summer of 1992. In order to provide stability to the markets, the government - with the support of the political opposition - announced blanket guarantees in September of that year.

The new government immediately brought together financial experts from across the financial and political spectrum. The Swedish political leadership neither sought to ignore the impending crisis nor blame it on the previous government. Instead, they chose to secure the main opposition political parties' support for inter-

25) Backstrom 1997; Englund 1999.

vention.

As the crisis began to unfold, the new PM, Karl Bildt, appointed Deputy Finance Minister Bo Lundgren to take charge of the government's response. Lundgren was tasked by Prime Minister Bildt to handle the crisis. So Lundgren gathered his key advisors, as well as the leader of the Social Democratic Party, and, in Lungren's words, "put together a package." When asked whether he felt much pressure from interests who would take losses due to the contents of "the package," Lundgren declared that "No one, nobody in government even approached me like that." His response is worth quoting at length:

> I remember we had a meeting with Kurt G. Olssen, who was the chairman of SEB at the time. We found out that when Gota was going bust in September, before this package, the shares of Gota Bank were put in collateral by their parent company, Gota AB. So SEB was holding the shares of Gota AB. And Gota AB was going bust. We wanted to handle the situation and avoid further losses. When I talked to SEB they said, "Well, if you want this so quickly, it must be worth something." So, I called Olssen to come up, together with the CEO, and I said, "I'm not paying anything. Well, perhaps 1 kronor." Then he started to say that his shareholders would take a great loss. So, I told him, "That's not my problem."

Soon after it became apparent there was a crisis in the financial system, the government took control of several of the most troubled institutions, injecting capital into them as well as providing blanket guarantees to those holding debt[26]. But the Swedes did not attempt to bail out the investors or the financial institution's stockholders. Bo Lundgren, Minister for Economic and Fiscal Affairs at the time, put the issue quite simply: "I'd rather get equity so that there is some upside for the taxpayer. For every krona we put into the banks, we wanted the same influence. That ensured we did not have to go into certain banks at all." Moreover, Urban Backstrom, another senior official in the Ministry of Finance at the time, also noted that the government believed it would be a political and economic mistake to "[Put] taxpayers on the hook without [giving them] anything in return ... The public will not support a

26) They also allowed the newest and most aggressive financial institution, GotaBanken, to go bankrupt.

plan if you leave the former shareholders with anything[27]."

Later Olssen approached Lundgren and asked him personally if something "couldn't be worked out." Lundgren turned him down again. In Lundgren's view, to yield to such pressure would not only violate public trust but also undermine his goal of managing the crisis with transparency and a responsible deployment of public funds[28].

On 24 September 1992, just two weeks after the Swedish currency crashed in international markets, the government, with the support of the political opposition, declared they would provide blanket guarantees for the entire financial system to protect the security of households, enterprises and other stakeholders. It is widely acknowledged that these guarantees prevented a major bank run and restored the confidence of international investors[29]. In December, the Riksdag (Swedish parliament) established a new institution with open-ended funding for the management of the crisis. In addition to investing nearly 4% of GDP in saving the banks, two quasi-public holding companies were established, Securum and Retriva, as asset management companies (AMCs) to manage Göta and Nordbanken's non-performing loan[30]. Then in May of 1993, the Bank Support Authority (Bankstödnamnen, BSA) was formally established by parliamentary decision. This new unit had considerable autonomy from the Riksbank and the Financial Supervisory Authority even while it was supported by these institutions[31].

The Ministry of Economic Affairs noticed that extant Swedish law gave failing financial institutions six months to consolidate before the government could take them over. They quickly understood that during a crisis such a long period prevented just the kind of decisive government action that was essential. Their solution was to go to

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27) *New York Times*, 23 September 2008.

28) Author's interview with Bo Lundgren, Stockholm, 24 February 2011.

29) Jonung 2009: 8.

30) Ergungor 2007.

31) In addition to investing nearly 4% of GDP in saving the banks, the government also chose to set up a new institutional structure to help manage the crisis. Two quasi-public holding companies were established, Securum and Retriva, as asset management companies (AMCs) to manage bad loans of Göta and Nordbanken. Ergungor 2007.

the Swedish High Court and ask its President, Johan Munck, to draft up a new law that would give the government the authority to seize a bank without the waiting period. He did so, and with the support of the Social Democrats they pushed the new law through the parliament under a 'shortened period of motion' that speeded up the legislative procedure. The bill became law with the support of all the main political parties and was passed in just three weeks. From that point forward, financial institutions understood that the government had both the tools and the intent to take whatever mechanisms necessary to defend the economy, and not just the banks.

