Feb. 14, 2013

Bailing out the Bankers or the Banking System?

Comparing Sweden and Japan's Responses to Financial Crisis

THIS TIME REALLY IS DIFFERENT

Reinhart and Rogoff's influential book, *This Time is Different* (2009), argues that financial crises over the past eight centuries have had similar causes and consequences across diverse societies, but they do not discuss the diverse ways governments have intervened in financial markets to deal with financial crises. Since these crises seem inevitable, and financial sectors are becoming increasingly large shares of national economies,[1] it is important for social scientists to examine the politics of how they are managed. More importantly, bank bail-outs since 2008 have driven such issues as burden-sharing, moral hazard and transparency towards the centre of the public debate. Taxpayers have been outraged by the spectacle of massive bank bail-outs with public funds, while not only does wrongdoing go uninvestigated and unpunished but the bankers get to keep their bonuses while working to undermine the establishment of new regimes of rules. The recent bank bail-outs have repeatedly demonstrated, as doyen of financial journalism, Martin Wolf, aptly put it, "no industry has a comparable talent for privatizing gains and socializing losses" (Wolf 2008). These recent events should draw social scientists' collective attention to examining the nature of financial crisis management and bank rescues. We believe that comparing the Swedish and Japanese cases from the 1990s can help explain why some nations opt to save bankers, with massive costs to the collectivity, while others choose to save their banking system even where it is necessary to make some bankers bankrupt.

Sweden and Japan in the early 1990s provide us with two sharply contrasting examples of managing quite similar financial crises. These crises had similar causes, including financial deregulation, credit expansion and massive asset bubbles. They also had similar fallout, with sharp declines in asset prices and immense increases in non-performing loans leading to a full-blown solvency crisis.[2]

[1] Capelle-Blanchard and Tadjeddine 2010.

[2] A solvency crisis, when underlying asset values have collapsed with the eclipse of the bubble, is thus distinct from a liquidity crisis. Solvency crises require fundamental reform and impose often prodigious political and

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Though their crises of the early 1990s had similar mechanisms and manifestations, it is almost impossible to overstate the extent to which the Japanese and the Swedes diverged in handling them. Among many distinct features of the Swedish and Japanese responses, we focus on the most important contrast: Swedish leaders did not rescue the bankers but imposed fundamental reform and protected the interests of the debt holders and households, whereas their Japanese counterparts repeatedly chose ad hoc interventions, and rescued the bankers per se while effectively sacrificing the public interest in a reformed and healthy financial system.

From the start of their crisis, the Swedish authorities sought to stabilize the banking system per se. The authorities organized a coalition in support of intervening promptly, massively and forcefully. The intervention was broad-based and included the political opposition in decision-making and supervisory processes. The intervention was also transparent, reassuring domestic constituencies and foreign investors. It was also deliberately structured to minimize moral hazards, by imposing objective rules and clarifying that the intention was to save the banking system rather than the bankers and their shareholders. This approach allowed the authorities to impose major losses on the bankers and the banks, including the sacrifice of bankers' jobs and investors' capital. Finally, new and robust regulatory measures were adopted and new political institutions were established to better manage and control the financial marketplace. The Swedish strategy stabilized the banking system and the larger economy and, in the end, imposed comparatively low costs on the public sector budget.

In contrast, Japan's policymakers chose to conceal the fundamental problems in the financial system and instead bailed out the bankers. They therefore extended a raft of fiscal, monetary and regulatory supports without fundamental restructuring of the financial sector, treating the financial problem as serious but temporary. The Japanese authorities' policies of forbearance and wait-and-see approach

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economic costs. But in liquidity crises, the public sector capacity to extend credit and other supports is sufficient to carry the financial sector through a short-term period of turbulence.

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. [3]

Reformist Elites v. Status-quo Oriented Elites

The questions 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. We argue that these different responses to the crises stemmed largely from the Swedish and Japanese elites' disparate cognitive frameworks. We identify two different cognitive frames and show how they led to different policy choices for the management of the financial crises. We show that reformist elites in Sweden preferred to save the banking system for the benefit of depositors and households even if this involved bankruptcies and major losses for bankers, whereas status-quo-oriented elites in Japan preferred to save their bankers with ad hoc measures and concealing the scope of the crisis.

