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by
Richard Nakamura

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Postal address: P.O. Box 6501, S-113 83 Stockholm, Sweden. Office address: Sveavägen 65
Telephone: +46 8 736 93 60 Telefax: +46 8 31 30 17 E-mail: japan@hhs.se Internet: http://www.hhs.se/eijs

The Big Cleanse: The Japanese response to the financial crisis of 1990's seen from a Nordic perspective*

Richard Nakamura

The European Institute of Japanese Studies
Stockholm School of Economics
P.O. Box 6501
113 83 Stockholm
Fax: +46 8 31 30 17
e-mail: richard.nakamura@hhs.se

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Abstract

As Japan and the Nordic countries entered the final decade of the 20th century, they experienced an abrupt end to a near decade-long rapid surge in asset prices. An era of economic optimism was transformed into recession and a difficult cleaning-up process of the financial sector started.

Although different in volume, the banking crises of Japan and the Nordic countries show close similarities in character and timing. Also the institutional setting was similar, where extensive regulations was the order of the day.

However, the Japanese response to the crisis was slow. Not until April 1998 did a liberalization package of the Japanese financial markets, called "Tokyo Big Bang", came into force. By that time, the Swedish and the Finnish financial crises were by and large solved and a new industrial structure had emerged, replacing the old one.

Drawing from the Swedish and the Finnish experiences, a successful solution to the Japanese financial crisis necessitates radical measures by wiping away the whole stock of bad loans and raise efficiency on the financial markets and within financial firms. This might imply even more thorough restructuring than it was originally intended from the Japanese side. What factors made the restructuring of the Swedish and the Finnish financial markets faster than the Japanese one? Given the reforms so far, can Japan resolve its problems in the financial sector in reasonable time and eventually catch up with European and North American financial markets?

The conclusions are that it is too late for Japan to simply emulate the Nordic model. Rather, reforms encompassing the whole Japanese economy are necessary in order to win back the confidence of the Japanese people.

In this paper, the Japanese financial reforms will be compared to the Swedish and the Finnish experiences, focusing on the evolution of the banking crises and the government response to these crises. Furthermore, the subsequent changes in the industrial structure and regulatory institutions are also addressed. Finally, the usefulness of implementing a Nordic style banking sector restructuring in Japan is discussed.

Keywords: Bad Loans, Banking Crisis, Deregulation, Financial Reform, Finland, Japan, Sweden.

**** The author is obliged to the commentators at the AICS 2 conference in Berlin on 10 August 2001 for valuable comments.***

1. Introduction

During the 1990's, Japan suffered from a deep recession resulting from the failure of the Japanese stock exchanges and the subsequent crash on the real estate markets in the end of 1980's. The actors in the Japanese financial sector, which were hit exceptionally hard by the sudden real estate revaluation and the drop in the number of deals, tried to find other markets in order to compensate the downfall in the Japanese economy. The South East Asian market, which still cried for foreign capital, then became the new business opportunity for the Japanese banks in order to recoup some of the losses made at home.

In 1997, the Japanese financial world experienced the worst crisis since the end of WW2. Even before the Asian Crisis in July of that year, the improvement of the Japanese economy was hampered by stiffened fiscal policies of the Hashimoto government. The low level of consumption became even lower after the increase of consumption taxes to 5%, followed by a decrease in the industrial production level, which in turn triggered another large-scale fall in stock prices. Although not the direct cause to the bad loan crisis in Japan, the Asian Crisis thus became a catalyst in making a serious financial situation unsustainable. In connection with this crisis, serious financial misconducts such as so-called *tobashi*[1] were revealed. Ultimately, the credit losses from the operations both in Japan and South East Asia could not be hidden anymore and resulted in the first of mega-failures affecting the Japanese financial sector[2]. The trust in the Japanese financial sector was severely damaged.

However, the Hashimoto coalition government had by that time also identified the need for structural reforms in the Japanese financial sector. In 1996, the then Prime Minister Ryutaro Hashimoto announced "the Tokyo Big Bang", which was a thorough reform package affecting both the financial industry and the legislation regulating the industry. The Asian Crisis just coincided with the reform plans and only made the necessity for urgent, non-cosmetic reforms even more acute.

As a phenomenon, there is nothing new about banking crises. They tend to surface from time to time, and seem to be an unavoidable part of a market economy system.

[1] See chapter 3 for explanation of *tobashi*.

During the 20th century, more than one hundred countries under various macroeconomic regimes have experienced banking crises of different scale[3]. The causes have been varying, and to group all these crises together in order to extract a single universal cause would not be particularly rewarding.

Did the Japanese financial crisis have a totally unique pattern? To some extent this might be true, in the sense that a major regional crisis being the trigger to a long due large-scale crisis in the financial sector of the world's second largest economy. On the other hand, the similarities to other contemporary crises are striking.

Despite having liberalized their banking sectors before their crises, the process in Sweden and Finland at the turn of 1989-1990 leading to their financial debacles is very similar to the situation in Japan. Sweden and Finland also experienced a sudden and drastic fall in asset prices, and a dramatic surge in bad loan volume as a result of a collapse of an overheated economy. Therefore, it is interesting to compare the development of these crises and see how the Swedish and Finnish governments responded to their crises respectively, and how the Japanese government has managed the financial crisis so far.

Each Nordic country, except for Iceland, suffered large-scale drops in asset values after several years of speculation leading to overpricing. In this paper, I will limit the study to look at the banking crises from a formal institutional perspective, since explanations to the crises and the following restructuring from the perspective of informal institutions, such as cultural norms, will force the analysis out of the scope and intention of this paper. Furthermore, it will mainly address the problems of the *banking* institutions of Sweden, Finland and Japan. In the first part, I will give a background to the situation before and during the crises, then describe the measures that were taken by the Swedish and Finnish authorities and compare them to what the Japanese authorities have done so far. Furthermore, achieved results from these measures will be assessed. A discussion whether the Nordic experiences can contribute or not to the situation in Japan will conclude the paper.