Sweden's management of its financial crisis can be declared a success in terms of its speed, its comparatively small cost and the subsequent recovery of the economy. Several specific factors underpinned this successful crisis management. First of all, the Swedish government brought the political opposition into the decision making process, making them part of supervisory bodies (such as the Bank Supervisory Authority) and the boards of nationalized financial institutions. For example, the September 1992 press release declaring blanket guarantees and other measures was co-prepared and presented by the government and the Social Democratic opposition. The Swedish authorities thus made it clear there were no party-political differences concerning the commitments[32].

Second, the government emphasized the need for transparency. All banks under the control of the Bank Support Authority, or which had accepted public-sector help, were required to open all their books to the Authority. In parallel, cabinet ministers and officials emphasized explaining the crisis-management program to international investors through repeated in-person visits to financial centers. Third, elites in all the main political parties believed that Sweden was in trouble economically, and that the current crisis was but the tip of an iceberg. Even key Social Democratic party leaders were increasingly persuaded that the traditional model of very high marginal taxes (over 80% on top earners) and public spending in excess of 60% of GDP was no longer sustainable in a globalizing economy. Though Finance Minister Kjell Olof Feldt had been moved out of his position even before the election, his influence on the ideas in the party can scarcely be over-estimated. He and his advisors argued vociferously that

32) Ergungor 2007.

significant policy changes were needed in order to maintain an egalitarian welfare state in the 21st century[33].

In short, Sweden's policy success derives in part from a moderate government's willingness to compromise and include opposition leaders. But an equally important aspect of the story is the fact that the opposition Social Democrats, in particular, were themselves willing to cooperate. Virtually everyone understood that this crisis had both deep roots as well as a long and potentially very fat tail.

The government was also acutely aware of the dangers of 'moral hazard,' and made it clear to all participants that their policy sought to save the banking system and not the bankers and their shareholders. The BSA's financial support meant an equal reduction in the share capital of the bank owners. Lundgren described the gov ernment's attitude as "[a] market economy means that you have to accept risk. If you as shareholder can't manage a company through the management you accept or choose, then you have to take the loss. That is a market economy. Otherwise a market economy won't work[34]". In line with this thinking, financial institutions that the authorities judged had reasonable recovery prospects received central government capital injections. Others judged to be beyond rescue were allowed to go bankrupt and their properties were transferred to asset management companies. This framework contributed to the legitimacy and transparency of the crisis management process in Sweden. In short, policy elites both depended on and wanted to reinforce citizens' trust in their political institutions and public authorities.

Sweden also established new institutions to overcome the crisis. The creation of the BSA was crucial. The Ministry of Finance did not have the necessary expertise and direct involvement of the Riksbank and the Financial Supervisory Authority would likely have led to conflicts of interest. With strong legal backing and the support of these other institutions, the BSA was quick to intercede, preventing the crisis from snowballing while also crafting new rules of crisis management. Also, it was important that the December 1992 Riksdag decision granted the BSA financial support without any legal limitations. Swedish policy makers recognized the necessity of par-

33) Feldt 1991; Steinmo 1989; Steinmo 2010.

34) Author's interview with Bo Lundgren, Stockholm, 24 February 2011.

ticular expertise for the legal and technical complications of real estate market and transferred the properties of these financial institutions to Securum and Retriva[35]. It should also be noted that Swedish authorities were aware of their dual task of rescuing the banking system as well as stabilizing the overall economy. The depreciation of the SEK constituted the main driving force behind an export-oriented recovery. Fiscal expansion acted as an automatic stabilizer for the Swedish economy, as the government incurred large budget deficits between 1991 and 1997[36].

We will now turn to the quite different Japanese case[37], one whose outcome is far less encouraging for those countries neither as institutionally advantaged as the Swedes nor as prepared to face the facts.