Crucial elements of our comparative analysis are historical timing and cognitive predisposition. In the early 1990s, the Swedish elites were already critical of their overall economic system and thus more inclined to accept the need for reform, even fundamental reform. At the same time, their institutionalized tradition of transparency in banking regulation precluded collusive relationships between the banks and their regulators. Swedish elites were thus able to take bold measures, even when these entailed significant losses and outright bankruptcies for bankers. Also, a generalized trust in the effectiveness of government enabled Swedish elites to craft bold measures and apply them forthwith. For instance, public trust allowed large sums of public money to be use for recapitalizing and nationalizing banks without hesitation and fear of corruption.

[3] Svensson, Mabuchi and Kamikawa 2006 focuses on the same puzzle. Their analysis, unlike ours, focuses on the blame avoidance strategies followed by Swedish and Japanese policymakers.

In contrast, Japanese elites at the outset of the 1990s possessed an undue optimism and perceived their financial crisis as a temporary shock. Furthermore, their banking model was marked by institutions that relied on non-transparent interaction between the Ministry of Finance, the Bank of Japan and individual financial-sector firms. And even when Japanese elites recognized they needed more clarity and comprehensive resolution mechanisms, profound public distrust impeded them from mobilizing the requisite finance. They were thus trapped in the status-quo because of their perceptions, institutions and public opinion.

Cognitive Frameworks: Perceptions, Institutions and Constraints

Governments not only wield power, but also puzzle over collective problems (Heclo 1974; Hall 1993). Their puzzling over policy options is perhaps most important in times of crisis, when established institutions and ideas fail to yield effective solutions to new challenges (Blyth 2002). We argue that financial crises represent an extreme case of this conundrum, combining the need for urgent and right action with high public visibility. Failure to act in a financial crisis can lead to rapid economic ruin, but there is no ready recipe for precisely what to do. Because of these features, financial crises provide us, as it were, with 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. Ideas are certainly important in equipping political elites with the rationales for action in turbulent economic times (Hall 1989) and sometimes in providing an “instruction sheet” (Blyth 2001). But we believe it is necessary to look beyond the role of ideas, per se, and investigate the cognitive framework for the actions taken by political elites. This cognitive framework takes perceptions, institutionalized practices and constraints into account (Steinmo 2003). Moreover, political elites’ joint interpretation of the world is often heavily shaped by material preferences and institutional constraints (Culpepper 2008).

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.[4] History matters directly in this sense, because it shapes 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 which *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 industrial policy studies.[5] 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.[6] 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.

The 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 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. 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 (Culpepper

[4] Similar to our argument about elite perceptions, based on survey data, Verba et.al. (1987) shows that Swedish and Japanese elites hold different perceptions towards diverse political issues including political and socio-economic equality in congruent with their political economy model.
[5] Vogel 1979; Zysman 1983.
[6] Kato and Rothstein 2006.

2008). In consequence, the Swedish elites were cognitively in the right place, and ready to reform the banking system completely when its crisis erupted.

Second, institutional practices reproduce themselves and create positive feedbacks to the extent that they provide increasing returns for the parties involved (Pierson 2000; Jacobs & Weaver 2012). Again, we will see below how these institutional practices shape the mindset of political and economic elites. In this respect, the Swedish-Japanese difference is not immediately apparent due to both having close-knit relations among the central actors in policymaking and regulation.[7] Both countries are marked by a political, economic and bureaucratic elite that is relatively concentrated, sharing 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 it is crucial to add that Swedish and Japanese 'corporatist' institutions evolved in different directions. Our empirical sections show that Japan's financial regulatory environment developed what an "Iron Triangle" that eventually became a *collusive* structure with non-transparent interaction between the Ministry of Finance, the Bank of Japan and individual financial institutions. These opaque and collusive institutional practices encouraged Japanese elites to focus on saving the bankers and concealing their losses.