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[2] The Japanese financial world had already in 1995 and 1996 experienced seven bankruptcies of the so-called *Jusen* housing loan corporations; however, these were not comparable in volume to the defaults in 1997 (see also page 16).

[3] Englund, p. 80.

2. The structure of the financial sectors before the crisis

2.1 The structure of the Swedish financial sector

Though the actual institutions were founded at different time periods, the structure of the financial sector in Sweden and Finland were very similar to the one in Japan and wore very much the same features. As in Japan, many of the financial institution as they existed at the turn of 1980's were children of the old-time and strict regulatory regime[4].

Sweden had at the turn of 1980's one of the most heavily regulated financial sectors within the OECD. The industry was dominated by a small number of banks, practically dividing the banking market between them: the commercial banks turned to corporate and urban households sectors, while the savings and cooperative banks were concentrating on smaller firms and households in smaller cities and rural areas.

Besides interest rate regulations, following features were prominent in the Swedish regulatory system[5]:

- Ceilings on the rate of private sector bonds issues
- Rules limiting stockholding by foreign citizens
- Requirements on Swedish banks to buy government and housing bonds
- Control of foreign exchange
- Limitations on foreign citizens buying interest-bearing assets denominated in Swedish kronor
- Prohibition on foreign banks opening subsidiaries or to start retail business

These regulations allowed the authorities to control the in- and outflow of capital, and in doing so, helped the government to pursue the fiscal policy. The Bank of Sweden also relied on quantitative limits on loans to banks and moral suasion to control the credit level in the banking system[6]. These regulations eventually led to a "main bank" system, with very close links between the major Swedish exporters and the large commercial banks. But the incentives to stick to such "main bank" relation was

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[4] One of the oldest regulations was the upper limit on interest rates, which was regulated by law since 18th century. This law also applied to Finland as well, since it was then a part of Sweden.

[5] Drees and Pazarbasioglu, p. 10.

[6] Ibid., p. 5.

significant as changing banks was associated with very high transaction costs, both in informal and formal terms. On the other hand, this lowered the firms' uncertainty and the main banks' information costs.

Even though the regulations were extensive, the banks found means to invent new business forms in order to avoid them. The main idea behind the introduction of these non-bank financial institutions was primarily to open up new businesses and adapt to the changing market conditions along the evolution of time[7]. In other words, many of these non-bank financial institutions were founded as a way to circumvent government regulations – which was silently accepted by the government in order to secure a smooth-running financial system.

However, first in 1987, the director of the Bank of Sweden, Bengt Dennis, marked in a speech that the role of the central bank as a regulating authority had long since been bypassed by the different measures Swedish banks had taken to escape the regulations. It is less likely that the Swedish central bank had understood the facts of the reality as late as in the end of the 1980's, but the authorities did at last publicly admit that the effectiveness of the regulatory system belonged to bygone days.

By the time of the speech of the Bank of Sweden director, the liberalization process had actually been going on since the beginning of the 1980's. The Swedish government had started on a limited scale in 1978 by abolishing the ceilings on bank deposit interest rates[8]. By 1990, all the regulations listed above were lifted, and the freedom of capital movement was complete.

2.2 The structure of the Finnish financial sector

Similar to Sweden, Finland has also a history of heavily regulated financial sector. In fact, the tradition of financial regulation in Finland stems from the Swedish rule of the country[9]. Like Sweden, the Finnish authorities made a significant effort to control the financial sector up until the 1980's. Haavisto (1992) mentions for example a number of agreements, where the major banks were invited to conferences by the Finnish

[7] Larsson, p. 47.
[8] Drees and Pazarbasioglu, p. 10.
[9] Haavisto, p. 19.

central bank in order to agree on a common interest rate for all banks[10]. In addition, each commercial bank was assigned a quota on advances from the central bank. By doing so, the Bank of Finland could effectively control the level of credits as the commercial banks relied heavily on marginal loans from the central bank[11].

Apart from the interest rates, the foreign exchange control and the prohibition on establishing subsidiaries for foreign banks were other targets of the regulation. In addition, non-commercial banks were discriminated in their dealings with the Bank of Finland. The secondary markets for bonds and equity were before the deregulation very small and insignificant, and bank borrowing was the primary capital source for corporations and households[12].

Another area that was strictly regulated was the foreign exchange. Going from being unregulated before the Second World War, the post-war foreign exchange regulation was used as a tool to cope with the chronic balance of trade problems following the post-war conditions and reconstruction[13].

The process towards deregulation started in 1983, which was somewhat later than in Sweden. By 1991, however, virtually all regulated areas were liberalized and Finland was on par with Sweden[14]. To start with, areas of lesser importance were liberalized by, for example, allowing foreign banks to set up subsidiaries and domestic banks to lend abroad. During the latter half of the decade the most important regulations, such as the regulations on interest rates and the prohibition of floating interest rates on all forms of loans, were abolished as well as restrictions for individuals and corporations to raise loans denominated in foreign currency.

By the time the crisis emerged, the conditions for doing financial business in Finland was therefore completely changed compared to the conditions a few years earlier.

[10] Ibid., pp. 25-30.
[11] Drees and Pazarbasioglu, p. 5.
[12] Haavisto, p.25.
[13] Ibid., p. 32.
[14] Drees and Pazarbasioglu, p. 11.

2.3 The structure of the Japanese financial sector

The roots to the industrial structure before the "Big Bang" of 1998 lay in the pre-war societal structure. In an attempt to enhance the country's economic ability to support the expansionistic policies of Meiji, Taisho and early Showa eras, the financial industry was strictly sectioned off in order to let each subsector become specialized in its designated area. Cargill (2000) has pointed out five characteristics of the Japanese financial industry that were established well before the start of the Second World War[15]:

- Virtually no direct financing through capital markets
- Large cartels of banks, promoting long-term relationships with nonfinancial firms and restricting competition
- Large number of small and poorly capitalized banks
- Government financial intermediation, especially through postal savings, to finance various projects became increasingly important
- The central bank being *de facto* an extension of the Ministry of Finance

It is interesting to note that despite the financial crisis of 1927 and defeat in the Second World War, this structure survived and was in fact regarded and used as an important factor for supporting the post-war recovery of the Japanese industry, much because of the shortage of capital. Besides a desire to reduce risks and uncertainty of investments, the aim was to allocate resources with the help from heavy financial regulations to those industrial sectors that were designated for development by the government. On the other hand, this also meant costs to society in the form of raised entry costs for outsiders and reduced competition in banking.