THE JAPANESE FINANCIAL CRISIS AND ITS (MIS) MANAGEMENT

Background

Japan's economic crisis in the early 1990s had similar roots and followed a remarkably similar pattern as that witnessed in Sweden: a sustained period of financial deregulation and loose monetary policy contributed to a steep rise in asset prices, especially real estate. The asset bubble burst, leaving Japanese banks and other financial institutions sitting on a swelling mountain of non-performing loans. This was the core of the financial crises, and rectifying it required fast, large-scale government action to separate the banks from their bad loans and return the financial sector to health. Quite unlike the Swedish authorities, however, the majority of Japanese authorities were initially slow to recognize the scale of the unfolding crisis and then found themselves unable to muster a consensus on comprehensive action. Policy turned instead to covering up unpleasant realities for the time being, to avoid the risk of a run on the banks, while hoping that economic recovery would lift asset prices and thereby bail out the banking industry. As asset prices dropped further and banks' liabilities swelled, however, the government found itself compelled to increase its fiscal and monetary-policy supports. In sharp contrast to the Swedish pattern discussed above, the Japanese government kept opting for non-transparent and non-systemic

35) Jonung 2009, 11; Ergungor 2007.

36) Jonung 2009, 12.

37) This section draws on DeWit et al 2012.

measures. The use of ad hoc policy responses to perpetuate the status quo, rather than biting the bullet of comprehensive reform, failed to bolster confidence in the financial system and bring vigor back to the real economy[38].

We have seen that Swedish authorities deliberately dealt with the moral hazard problem and contained their crisis. By contrast, Japan's post-bubble financial policy has become the advanced countries' textbook study in the enormous costs of dithering in defense of vested interests. Two "lost" decades have seen subpar economic growth while Japan's gross public-sector debt, propelled by the financial chaos and its fallout, has ballooned from 60% of GDP in 1991 to well over 200% of GDP in 2014. The latter level of gross debt has hitherto been seen only in wartime. And it has clearly not yet peaked, as Japan's goal in FY 2014 is to fund marginally more of its general budget from tax revenues rather than red ink.

Industrial, not Social Policy

The origins of this story bear some resemblance to what we saw in Sweden. Japan's postwar financial system was also a tightly regulated structure, albeit one more deliberately deployed to direct the flow of investment capital. The system's core comprised strict controls on interest rates, cross-border financial transactions, the location of bank branches, non-price competition among the banks, separated categories of banking, and a variety of other mechanisms. Distinct from its largely unregulated prewar predecessor, the Japanese financial sector became a conduit focused on financing rapid economic growth. And in a sharp contrast to Sweden and other European welfare states, the postwar Japanese state saw its mission as constructing an export machine centered on heavy industry. The public sector was not there to lay the foundations of a comprehensive welfare state to defend the citizens against the vagaries of market capitalism[39].

A keystone of this "Japanese Model" was stability in the financial system so as to ensure a healthy flow of bank loans for corporate investment[40]. Instead of building a public welfare state to insure individuals against economic risk, this system relied

38) Kaneko 2002.
39) Amyx 2004; Estevez-Abe 2008.
40) Zysman 1983; Schaede 1996.

on firms to provide benefits and jobs - even during economic downturns[41]. Financial stability was thus part of Japan's unusual 'welfare state'[42]. One of the tools financial authorities used to maintain stability was a powerful administrative guidance over financial firms. But this was not a top-down, command style of supervision. Postwar Japanese financial regulation was centered on cooperation between government officials, such as the various bureaus of the Ministry of Finance as well as the Bank of Japan, and the financial community. These actors routinely exchanged personnel as well as consulted within an array of committees.

The regulatory structure maintained a hierarchy between larger and smaller banks as well as among the various sectors of financial activity, such as financing of large versus small and medium-sized firms. A "convoy system" was developed, wherein each sector of the financial industry proceeded at the pace of its least-competitive firm[43]. It was a dense network of trust-based relations among the regulators and their respective clients in the various sectors of industry[44]. The convoy system also afforded an informal protection of bank deposits, coordinated by the regulatory autho rities' administrative guidance. This meant that there was largely an implicit rather than explicit safety net for the financial sector. The state stood in the background as the guarantor of last resort, and financial crises saw the public sector extend emergency liquidity to troubled banks and then generally arrange a merger of the failed institution with larger, healthy banks[45]. Interest rate ceilings were also used to ensure that financial firms did not compete on price while enjoying predictable and quite substantial profit margins[46]. Another characteristic feature of Japanese finance was the "main bank" system wherein business conglomerates (keiretsu) were centered on large banks. These banks were the primary (but not exclusive) conduit to funnel finance into the firms within the conglomerate. The main banks also held shares of the