Sweden too has a long history of elite central authority with a relatively small group of men who know each other and rely on each other's confidence.[8] Yet Sweden developed a more prudent, objective policymaking system, with more diverse inputs. Sweden has long been known for its "Politics of Compromise," which features mechanisms for including diverse interests into the decision making

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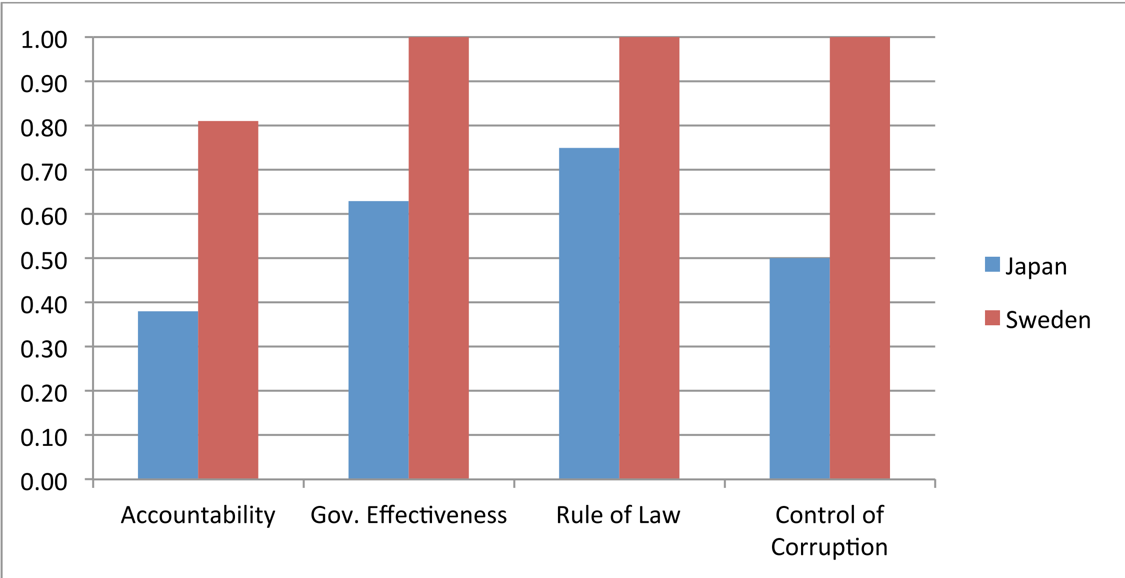
[7] For the Swedish policymaking process and insights for the crisis management, see Bergh 2010; Lindvert 2008; Swenson 2002. For the Japanese, see Vogel, 2006. Katz 2008 provides a comparative analysis of Sweden (Scandinavian countries) and Japan with respect to crisis management and structural reforms.
[8] Lindquist 1980.

process – even interests or parties not formally part of the governing coalition.[9] One of the key consequences of this inclusiveness is the Swedes' tradition of openness, or *transparency*. Japanese regulators and bankers also had long-standing, cooperative relationships, but almost no tradition for bringing outside interests into the decision-making system. Pempel and Tsunewaka aptly described the Japanese case as *Corporatism without Labor.*[10] For many years this system was admired for its decisiveness and capacity to make difficult policy choices.[11] Yet we show that, at least in the case of banking regulation, the system had become a collusive structure in which policy makers opted to conceal the scope of their insolvency crisis with policy measures that lacked transparency and protected vested interests.

Figure 1. Governance Indicators in Japan and Sweden (1996)[12]



Source: World Bank Governance Indicators

[9] Rustow 1955.
[10] Pempel and Tsunewaka 1979.
[11] Pempel 1982; Thurow 1992; Wolferen 1990.
[12] 1996 is the most recent directly comparative data available, but the evidence suggests these differences between Japan and Sweden persist. See eg, OECD, 2011.

The third feature of the cognitive framework approach takes the political constraints into account. Political elites always look for policy options that are politically viable and institutionally possible, but precisely what policies satisfy these conditions is by definition unknown. Our cases show that policymakers in Sweden and Japan had very different perceptions about the use of public money to solve their financial crises. Even after Japanese policymakers realized they needed to resort to open and massive capital injections in order not merely to rescue insolvent banks but the banking system itself, they were inhibited from taking action by public opposition to using public money. In contrast, the Swedish public supported the use of public funds to resolve the insolvency in the financial system. The key difference here was the degree of *trust in public institutions*. Kato and Rothstein (2006) demonstrate that the Swedish welfare state's universal character, with its equitable distribution of resources that are independent of particular interests, underpins public confidence that their money was well spent. In Japan, however, government funds remain widely perceived as political benefits used to placate specific interests and buy off powerful constituencies. The World Bank Governance Indicators (see Figure 1) support this argument, at least for the early to mid-1990s period of time under study here. The indicators suggest that Sweden was well ahead of Japan in terms of governance measures such as accountability, government effectiveness, rule of law and the control of corruption. We believe that this background helps explain why the Swedish public supported the use of public money while the Japanese public opposed it. This constraint in Japan contributed to the fateful choice, for nearly a decade, of sticking with a strategy of concealing the crisis and protecting vested interests rather than supporting a larger scale restructuring of the banking system in a publicly visible way.