As in Sweden and Finland, the structure of low competition and similar setting of prices and interest rates seems to have fostered close bank-customer relationship. But unlike the Nordic countries, the Japanese banks also had extensive stock holdings in the companies they financed.

Primarily due to the record growth of the Japanese economy, these drawbacks of the regulatory system were not apparent enough in an atmosphere of high investment rate,

[15] Cargill, p. 2.

increasing exports and growing domestic consumption. One might say that the welfare loss in sustaining this structure was offset by the general performance of the Japanese economy.

Deregulations were not completely absent before the 1998 "Big Bang" however. After the first oil crisis in the 1970's, the first steps were taken towards liberalization. The major reason for these early reforms was more structural than an aspiration for efficiency, in the sense that it was initiated by the Ministry of Finance in order to internationalize the yen. An amendment to the Foreign Exchange and Foreign Trade Control Law of 1947 was passed by the Diet in 1980, making it the first reform of any major significance. By the end of the decade, the euroyen and yen-dominated foreign bond markets were liberalized, and an offshore market for yen was established in Tokyo after further amendments to the Foreign Exchange and Foreign Trade Control Law. Closely connected to this reform, the interest rates were also deregulated. In 1979, CD was introduced, followed by a liberalization of time-deposits rates. By 1994, this process was concluded by the liberalization of the interest rates for all liquid accounts, except for checking accounts.

Here, a few words on the liberalization of short-term foreign borrowing are necessary. In mid-1980's this was set free, leading to a sudden increase in short-term borrowing by Japanese corporations and banks, and in length, contributed to the liquidity overflow in Japan. Meanwhile, long-term borrowing abroad was still restricted by the existing regulation. Although not being the only source of funds for the Japanese "bubble"-time speculation, short-term foreign loans were a significant contributor to the defaults when it was converted to long-term domestic loans.

Despite all this, Japan remained financially one of the most rigidly regulated countries in the industrialized world[16]. Much of the banking structure was identical to the one half a century earlier, and like e.g. Sweden, Finland and Germany, financing through banks, often through several intermediaries, rather than through capital markets was prevalent. In addition, the power of the Ministry of Finance as regulator and supervisor was still absolute, and often exercised its power by moral suasion.

[16] Ibid., p. 5.

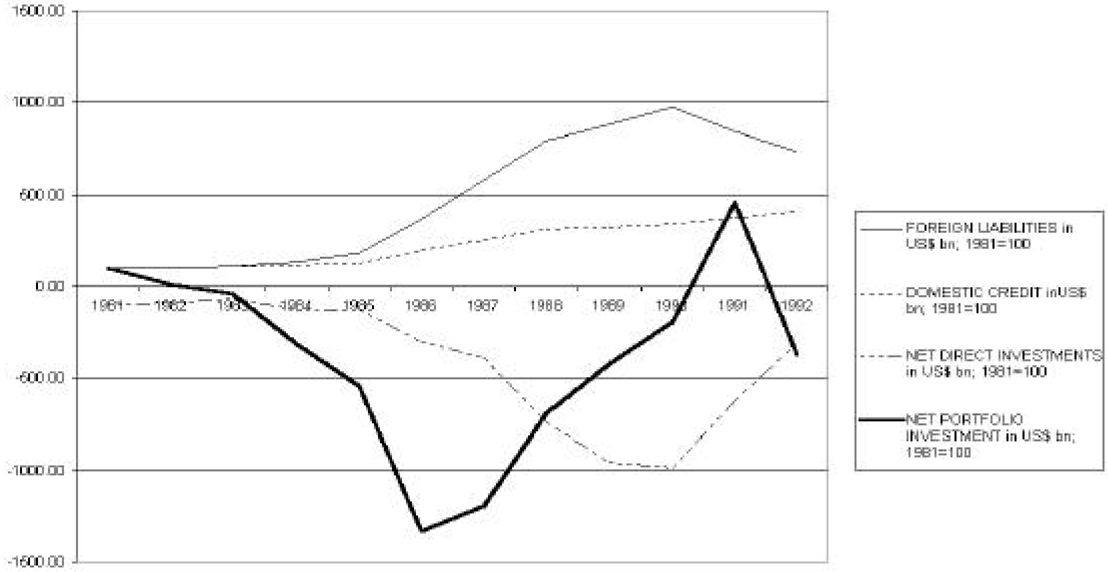

Figure 1. Foreign and domestic liabilities vs. Japanese foreign investments during the 1980's. Values indiced. (*Data source:* IMF)

Practices such as the so-called "convoy" system, where strong banks rescued ailing financial institutions by the order of the ministry, was the order of the day.

3. The financial crises

3.1 The Swedish financial crisis

A popular explanation to the financial crisis in Sweden at the time was that the crisis was caused by the financial liberalization during the 1980's[17]. Two factors in particular were pinpointed as a direct cause of the crisis. One factor was the complete removal of limits in lending in 1985. Similar to Finland and Japan, Swedish banking was a mature business, protected from international competition. One of the few ways to grow in such an environment at the time was through credit expansion, which suddenly exploded as a result of this deregulation. The second factor was the liberalization of capital movements in 1989, which made it possible for investors to buy assets in more high-yielding locations such as London and Brussels, thus leading to a pressure on real estate prices.

[17] E.g. see Afrell and Sundqvist (1992).