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41) Steinmo 2010.
42) Estevez-Abe 2008.
43) Seabrooke 2006.
44) Suzuki 2010.
45) The big banks would buy up the assets and assume deposits of failed smaller banks; hence there was minimal need to activate the depositor insurance scheme that had been established in 1971. The scheme in fact had only 10 employees in a BOJ office through the 1980s.
46) Schaede 1996; Hamada and Horiuchi 1987, 238, note that the "average annual after-tax profits for all banks ranged above 12 percent" during the high growth years.

keiretsu firms, and these shares were in turn part of the banks' regulatory capital base. This key strategic position gave main banks powerful incentives to discipline themselves as well as oversee the credit conditions of their major borrowers[47].

The initial moves toward deregulation of the Japanese financial system began in the late 1970s, but it was not until the 1980s that they accelerated appreciably. Much as in Sweden, capital controls were progressively dismantled, as the 1980s saw the gradual removal of interest rate ceilings and restrictions on foreign and other financial transactions. The banks were increasingly able to compete among themselves and lend to an ever-more diverse clientele. One measure of the banks' growing base of customers outside of traditional corporate networks is seen in loans to real-estate. In 1984, these loans were only 27% of the volume of the manufacturing sector, but by the end of 1991 had swollen to 74% of that figure[48].

The 1980s thus saw increasing divergence between theory and practice in Japan's financial markets. The postwar convoy system's opaque and informal negotiated mechanisms of banking supervision and crisis management remained in place even as the real role of finance was swiftly expanding and evolving around it. Indeed, the regulatory sinews that kept the system coherent were being cut. The financial system was therefore entering into new realms of risk without explicit rules and robust institutions for averting systemic failure or intervening effectively should it erupt.

In the 1980s, the Japanese banks' increasingly powerful incentives to extend credit to realtors, households and small business for often speculative investment saw credit pour, in particular, into real estate markets[49]. This was similar to and almost contemporaneous with what went on in Sweden. Richard Katz reports that from 1981 to 1991, commercial land prices in Japan's six biggest cities rose by 500 per cent[50].

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47) Aoki 1994; Kaji 2010.

48) Noguchi and Yamamura 1996, 59.

49) The "myth of land" was so strong that by the late 1980s Japanese banks were commonly making loans equal to 100% of the market value of the land used as collateral, a figure that had been in the 60% to 70% range until the early 1980s. See Shimizu 1992, 40.

50) Katz 2008.

This bubble was further encouraged with inheritance and corporate income taxes favoring investment in land[51]. And driving it all forward was an exuberant faith that real estate prices would surely continue to increase. All these factors encouraged new investors to pile in and further whetted Japanese banks' appetite to make even more of these loans.

But the speculative bubble and overheated economy flamed out in 1990. The Nikkei stock exchange index reached its peak on December 29, 1989, at an astounding level of YEN 38, 915. The Nikkei's asset value was approximately 44% of the world's equity market capitalization at the time[52]. In the spring of 1989, the Bank of Japan had begun trying to deflate the enormous bubble through increasing the discount rate, which they raised from its May 1989 level of 2.5% to 6% by the end of August 1990. These and other policies were effective, driving the Nikkei down to YEN 26,000 by Aug 30, 1990[53].

The Japanese and Swedish bubbles' roots of course differed in myriad particulars, and so did the fallout. But before we get back into the trees, let us consider the forest. From that vantage, we have had two similar cases wherein enormous speculative bubbles brought on a systemically threatening crisis. The key difference between the two cases lies in the ways in which the authorities managed the crisis, and why they chose the policies they did.

The Initial Stage: 1990 to 1994

We can periodize the initial stage of Japan's crisis management as roughly 1990 to 1994. These four years opened with an initial optimism that the bubble had been successfully lanced, but that hope soon gave way to dismay as the financial authorities realized the asset crash was pushing up a mountain of bad loans. No major financial institutions were allowed to fail during this period in spite of the sharp declines

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51) Fukao 2009.