In sum, Japanese and Swedish policymakers confronted crises in their financial markets, and responded with policies conditioned by their perceptions of their national economies, the political constraints they felt imposed upon them, and the opportunities they felt were available. We are *not* arguing that these perceptions were accurate. Instead, our point is that the ways in which policy makers viewed recent history cognitively framed the choices available in each case. Japanese policymakers were confident in their growth model and banking system. They generally expected a

prompt recovery and thus adopted a wait-and-see approach, coping with bank failures via ad hoc solutions that conformed to and reproduced the institutional status quo. It literally took them seven years to recognize the scope of the problem and begin adopting comprehensive measures adequate to a solvency crisis. In contrast, Swedish policy makers already believed their economy was in trouble, even before the crisis hit, and were therefore quick to grasp the scale of their financial meltdown. Seeing the evidence for what it was, they reasoned that they had to act immediately and save the banking system rather than rely on piecemeal fixes to save bankers. In short, perceptions about the recent evolution of their political economy models shaped the actions taken by the policymakers in Sweden and Japan.

Alternative Perspectives

What might be the alternative explanations for the divergence in crisis management? Here we briefly discuss three common explanations in political science. Probably the most common explanation centers on economic interests (Gourevitch, 1986). As a rule, the financial sector will seek to maximize monetary, regulatory and other support while minimizing any cost to its independence, in particular capital injections with stringent conditions. But everything becomes negotiable the deeper the crisis, the clearer the differentiation among failing and still-viable institutions, and the broader the political coalition favoring intervention. One cannot predict the positions that non-financial interests, such as other business groups and labor, will adopt in a crisis. Faced with financial meltdown and a possible tsunami of bankruptcies, even staunchly free-market business groups may support capital injection. So too might labor and low income groups, especially if the rescue includes the use of public money to stimulate economic growth and employment. This fluidity of interests is key. Solvency crises are systemic events whose effective resolution requires the capacity to go beyond the logrolling of normal politics and build a coalition that agrees to shoulder the costs of unwinding insolvent institutions. The Swedish success in gaining interest-group support for comprehensive intervention was the product of credible policy in a palpable crisis. Policy shaped interest groups' responses, rather than being read from a laundry-list of their demands. Japan's failure was rooted in policymakers not being able to

reach far enough. Fear of public opposition saw policymakers opt for ad hoc and non-transparent policies. But this coddling of the banks further alienated the public on the use of public funds, compounding the challenge of building an effective coalition.

The second alternative explanation centers on the political complexion of the party or coalition in power. But this approach, too, is not especially relevant to the comparative politics of Swedish and Japanese financial crisis management because at the time both countries were governed from the center-right. Sweden's center-right coalition responded quickly and effectively in protecting the banking system, whereas the similarly center-right Liberal Democratic Party in Japan was hesitant to disclose its scope and use public money to resolve the major problems in the banking system. This is not a story of party labels determining policy outcomes.

The last perspective we treat here is a structural approach that focuses exclusively on the ways in which formal political institutions shape the strategic behavior of actors and interests (Fiorina 1995, Weingast 1996; Tsebelis 2002). We show in the following analysis that the particular choices made in Sweden and Japan simply cannot be 'read off' institutional incentives. Actors' choices were instead framed by their perceptions and, indeed, their particular politico-economic histories. The considerable literature that has sought to explain Japanese forbearance in institutionalized principal-agent terms has certainly elucidated many useful points (Muramatsu and Scheiner 2007, Rosenbluth and Thies 2001). But we argue that our comparative analysis demonstrates that actors' interpretations of past events and expectations about the future in the context of uncertainty (Knight, 1995) had more profound consequences for the actual choices taken.