It is worthwhile to take a closer look at the pattern of the credit expansion in Sweden. After the removal of the limit on credit expansion, most banks identified this deregulation as an opportunity to rapidly increase market share in an industry where the average of market share growth during *fortunate* years was at most 1% annually. The head offices of the largest banks (with the exception for Svenska Handelsbanken) encouraged local branches to expand their stock of loans to both commercial and private borrowers in order to increase the bank's loan market share. Some banks even had bonus incentives for managers at local branches if they increased the amount of lending. This hardly encouraged careful risk assessment of borrowers, but rather increased the risk taking from the banks' point of view. On top of the credit expansion that local branches were responsible for, the headquaters of the banks were also generous lenders and lent out money to dubious prestige projects such as investments in real estate in the United States.

Eventually, the loans amounted to 50% of the GDP in 1993, of which 22% constituted of bad loans. Of these, 50% was related to losses from real estate investments (in the peak year of 1990, this figure amounted to 75%). The major part of the credit losses (77%) was related to loans to the non-financial corporate sector, whereas the households' share of bad loans only was 20%[18]. Thus, in Sweden, the banking crisis was triggered by the sudden burst of the real estate and land price bubble.

The situation thus became unsustainable in 1992. As a result of the crises in the asset markets in the previous years, the volume of bad loans increased dramatically. In addition, the currency crisis during the fall of 1992 put many domestic firms without own earnings in foreign currency in a hopeless position[19]. As the time passed by, it was more and more obvious that some banks were on the brink of bankruptcy because of defaulting borrowers.

3.2 The Finnish financial crisis

Apart from the crises in Japan and Sweden, the Finnish case shows some particular features. Being a small open country and a net borrower, the economy of Finland was,

[18] Drees and Pazarbasioglu, p. 23.
[19] According to Drees and Pazarbasioglu (1998), half of the foreign currency loans had been extended to domestic firms in the non-tradable sector.

similarly to the Swedish one, dependent on the situation on the international financial markets. The bad loan problems experienced by Finland were by and large founded in loans denominated in foreign currency[20]. Also the stock of loans to private households, denominated in local currency, were a source of anxiety for the Finnish banks[21].

The lack of competition in the banking sector[22] had led to, again like in Sweden, a competition strategy of gaining market share by establishing an extensive network of branches throughout the country and by differentiating the quality of services offered[23].

Naturally, the private sector's behaviour changed after the liberalization of credits. As the liberalization occurred during a time of high growth, both firms and households increased their loans rapidly. This process was strengthened by two rather unfortunate circumstances: generous criteria for tax deduction of interest payments and freedom for all to obtain loans denominated in foreign currency. Since the inflation was relatively high and the exchange rate was fixed (the same conditions applied to Sweden as well), the result was very cheap loans for borrowers. Even though the monetary policy turned more restrictive in 1989, the loans were in real terms still cheap. Only after the drastic measures taken by the Bank of Finland in connection with the currency crises of 1991 and 1992, the real interest rates turned positive.

During the 1980’s, the credit expanded dramatically, and from being about 50% of GDP in 1983 when the deregulation process started, the ratio of bank loans to GDP was nearly 100% at the peak year 1990[24]. Thus, the increase was even more dramatic than in Sweden, and the liberalization resulted in a loan-financed consumption and investments pattern in these two countries[25].

In 1989, the first signs of a financial crisis emerged. After a decade of high economic growth in the country and high bank profitability, the economy had started to weaken

[20] Drees and Pazarbasioglu, p. 1.
[21] Ibid., p. 1.
[22] Only two major banks, Kansallis Osake Pankki and the Union Bank of Finland, dominated the market.
[23] Vihriälä, p.31.
[24] Drees and Pazarbasioglu, p. 13.
[25] Ibid., p. 12.

owing to higher short-term interest rates and the consequent decline in asset prices and slowdown of the earlier rapid credit expansion[26]. Sustained by the generous lending, asset prices had by that time raised dramatically compared to the situation before the financial liberalization, and the fixed exchange rate made capital import an attractive option for investors[27]. All of a sudden, a sharp revaluation of market prices brought about an immediate debt crisis.

In addition, the sudden disappearance of the important Comecon trade meant a considerable external shock that severely hampered the Finnish economy, which depended to a large extent on exports and imports from the Eastern Bloc[28]. Finally, the currency crises in 1991 and 1992, which hit the currencies of Sweden, Finland and Norway particularly hard, acted as a coup de grace for the system, due to the large amount of loans denominated in foreign currency.

All these factors combined made the Finnish banks suddenly exposed with a large stock of loans for which it was highly uncertain whether the borrowers could repay. In 1991, the situation had deteriorated enough to seriously threaten the solvency of the whole Finnish financial system.

3.3 The Japanese financial crisis

In 1982, the Topix index of the Tokyo Stock Exchange skyrocketed suddenly after having a relatively stable and modest development. In a mere eight years, the index increased by 564% before it collapsed in January 1990[29]. At the same time, the asset prices also increased rapidly, and for the real estate market, the urban areas of the major cities experienced an unprecedented increase in land price. Japan had at that time enjoyed a long period of high economic activity, and the domestic economy was expanding quickly, sustained by a high domestic consumption. The trade and current account surpluses in combination with Bank of Japan's expansionist monetary policy led to an overheated economy and an accumulation of surplus funds. In other words, the financial institutions experienced a literal money overflow.

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[26] Vihriälä, p. 37.
[27] Nyberg, p. 116.
[28] Honkapohja et al., p. 38.
[29] Tokyo Stock Exchange (1995).

As observed in the cases of Sweden and Finland, the Japanese banks also expanded credits in order to gain market share and the credit to firms and consumers tripled between 1986 and 1989[30]. The private financial institutions were largely responsible for the major part of this credit expansion and the governmental financial institutions' share of the total credits was relatively low. Banks actively encouraged both firms and individuals to borrow money for various purposes, and were less careful in judging whether they were in need of the money or were solvent. Incentives for doing careful assessments were low, since the value of the securities for loans, which typically was real estate, increased constantly. Therefore, the process became self-amplifying as new loans were granted on the basis on already over-valued assets.