52) Stone and Ziemba 1993, 149.

53) Four months later, the economy had appeared to achieve stabilization, with the Nikkei staying largely in the YEN 20,000 range for most of 1991. Along with the drop in stock prices, land prices started declining in 1990 and continued to fall. Commercial real estate prices eventually sank below their 1981 levels, erasing the five-fold increase that had occurred in that decade. See Katz 2008.

in real estate and other asset prices and the banks' heavy exposure to these markets through their loans.

Matters came to a head in the summer of 1992. Stock market values plunged to the YEN 14,000 range, threatening to put financial institutions clearly into the red for the September 30 financial reporting deadline. Given the background of increasing uncertainty and sharply declining asset values, this exposure of the banks as insolvent would almost certainly have led to a very sharp credit crunch. And because Japan had become the world's biggest banker, the crisis would have had global ramifications. Then-Prime Minister Miyazawa Kiichi was not only a former career MOF official but also Finance Minister from July 1986 to December 1988. He was one of the country's most astute experts on finance, and readily understood that sliding asset values were demolishing the banks' balance sheets. He also knew that this process risked a downward spiral wherein more borrowers were likely to become unable to pay back loans on steadily devaluing assets, leading to more damage to bank balance sheets, thus restricting the financial system's capacity and willingness to finance new business, and hence further eroding the economy's strength. He understood that Japan was confronting a solvency crisis, and that the longer one put of dealing with it as such, the greater it would cost to fix it. Similar to the Swedish authorities, Miyazawa determined that the only way to resolve the crisis was to intervene with public funds and relieve the financial sector of its toxic assets. In mid-August, Miyazawa discussed using public funds with BOJ governor Yasushi Mieno, securing the latter's agreement. While the Nikkei stock exchange continued to dive, Miyazawa prepared to return to Tokyo from his summer retreat in Karuizawa, shut down the exchange and engineer a capital injection[54].

But Miyazawa was not the only high-level actor who had been working on a plan. On the evening of August 17th, at his summer retreat, Miyazawa was presented with MOF's "Urgent Management Plan for Financial Administration." Miyazawa's plan might have been the correct solution from a technical point of view, but to take this path would be to reject MOF practices. Recall that no bank in post-war Japanese history had been allowed to go under. To accept Miyazawa's proposal would be, in ef-

54) Kume 2001, 110

fect, to admit that Japan's entire economic model was flawed - when the *common knowledge* was that Japan was by now #1[55]. The MOF's alternative was to effectively continue to extend the traditional practice of offering the banks forbearance. But recognizing the severity of the situation they also proposed to flood the markets with liquidity. It had not been the MOF's role to intervene directly in the troubled banks in the past, and they would not do so now. The MOF's plan did include fiscal, monetary and regulatory changes, however, aimed at getting a floor under stock prices and otherwise stabilizing the markets. Among the highlights were administrative guidance that would suppress sell-offs; accounting changes that would allow firms to avoid booking the real value of soured assets; and the use of at least YEN 2.82 trillion in pension, postal and other funds to prop up market prices.

The MOF's plan boosted the markets, and Miyazawa's idea of capital injections was soundly rejected. He did try to reintroduce the idea of capital injections later in the month at a party seminar, but was met with a flurry of opposition. Much of this rejection came from the big banks' doyenne class, especially the so-called "Napoleon" Takuji Matsuzawa, head of Fuji Bank and chairman of Keidanren's Board of Councilors. This opposition was especially influential and did much to galvanize big business' stance against capital injections. From Keidanren, the opposition spread, as the talk shifted from fear of a systemic crisis to the prospect that transparency would shift the public spotlight onto pay and perks across a range of sectors. The financial authorities also resisted going beyond the institutions of the convoy system in seeking to resolve the swelling mountain of bad loans. The combined opposition carried the day, both inside the ruling Liberal Democratic Party as well as in the larger public arena[56].

The rejection of the comprehensive approach to the solvency crisis then tipped the scales even more to the policy of maintaining the system via forbearance and fiscal and monetary supports. In retrospect, it seems obvious that the Japanese should have followed the Prime Minister's original proposals to use public money to backstop the shift to a new, rules-based order while recapitalizing the banks and penalizing past excesses. Yet many observers of this period suggest that the Japanese authorities

55) See Vogel 1979.