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 1987, public spending had grown to nearly 60 percent of GDP and taxes had reached 54% of GDP. In the context of an increasingly competitive and open world economy, these facts presented Swedish policy makers with acute dilemmas. The Ministry of Finance was dominated by what must be called "liberals" within the Social Democratic Party context. These officials were 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. Led by Minister of Finance, Kjell Olof Feldt, ministry elites concluded that the pattern of inflationary policies followed by currency adjustments could not be sustained in an increasingly fluid and open financial world.

In the early 1980s, under Feldt and his team's stewardship, Sweden began to introduce 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.[13] As in many countries, Swedish policymakers and the financial community did not fully appreciate the extent to which financial deregulation brought new systemic risks. But they found out when a full-fledged banking and currency crisis hit the Swedish economy in the early 1990s.

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 well as strict controls on international capital movements. Given the very strict regulations before the 1980s, banking was more like a staid administrative endeavor than a business. Virtually all aspects 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

[13] Feldt 1991.

financial markets and domestic concerns such as financing large budget deficits.[14] 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.[15]

Along with these regulatory changes came a gradual evolution in the structure of the banking industry itself. Historically, the Swedish financial industry was divided between two main large private commercial banks, HandelsBank, and Stockholms Enkilda Bank (SEB), which was owned by one of Sweden's most powerful and important families, the Wallenbergs. In addition to these two major banks, there was also Nordbank, a quasi-public bank. Nordbank had essentially been knit together from a variety of different institutions over the years including, for example, the Postal Savings Bank (PK). A large number of smaller local savings institutions could also be found in almost all of the smaller towns and villages across Sweden. These latter institutions traditionally focused on local loans.

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, opportunities for risk-taking increased. Competition expanded immensely within the traditionally rather staid industry,

[14] Englund 1999 and Jonung 2009 provide the best accounts of Swedish financial liberalization and crisis management.
[15] Drees and Pazarbasioglu 1998.

with new entrants driving a hitherto unseen, and increasing, competition for borrowers as well as investment products.

One of the new entrants to the market, GotaBank, (which grew out of a set of mergers of smaller banks) became especially active in the commercial real estate market and also began selling sophisticated investment instruments. The management style of traditional Swedish banks also changed. Some of these changes arose from new managers being brought into the banks, and some through formerly conservative bankers now being able to invest outside their local communities. Several economists and industrialists had criticized the traditional financial institutions for being risk-averse and thus helping to stifle Swedish economic performance. Deregulation changed Sweden's banking industry from being a rather stolid service industry to much more of a center for generating profits.

Regulatory changes regarding the quantities, interest rates, domestic and international transactions 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."[16] 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 was viewed as a boon to the Swedish economy.

[16] Rodriquez, Interview, February 25, 2011

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.[17] 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.[18] These trends were accompanied by a 4 percent per annum increase in household consumption.[19]

Figure 2 about here

In the late 1980s, it became increasingly evident that the economy was over-heating. In 1989, the unemployment rate declined to 1.4 per cent just as the stock and real estate markets peaked. Precisely as Reinhart and Rogoff would predict, the boom eventually elicited a fall, which the above figure shows that the fall in real estate values was steep. Unsurprisingly, this precarious decline in asset values put Swedish banks under enormous pressure. The construction and real estate stock price index declined by 25 per cent in 1989,[20] 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.[21]

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.

[17] Englund 1999, 84.
[18] Backstrom 1997, 131.
[19] Englund 1999, 84-5.
[20] Englund 1989, 89.
[21] Jonung 2009, 4.

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.[22]

To make matter 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.[23] 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. However, the choice to protect SEK inevitably drove up interest rates and increased the Swedish financial system's vulnerability to speculative shocks. Insistence on retaining a pegged rate deteriorated international borrowing requirements of Swedish banks forcing higher interest rates which of course put even further pressure on the financial system. Swedish authorities let the SEK float on 19 November, and 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 cent and public sector deficit rose to 12 per cent.[24]

Response

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[22] 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.

[23] 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. The primary rationale for the pegged exchange rate regime was that a pegged rate would act as a nominal anchor for stabilization and encourage growth and employment. However, Swedish authorities did not realize how deregulation of financial markets would increase the vulnerability of the Swedish economy and limit the utility of pegged rate against financial speculation and outflows.