The Bank of Japan did observe the development in 1987, and identified it as a speculative bubble. Furthermore, the central bank did warn about the consequences this speculative behavior, which fuelled the asset price bubble[31]. Two years later, in the Chosa Geppo no. 5/89, the central bank continued to warn about the development in similar wording as in 1987. Also the Ministry of Finance did express its worries about the situation in its white books of 1989 and 1991[32]. The supervising authorities were in all probability aware of the situation, and did understand the causes behind its development.

However, the concerns about a possible recession following the Plaza accord in 1985 might have made the government hesitant to implement stricter monetary policy. The stock market crashes in 1987 and 1989 also influenced the Bank of Japan’s (and indirectly also the Ministry of Finance) lenient stance since it feared that a tightening of the monetary policy would have negative effect on the asset prices[33].

1990 is widely recognized as the year when the “bubble” burst in Japan. At first, it seemed as Japan could by the sheer size of its economy survive the crash in the asset markets, and many observers pointed at earlier experiences such as the two oil shocks, when the Japanese firms eventually emerged from the crises stronger than ever. But the recession dragged on, and in 1998 the country even experienced negative growth

[30] Okumura, p. 129.
[31] Bank of Japan, Chosa Geppo no. 5/87.
[32] Okumura, p. 141.
[33] Ozawa, p. 356.

for the first time since 1973[34]. More and more, it was obvious that the days of high GDP growth rates were past and could now be compared to those of the European countries. As the record-long recession continued, phenomena that Japan had not experienced for years started to appear: large-scale dismissal of white-collar workers, university graduates having difficulties in finding an employment upon graduation, collapse in the domestic consumption and failure of financial institutions.

In order to improve the efficiency of the financial markets, the Hashimoto coalition government announced in 1996 a multiple step programme of financial deregulation called the "Tokyo Big Bang". The deregulation plan called for a wide-range reform of the industrial structure by an introduction of a whole new institutional framework. In principle, all types of financial services were now open for every firm with concession, as well as a complete freedom of capital movement. In addition, a new supervising authority, the Financial Supervisory Agency (FSA)[35], was set up. Starting in 1998, the "Big Bang" scheme was to be implemented by the end of the fiscal year 2001. The aim for this liberalization was to:

- Prevent the hollowing out of Japan's financial markets
- Enhance the international competitiveness of Japan's financial intermediaries
- Enhance the status of the yen as an international currency
- Smooth the flow of funds to indigenous growth industries
- Increase "efficiency" of the market, that is, to adopt a free market principle
- Increase transparency and reliability of markets
- Maximise "user" benefits in the form of investment returns, freedom of choice of financial products etc.

However, a year before this ambitious plan was set afloat, the Asian Crisis occurred. To the surprise of many, this crisis affected Japan in an unexpected manner. Suddenly, even large financial institutions announced financial difficulties, which was a phenomenon that earlier during the 1990's happened only to smaller financial firms with relatively small capital bases such as *Jusen* housing loan companies.

[34] OECD Statistical Compendium, ed. 1#2000.
[35] The current name is Financial Services Agency.

Soon after the fiscal tightening made by the Hashimoto government during the spring of 1997 and the subsequent decrease in consumer demand and stock prices (which were already on low levels since burst of the “bubble” in 1990-1991), the Asian Crisis occurred. The effects of it on the Japanese financial world were devastating. To many Japanese financial actors' dismay, the crisis was a final blow that put their firms in a very bad state; the credit losses and bad loans from the 1980's could not be hidden anymore, and it was evident to everyone that the stability of the Japanese financial system itself was threatened by the long-time neglect of the problems. It was revealed that many of the large financial institutions practiced advanced bookkeeping within the legal boundaries in order to wait out the economic recession that hit Japan after 1990. Since the turn of the 1990's, there were mergers between principally small regional banks, saving associations and saving unions had occurred in order to strengthen their books. The major banks, however, pursued another strategy by turning to the Asian loan market, where foreign capital still was in large demand, in an attempt to recoup some of the losses made on the domestic market.

After the crisis of the minor financial institutions[36] in 1995 and 1996, the banking crisis in Japan culminated in 1997 and 1998 when several large financial institutions such as Hokkaido Takushoku Ginko and Yamaichi Securities went bankrupt. During the same period, it was also revealed that Nippon Credit Bank (NCB) was overloaded with bad loans. The picture of the financial situation of the banks was scewed by the fact that the Japanese accounting laws permitted them to state the value of the stocks on their balance sheets to the market value *when they were purchased*, not to the current value. Furthermore, it was not necessary under Japanese accounting laws to present consolidated accounts in the annual reports. As a result of this, it was revealed in 1997 that these firms exercised so-called *tobashi* during the 1990’s, which was a practice to "export" credit losses and bad loans to subsidiaries registered in foreign countries in order to clean up the books of the parent company. These factors made the banks look healthier than they really were, and were made possible because of the comparatively lax Japanese accounting laws[37].

[36] I.e. *Jusen* house loan firms, small regional banks, saving associations and saving unions.
[37] For example, the legislation regarding consolidated accounting in Sweden was enforced already in 1930's after the crash of Ivar Kruger's Swedish Match industrial empire, which used similar practices as the Japanese financial firms using *tobashi*.