56) Kume 2001, 110–113.

opted for this blatant degree of forbearance because they honestly believed the economy would recover in short order. For example, former Assistant Director of the Bank of Japan, Hiroshi Nakaso observes that the Japanese authorities and financial community were confident prices would return to more sustainable levels and markets would recover on their own[57]. We should bear in mind that in the early 1990s, Japan appeared to have won the ideological competition between its growth model and the Anglo-Saxon alternative. And in addition, there was the plain fact that no Japanese financial institutions had gone bankrupt in the postwar period. The MOF had always managed to coordinate an effective response. In short, the collective cognitive frame was that the institutions of the convoy system had clearly worked well for decades, financing a spectacular postwar recovery, and plenty of actors were confident the momentum would continue in the 1990s.

The Crisis Deepens

The next phase of Japan's protracted crisis began in the mid-1990s and lasted until about 1999, when capital injections truly began. In the mid-1990s, it was becoming clear that the policy of forbearance towards non-performing loans was unsustainable. It was also obvious that the previous years of hoping for a recovery had wasted precious time. Now even big Japanese financial institutions were drifting, in convoy, towards default while the Japanese government was running into the limits of the convoy's informal resolution mechanisms. In the mid-1990s, the MOF began moving from mere forbearance to unwinding the weakest institutions and encouraging write-offs of non-performing loans. The total unrecoverable losses of financial institutions were estimated in late 1995 as YEN 27 trillion[58]. In July of 1995, the MOF was compelled to put a real deposit guarantee in place to limit the risk of a run on the banks. In June of 1996, it announced that the Deposit Insurance Corporation would protect all deposits (rather than the existing limit of YEN 10 million per person) and other liabilities of banks until March 2001.

The MOF was being forced by circumstance to expand the public sector's role in insuring deposits and other means to prevent a run on the banks. Yet the lack of public trust continued to hobble progress towards a comprehensive solution. In the

57) Nakaso 2001, 2.

58) Cargill, Hutchison and Ito 1997, 119–120.

summer of 1995, the seven housing loan corporations (Jusen) ran into serious solvency problems. But the issue became a political football, and public resentment strengthened enough for Japanese authorities to refrain from turning to public funds until 1997, when the solvency crisis re-erupted. The bailout of the Nippon Credit Bank in the spring of 1997 triggered an even deeper systemic crisis that autumn. By the time the authorities intervened to protect troubled banks, Sanyo Securities, Hokkaido Takushoku Bank and Yamaichi Securities had already failed. Similarly, the Long Term Credit Bank (LTCB) of Japan failed after unsuccessful attempts to have it merge with Sumitomo Trust Company. The LTCB was nationalized by an act of the Diet on October 23, 1998. At YEN 3.2 trillion, it was the largest failure in the Japanese financial system thus far.

Even after the Japanese authorities had departed from the institutional confines of the convoy system, they continued to hold back from taking fast, large-scale and comprehensive action comparable to Sweden's. Wishful thinking seemed still to play a role in Japan. The world saw it on display on February 2 of 1999, at an international symposium in Davos, Switzerland. There, MOF Vice Minister Sakakibara Eisuke declared that bank chiefs and the financial authorities were meeting and that the "fin ancial crisis is over or ending. I think it will be over in one or two weeks[59]."

Sakakibara's timing was way off, of course. Years of forbearance, coupled with ultra-low interest rates and the liberal use of public finance, had helped keep the old regime in power atop a mountain of toxic debts. But these policies had also sucked much of the life out of the economy as, among other problems, "zombie" firms were coddled rather than new firms created and financed[60]. The 2000s opened with Japan's financial crisis deepening and its economic challenges worsening. In the early 2000s, there were repeated crises as the markets tested the banking structure and Japan's weak domestic consumption left it vulnerable to the vicissitudes of global demand. It was not until March of 2005 that writing off bad loans was completed at the major banks. All told, the disposal of NPLs was YEN 77 trillion. The total cost of the banking crisis itself has been estimated as YEN 100 trillion as of the early 2000s[61], but

59) Sprague 1999.
60) Nishimura 2011.
61) Hoshi and Kashyap 2004.

that figure obviously does not include lost opportunities, eroded social capital, and a greatly diminished global role.