[24] Backstrom 1997; Englund 1999.

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 the parliament. This unusual turn of event put the Swedes into a position where no one could form a majority government without this new, allegedly racist, party included. Eventually, the Moderate Party, led by Carl Bildt formed a minority government despite the fact the Moderates had only received 80 mandates and was 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. 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 the year. In short, the newly elected government encountered a severe crisis but successfully identified the underlying problems and took steps essential to overcome it.

The new government first 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 intervention.

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. 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 plan if you leave the former shareholders with anything."[25]

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."

[25] Dougherty 2008.

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.[26]

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.[27] 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 loans (Ergungor 2007). Then in May of 1993, the Bank Support Authority (Bankstödnamnen) 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.[28]

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 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

[26] Interview, Feb 24, 2011.
[27] Jonung 2009, 8.
[28] 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.

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. Sweden had little experience with minority governments, but it did have a long tradition of coalition governments and of neo-corporatist decision making in which opposition parties and interests were brought together for discussions as new policy initiatives were being considered. During the financial crisis, the long-governing Social Democrats were out of office. But the Conservative government chose to follow tradition and go for as inclusive a process as possible. Indeed, 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.[29]

Second, crisis management was transparent from the start – and quite deliberately so – so as to gain the confidence of domestic and international investors. Transparency involved disclosing credible information about the scale and character of the crisis. The Swedish government disclosed expected loan losses, rapidly assigning realistic values for asset-related losses rather than deferring losses to the legally permissible limit.[30] All banks under the control of the Bank Support Authority, or which had

[29] Ergungor 2007.
[30] Ingves and Lind 1996.

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. These efforts maintained confidence in the Swedish financial system, preventing a capital flight that would have done much harm to Swedish firms heavily dependent on foreign funds to roll over their short-term debt.

Third, elites in all the main political parties understood 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 significant policy changes were needed in order to maintain an egalitarian welfare state in the 21st century.[31] In short, part of Sweden's policy success derives from a moderate government's willingness to compromise and include opposition leaders. But an equally important part 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 and a long 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. A common framework for government intervention was also built in order to set objective criteria for capital injections. This framework saw financial institutions divided into three groups based on their level of capital equity and their prospects of recovering in the short and medium term. Lundgren described the government'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,

[31] Feldt 1991; Steinmo 1989; Steinmo 2010.

then you have to take the loss. That is a market economy. Otherwise a market economy won't work".[32] In line with this thinking, financial institutions which the authorities judged had reasonable recovery prospects received central government capital injections. Others judged to be too far gone 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. Similarly, creating Securum and Retriva as asset management companies for Götabanken and Nordbanken was a practical solution for non-performing loans backed by real estate properties. Swedish policy makers recognized the necessity of particular expertise for the legal and technical complications of real estate market and transferred the properties of these financial institutions to Securum and Retriva.[33] 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.[34] Considering all of these elements, there can be no gainsaying that the Swedish authorities were remarkably successful in managing the financial crisis in the early 1990s.

[32] Interview, Feb 24, 2011.
[33] Jonung 2009, 11; Ergungor 2007.
[34] Jonung 2009, 12.

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

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 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.[35]

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

[35] Kaneko 2002.

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 2012. 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 2013 is to fund marginally more of its general budget from tax revenues rather than red ink.

Industrial, not Social Policy

How Japan got into this mess bears 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.[36] And in a sharp contrast to Sweden and other European welfare states, the postwar Japanese state saw its mission as constructing an export machine centred 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.[37]

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.[38] Instead of building a public welfare state to insure individuals against economic risk, this system relied on firms to provide benefits and jobs – even during economic downturns.[39] Financial stability was thus part of Japan's unusual 'welfare state'.[40] 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

[36]Japan's prewar financial system was very unregulated, and in 1931 87% of funds for corporations came from capital markets. The banks' role was only minor. See Noguchi, 1998, 405.
[37] Amyx 2004; Estevez-Abe 2008.
[38] Zysman 1983; Schaede 1996.
[39] Steinmo 2010.
[40] Estevez-Abe 2008.