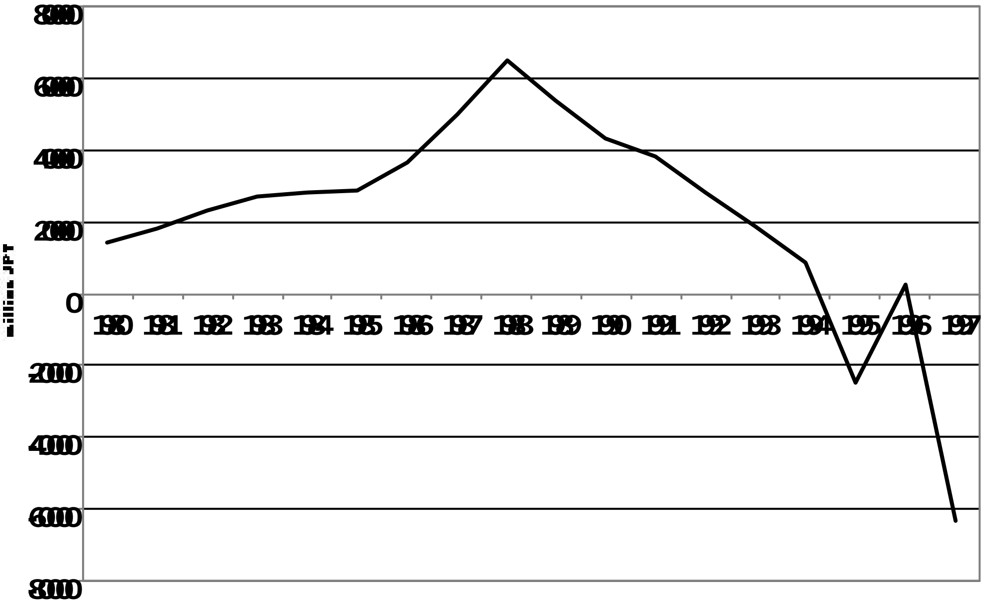

Figure 2. Profit before tax for the Japanese city banks 1980 – 1997. (*Data source*: OECD)

Close relations with firms under the *keiretsu* umbrella in combination with large stock holdings in these firms caused further problems to the banks. As long as these bank group companies performed well in the seemingly ever-expanding Japanese economy, this was not a problem. However, problems with this system became apparent in the 1990's. In their paper, Morck and Nakamura (1999) found that the bank groups tended to differentiate their *keiretsu* companies from non-*keiretsu* companies. In the former case, banks act primarily in the short-term interest as creditors, while in the latter case, the banks acted in the broader interest of a range of stakeholders. This included the banks themselves, not only as lenders but also as stockholders. Under the pre-Big Bang period, ordinary banks were forbidden to deal in stocks and other forms of securities except for portfolio investments for the bank's own account. The authors' hypothesis was that the "house banks" could "prop up" *keiretsu* group companies in distress instead of letting them go bankrupt, leading to the survival of inefficient companies. In other words, here is an incentive problem and a loss to the society present due to an institutional structure. According to Morck's and Nakamura's findings, the banks were indeed "propping up" its *keiretsu* firms.

The impression of a profound crisis among the Japanese public was strengthened even more during these years due to the revelation of several scandals at a high level, which demonstrated the nature of the close social networks between supervising officials and managers of the financial institutions. Thus, the pressure on the politicians increased as the public support for faster reforms grew.

Eventually, many financial institutions, of which the Long Term Credit Bank of Japan (LTCB), NCB, Hokkaido Takushoku Bank and Yamaichi Securities were the most well known, were forced to reveal their huge losses and cease operations. Previously between May 1995 and December 1997, 11 institutions had gone bankrupt with total losses of JPY 2.2 trillion (about US$18.2 billion in 1997 average exchange rate). In addition, examples of bad corporate governance were revealed, such as Sumitomo's and Daiwa bank's attempts to hide their speculation losses[38]. In connection with the Yamaichi failure, the weaknesses of the accounting practices also became apparent since Chuo Audit, who were responsible for the external audition of the brokerage firm, whose chief auditor reportedly audited Yamaichi for 35 years, failed to detect off-book losses of JPY 274 billion (about US$ 2.6 billion[39]) and signed off the annual report of Yamaichi just months before its huge bankruptcy[40].

4. The aftermath of the crises

Sweden and Finland experienced a profound drop in economic activity as their "bubble" burst. The stock and real estate markets crumbled as well as private consumption[41].

The Swedish government was eventually forced in September 1992 to give a general guarantee for all deposits in the whole banking sector, as opposed to their original case-by-case treatment. The level of the commitment was at the time equal to 6% of the GDP[42]. Later the same year, the Swedish parliament approved a proposal from the government to form the Bank Support Authority. The support scheme involved all banks that had permission to conduct banking business in Sweden, including the non-bank financial institutions owned by these banks[43]. Of the Swedish banks, the

[38] Sumitomo suffered huge losses from speculation in copper, while Daiwa lost US$1.1 billion in US Treasury bond trading.
[39] In 1997 average exchange rate.
[40] FEER, 27 January 2000.
[41] However, the net savings turned positive as a result.
[42] Vihriälä, p. 40.
[43] The Swedish Ministry of Finance, SoU 1993:28.

commercial banks Nordbanken and Gotabanken were in the worst shape. Typically enough, these banks were the most aggressive actors on the credit market during the 1980's, and suffered the greatest losses of all banks relative to its capital base. Despite desperate measures made by the government (who well before the crisis was the largest shareholder of Nordbanken) to save Nordbanken, it was apparent in early 1992 that the bank was about to go bankrupt before the end of the year. Gotabanken was also in a similar situation, and the government eventually seized control over both banks as a part of the bank support[44]. Under the guidance of the government, the banks merged to a new Nordbanken. In addition, two asset-management institutions, Securum and Retriva, were also formed to take care of the claims with worst perspectives for Nordbanken and Gotabanken, respectively. In 1995, Securum acquired Retriva, and in 1997, Securum was purchased by a state-owned company and had by then finished the job it was set to do. Other banks followed the example and set up their own asset-management firms.

In total, five banks actively applied for funds from the government. Apart from the two commercial banks Nordbanken and Gotabanken (which were recipients of 98% of the government support[45]), three of the largest banks, Skandinaviska Enskilda Banken, Sparbanken and Föreningssparbanken also applied for support. A sixth, Svenska Handelsbanken, considered an application but eventually disbanded the idea. Of the total commitment of SEK 88 billion (US$ 12.34 billion[46]), only 65 billion (US$ 9.11 billion) was used, much owing to the fact that neither of the two largest commercial banks, Skandinaviska Enskilda Banken and Svenska Handelsbanken, were in need of government support and the asset-management firms of these banks were, like Securum, very successful in liquidating their assets.