In sum, Japanese management of their crisis was virtually the complete opposite of the Swedish success story. Whereas the Swedes quickly took transparent action, the Japanese authorities opted for a wait-and-see approach and sought to conceal the scope and depth of the financial crisis. A host of interest-oriented factors played a role in driving the divergent outcomes. But it should be evident from the narrative offered here that the simplest explanation for Japan's policy mistakes stemmed from the general expectation of quick recovery. Policymakers, the financial community and households proved to be overly optimistic about the country's economic and financial situation. Committed to the convoy system, Japanese authorities were slow to identify the changing risks in an internationally integrated financial world. They could not, as it were, get their collective act together and implement systemic change. Instead, they kept trying to extend the convoy system via one-off interventions. Their interventions were not transparent and did not use uniform and objective criteria as in Sweden. The legal and institutional framework for capital injections and NPL assessments also had to wait until the late 1990s for systemic reform. Virtually all observers of the case see it as puzzling that it took eight years for the Japanese to introduce these legal and institutional changes[62].

CONCLUSION

It is one thing to look back on a set of policy choices and admire the apparent efficiency and logic of the decisions taken in one case and the inefficiency, if not downright incompetence, of the decision made in another case. Of course, it is only after the fact that one can declare with any confidence and credibility that the decisions were good or bad. The more difficult and interesting question remains: *Why* were Swedish authorities able to make these apparently good choices? Why, in contrast, were Japan's choices so sub-optimal? The answer cannot be that they were obvious choices.

62) Katz 2008.

We argue that framing of elites played the most important role in the management of crises. In the Japanese case, most of the Japanese elite did not perceive the severity of the crisis and expected a quick market recovery. This was largely due to the success of the Japanese economy in the post-war era. Not only had no financial institution ever gone bankrupt in post-war Japan; but equally importantly, the Japanese convoy system was widely credited for being the cornerstone of Japan's awesome post-war economic development. Their economy had proven resilient against the oil shocks in the 1970s and there was a growing consensus that declared Japan as the new reference political economy model. This cognitive framing led the Japanese elite to stick with the status quo. In contrast to their Japanese counterparts, Swedish elites had already become critical of their political economy model from the early 1980s, having suffered consecutive devaluations, problems in their industrial relations, and a decade of comparatively low growth. With that in mind, Swedes were more prepared to perceive the crisis as severe and take the tough but necessary measures to prevent it from worsening. We do not suggest that these differing perceptions or cognitive frames were accurate. Instead, we believe that, to truly understand why elites in these two countries acted as they did, it is not enough to simply focus on the structural or institutional variations and show how they provided different incentives to policy makers. Clearly, as we have shown, institutions and incentives matter. But if one wants to understand real choices by real people one needs to bring in the different cognitive models they bring with them when facing the need to act but a range of possible actions.

While at first glance there appeared to be considerable similarities between the Swedish and the Japanese models of decision making in that they had both developed cooperative relationships between regulators and the regulated and that both had been supported by a single party dominated political regime for several decades[63], our analysis reveals significant differences in how these institutions actually work. Most importantly, differences in the relationship between the government, bureaucracy and political interests who are not already inside the governing coalition explain the degree of transparency in the crisis management. The Swedish model of social corporatism led the government to manage the crisis in a transparent way that in

63) Pempel 1990.

turn encouraged them to focus their attention on protecting the interests of the broader public. From the very beginning, the government brought opposition political leaders into the center of the decision making system, disclosed information about the scope of the problem, and jointly explained to the public their reasoning behind their various decisions - including why they bailed out some of the financial institutions while letting others go bankrupt.

The contrast to the Japanese case could scarcely be starker: in the latter case, the government and the bureaucrats concealed the scope of the crisis from both the public and the opposition political parties, and instead focused on protecting the interests of Japanese financial institutions. They trusted the capacity of their convoy system to solve the problems, and distrusted parties and interests who were not already insiders in the system. Consequently they acted in a non-transparent way by encouraging and supporting their major financial institutions to bail out the smaller ones with mergers and acquisitions. This strategy appeared to save the day - until the major financial institutions started to go bankrupt.

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