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.[41] It was a dense network of trust-based relations among the regulators and their respective clients in the various sectors of industry.[42] The convoy system also afforded an informal protection of bank deposits, coordinated by the regulatory authorities' 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.[43] Interest rate ceilings were also used to ensure that financial firms did not compete on price while enjoying predictable and quite substantial profit margins.[44] 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 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.[45]

In practice, much of the oversight of the financial sector was ad hoc and handled through special relationships between bureaucrats from the Ministry of Finance and Bank of Japan together with the personnel of financial institutions. In return for special treatment and implicit guarantees, financial

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[41] Seabrooke 2006.
[42] Suzuki 2010.
[43]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.
[44]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.
[45] Aoki 1994; Kaji 2010.

institutions were expected to finance investment in accordance with national developmental strategy. Over time, this interaction evolved into a collusive type of regulation, with ample opportunities for rent-seeking at the expense of the larger public interest.[46]

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.[47]

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.[48] 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.[49] This bubble was further encouraged with inheritance and corporate

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[46] Kaji 2010.
[47] Noguchi and Yamamura 1996, 59.
[48] 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.
[49] Katz 2008.

income taxes favoring investment in land.[50] 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.[51] 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.[52]

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 have 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 failed during this period in spite of the sharp declines in real

[50] Fukao 2009.
[51] Stone and Ziemba 1993, 149.
[52]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.

estate and other asset prices and the banks' heavy exposure to these markets through their loans. The convoy system contained several minor failures, but the lack of systemically threatening bankruptcies did not mean the banks and other financial institutions were solvent. Instead, fiscal and monetary means were used to cushion and conceal the shock, with help from creative accounting and other administrative evasions.

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.[53]

Miyazawa was moving towards the Swedish approach of dealing with the solvency crisis in a comprehensive way. As we have seen, this approach entailed organizing a coalition of interests from

[53] Kume 2001, 110

within and without the financial system, to support the short-term pain of resolving the morass of bad loans. The sum of money was a few tens of trillions of yen, a lot of money. But the only alternative was to risk the virtual certainty of much higher costs down the road, through even more devalued assets, squandered fiscal stimulus, lost growth, and the like.[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." This program for massively increased forbearance proposed to flood the markets with liquidity rather than intervene directly in the troubled banks. MOF's plan also included fiscal, monetary and regulatory changes 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. Deceased since June of 2007, Miyazawa never explained why he assented to the plan even though he regarded it as a "strange document."

MOF's plan boosted the markets, and Miyazawa's idea of capital injections became a no-go. He mooted 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.[55]

[54] Tahara 2010, 70-73.
[55] Kume 2001, 110-113.

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. Understanding the unraveling of bad assets and the banks is not a matter of rocket science. Yet many observers of this period suggest that the Japanese authorities 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.[56] We should probably bear in mind that back 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.

It is important to understand that the opposition to Miyazawa's suggestion also drew heavily on concern about adverse public reaction to using taxpayers' money to recapitalize the banks.[57] The idea that the public would not accept capital injections became fixed and a self-fulfilling prophecy. Public trust was further alienated by reams of media reports about collusive banks and bureaucrats. But in general, Japanese voters were increasingly skeptical of their state and given the paucity of direct social or welfare benefits they received, it was perhaps not surprising that they would be hostile to giving some of the largest financial institutions in the world their tax dollars. Public trust in political

[56] Nakaso 2001, 2.
[57] Nishimura 1999, 83.

institutions and leadership was falling dramatically in this period,[58] and no serious program for reforming the clubby sectors of the overall financial system.

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.[59] 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 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

[58] Ide and Steinmo 2009.
[59] Cargill, Hutchison, and Ito: 1997, 119-120.

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.

Progress had been made: the authorities largely recognized that it was essential to treat the solvency problems in a systematic way rather than seek to resolve them case-by-case. In February of 1998, the "Financial Crisis Management Committee" was put in place to identify banks in need of injections.[60] In a telling contrast to Sweden, whose Bank Support Authority was set up early with significant powers, Japan's previous "Financial Crisis Management Committee" (also known as the Sasanami Committee) had lacked supervisory powers as well as crucial information about individual banks. The new Committee did have the requisite power to do inspections. And as of June 1998, the MOF had lost its control over bank regulation and supervision to the Financial Services Agency, a new agency, in cooperation with Deposit Insurance Corporation. The MOF-guided convoy system, with its reliance on informal protection of deposits and case-by-case bailouts organized via MOF and the industry, was no more. There was a formal and comprehensive financial safety net in place. But incredibly, getting this far had taken nearly a decade.[61]

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 "financial crisis is over or ending. I think it will be over in one or two weeks".[62]

[60] Takinami 2010.