The Finnish government was forced to take similar steps as in Sweden, but the actual approach was somewhat different. The Bank of Finland took extraordinary measures in saving the SKOPbank in September 1991[47], but this was just a panic move. The year after, the crisis had grown even more and the Government Guarantee Fund

[44] Nordbanken was bought by the government for SEK 2 billion (US$ 257 million in 1993 average exchange rate) , whereas the control of Gotabanken was transferred to the government for free (Drees and Pazarbasioglu, p. 29).
[45] Drees and Pazarbasioglu, p. 29.
[46] In 1995 average exchange rate.
[47] Nyberg, p. 116.

(GGF) was thereby formed. In addition, the Finnish government also chose to support the ailing banks directly from the state budget.

In the beginning, the government support to the banking sector was insufficient. The Bank of Finland stepped in only in the SKOPbank case, but soon it was apparent that many other banks were financially distressed. Still, the government did not give GGF adequate resources; it did not even have its own full-time employees[48]. In 1993, the situation improved when GGF got a new organizational structure and was reporting directly to the government, which in turn decided to which institution to give support. During the same year, the structure of the financial supervision improved when the Banking Supervision Office, which had until then been a part of the Ministry of Finance, became an independent part of the Bank of Finland under the name of Financial Supervision Authority.

The banking crisis in Finland hit in particular the savings banks. Many had stakes in SKOPbank, but they were also engaged heavily in aggressive lending themselves during the 1980's. In the case of the SKOPbank, two asset-management companies were formed by the Bank of Finland, where one acquired SKOP's industrial holdings and the other the real estate holdings of SKOP. In 1992, GGF acquired the bank operations of SKOP from the Bank of Finland, while the two asset-management companies remained under the central bank[49]. Later, GGF sold in their turn the two asset-management companies to the Swedish commercial bank Svenska Handelsbanken.

For the savings banks, the process was even more drastic. Due to a mutual solvency scheme, which connected many savings banks, a total of 41 banks were merged into the Savings Bank of Finland under the ownership of the GGF[50]. The following year, the Savings Bank of Finland was sold in equal parts to the Kansallis Osake Pankki (KOP), the Union Bank of Finland, the Postbank and the cooperative banks respectively, and was sold again for the third time in 1994 to the asset-management company of the Savings Bank of Finland called Arsenal. Arsenal acquired at the same time the remaining assets from the GGF that not had been part of the 1993 sale.

[48] Drees and Pazarbasioglu, p. 31.
[49] Ibid.
[50] Ibid.

Before the banking crisis in Finland was settled however, a third rescue operation was necessary. The format was the same as in the case of SKOPbank and the Savings Bank of Finland. Like other savings banks, the Suomen Työväen Säästöpankki (STS) was engaged in aggressive lending and was close to bankruptcy in 1992. The original plan was to merge STS with KOP, and transfer the bad loans to an asset-management company. However, the Finnish parliament hindered the plan to set up an asset-management company by voting against the government proposal, effectively postponing the reconstruction of STS. The problems with STS were finally solved in 1993, where the bank merged with KOP and the “old” STS bank was transformed into an asset-management company[51].

In addition, the Finnish government offered in 1992 a FIM 7.9 billion (US$ 1.76 billion[52]) capital injection to the banking sector as a credit crunch threatened. This offer was accepted by all banks, and the capital injection was in practice a preferential loan as the interest rate of it was only slightly over the market rates. The catch was a threat of government takeover if the accepting banks’ equity ratio fell under a certain level or the bank defaulted in interest payments.

By 1996, the total public cost of the banking crisis was FIM 88.6 billion (US$ 19.29 billion[53]), that is, the banking crisis being far more expensive for Finland than for Sweden.

The crisis meant also great structural upheavals in the banking sectors for both Sweden and Finland. In Sweden, a number of banks merged during the first five years following the banking crisis, and new, smaller banks emerged. In Finland, the savings banks disappeared in large numbers and the number of actors in the banking market was concentrated to the four major banking groups mentioned above. Mergers were also taking place, notably the one between Unitas bank and KOP, forming Merita Bank (which later merged with the Swedish Nordbanken).

[51] Ibid., p. 33.
[52] In 1992 average exchange rate.
[53] In 1996 average exchange rate.

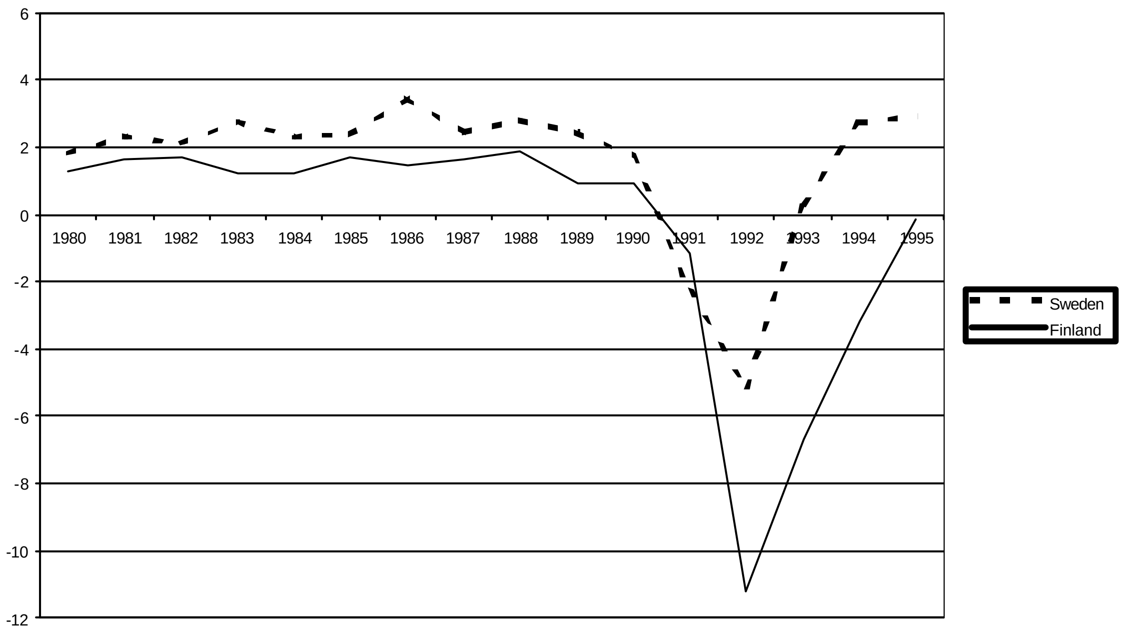

Figure 3. Profit before tax (in % of average total assets) for commercial and savings banks 1980 – 1995. (*Data source*: OECD)