[61] For example, the February 1998 Financial Stabilization Law made YEN 30 trillion available for capital injections, and in March the authorities injected public funds into the banks. But their efforts led to an inadequate injection of YEN 1.8 trillion for the 21 leading banks. And on top of that the authorities, continuing to be soft on the banks and their clients, made an accounting change that allowed banks to choose whether to use market or book values in assessing the value of stocks held in other firms as well as real estate holdings. Measures like this reduced the pressure to write off bad loans.

[62] Sprague 1999.

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.[63] 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,[64] but 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

[63] Nishimura 2011.
[64] Hoshi and Kashyap 2004.

late 1990s for systemic reform. Virtually all observers of the case see it as puzzling that it took eight years for Japanese to introduce these legal and institutional changes.[65]

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 down right 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. Reinhart and Rogoff demonstrate that in most cases good policy choices are not made in response to economic crises.[66] Moreover, as the section on the Japanese and Swedish experiences demonstrated, with a similar crisis very different policy choices were still available.

We argue that cognitive framing of elites played the most important role in the management of crises in Sweden and Japan. 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 more 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

[65] Katz 2008.
[66] Reinhart and Rogoff 2009.

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.

We also argue that these cognitive frames were shaped by old institutional practices. 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,[67] 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 which in 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 more stark: 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

[67] Pempel 1990.

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.

We discuss how cognitive frames do not necessarily discard material preferences or political constraints. Even when Japanese elites realized the weaknesses of convoy system and ad-hoc measures to combat with systemic problems in the Japanese financial system, they did not have the liberty to inject public money to bail out the banking system. They were constrained with negative public perception towards the use of public money. Given Japan's high level of corruption and low level of government effectiveness, its public had long distrusted use of large amounts of public money for costly projects and bail-outs. Contrast that with the confidence and trust of the Swedish public towards government. The fount of trust gave Swedish elites the capacity to inject large amount of capital to save the banking system. The public trust towards government is one crucial factor that enabled Swedish elites to act fast and effectively.

What does this analysis tell us about other countries facing economic and financial crises in the second decade of the 21st century? We think there are many lessons here. First, Reinhart and Rogoff 's conclusion is incomplete: Economic crises can be quite different. Even where crises look very similar on the outside – as the Swedish and Japanese crises of the early 1990s did – how governments respond can and does vary enormously. Moreover, these different responses have immensely important implications for the economic health of the countries involved. Despite all the evidence to the contrary, the neo-liberal ideology suggesting that government action is almost by definition ineffective or inappropriate continues to hold enormous power – especially in the United States. Our analysis here demonstrates quite clearly that it is not how much the government intervenes that is the most important factor, but rather how effective that intervention is.

Secondly, this analysis suggests that similar institutions can be manipulated and used in remarkably different ways. A key to these differences is what we have called 'transparency.' In Japan's case, the public was not truly involved in the economic crisis for many years, after which it was too late to

avoid massive economic damage. Confidence, or trust, in public institutions is essential for successful decision making in difficult times. In Sweden's case, citizens, interest groups and even opposition political parties were involved in resolving the crisis from the beginning. Consequently, even while some of the decisions made were difficult and painful, the public and the opposition continued to support these choices. Today, Sweden emerges as a strong competitor and vibrant economy as the world trembles. Japan's future is far more bleak.

The very nature of our analysis suggest caution in drawing implications from these narratives directly to other countries whose histories, institutions and public/government relations are necessarily different. But the comparisons and contrast between these cases and the American, especially, can scarcely be avoided. The United States and its new government initially addressed its financial implosion with a bailout of the financial industry. To this day, almost no one knows where this money went and/or how it was spent. (We do know that the executives in the firms receiving the bailouts got huge pay bonuses, though.) Secondly, while the new Obama government has tried to build a new financial regulatory regime, they have had to fight against powerful interests who reject regulation for narrow and selfish interest reasons and/or because they are philosophically opposed to government itself. Finally, the fund of public trust for government action in this area – and virtually every other – is even lower in the US than in Japan.

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