However, both Sweden and Finland managed to rise from the ashes in relatively short time. Thanks to a well-organized government action, the bad loans could be eliminated parallel to the measures taken against the severe recession. Already in 1993, the trend of negative or zero GDP growth was broken, and the management of the credit losses and the bad loans were handed over to institutions specially set up for this purpose. By 1994 (for Sweden) and 1996 (for Finland), the bad loans were written off and having got rid of all bad loans, the banks increased their profitability dramatically and went out of the crisis stronger than ever.

In Japan, the bad loans from the "bubble" era still linger, and it is still uncertain how large the stock of bad loans really is. In 1998, OECD made an estimation of one quadrillion yen (over US$ 7.4 trillion, calculated by the average exchange rate of the "bubble" peak year 1991), which represented over 14 per cent of the value of the total assets in Japan at the end of 1989[54]. Anderson and Campbell (2000) cite a NBER report, estimating the bad loans in the Japanese banking sector to be 7% of the GDP in 1998[55]. Analysts cited in Financial Times of June 19, 2001, estimate the bad loans that still linger to be worth between JPY 40 and 70 trillion (US$ 328 ~ 574 billion), or

[54] OECD (1998), pp. 45-46, 64-65.
[55] Anderson and Campbell, p. 199.

8 to 13% of the GDP in 2000. The figures of 2002 are still unknown, but for the major city banks, the stock of bad loans has increased even further by 74% from 2001 to 2002[56]. Thus, the seriousness of the bad loans problem is very hard to calculate, and the only thing that is certain is that the total amount is substantial even for a huge economy such as Japan's.

The most prominent effort so far to reconstructing the banking system is the 1998 "Big Bang " reform plan. Although ambitious, it only spells out broad-ranged deregulations and reforms, and does not explicitly addresses the issue of bad loans. Before the "Big Bang" reform, the Japanese government did address the bad loans only a couple of times, most prominently through the measures taken in 1996 and 1998, aiming for stabilization of the financial system by make limited injection of public funds into the financial system possible. After the introduction of the "Big Bang" reforms, the Financial Revitalization Law was passed through the parliament in October 1998, which allowed even larger injection of public funds into the financial system. In relation to the number of the bad loans, the result was however doubtful and the government failed again in reviving the financial sector, and in length, the Japanese economy.

The Japanese government's failure to clean up the post-bubble mess can therefore be attributed to the lack of coherency in its economic policy and to the inability to simultaneously address the recession and the financial crisis in a Nordic manner. The closest Japan has come a government-led bank restructuring of the Nordic type so far is in the cases of LTCB and NCB. The bankruptcy of these banks, both nationalized in 1998, was handled on case-by-case basis by a new authority, the Financial Reform Commission (FRC). In addition to the JPY 17 trillion (US$ 143.5 billion) the Japanese government has used to clean up the books of the nationalized banks, a general capital injection of JPY 7,5 trillion (US$ 63.3 billion) was made from public funds to the banking sector in 1999. The remains of LTCB and NCB were later sold in separate deals, brokered by non-Japanese consultancy firms (quite unthinkable only a few years ago), but have brought back only a fraction of what the government has spent on the banks.

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[56] Nihon Keizai Shinbun, June 28, 2002.

The case of NCB is interesting as an illustration of the Japanese banks' approach to the bad loan problem. Until 1997, NCB would have never admitted any problems with their loans. Suddenly, the bank announced that it was in immediate need of new capital injection, and the Ministry of Finance called on the Tokyo-Mitsubishi Bank and the Industrial Bank of Japan to assist NCB under the "convoy" system[57]. Despite these efforts, the situation for NCB deteriorated further and finally in 1998, there was no option but to nationalize it in order to rescue the bank after pressure from the newly independent FSA[58]. NCB first estimated in 1999 that the bad loans constituted 40% of the loans, only to revise the figure the year after, when more loans were classified as bad according to the new rules of loan classification[59]. In this connection, the action of the opposition parties in the Japanese parliament have to be considered. Since the nationalization and the subsequent sale of LTBC and NCB, furious discussions have taken place in the parliament. In August 2000, the sale of NCB was postponed a month because of political discussion between the LDP coalition government and the Democratic Party of Japan (DPJ), where DPJ accused the FRC of being too generous in the terms of sale. The same kind of intense political discussions has also surrounded the sale of LTCB.

The FSA, which was a bureau under the Ministry of Finance, was made an independent government agency in 1998 and has so far, except from minor cases in the very beginning of its existence, taken up a rather tough stance versus the banks. Among the measures it has taken is to force banks to fully reveal their bad loans. It has also shown an unusual speed in handling its administration, which is shown e.g. in the case of the Mitsui Trust and Chuo Trust merger.

Since 1998, the banking sector has gone through profound structural changes. Four major mergers have been announced, and two new smaller banks, the Sony Bank and IY Bank, had opened business. Several more are in process for approval by FSA.

So far, the efforts made by the Japanese government through the FRC[60] and the FSA have led to two bank take-overs and four closures of regional banks. The government

[57] Ibid., p. 200.
[58] Ibid., p. 201.
[59] For example, the NCB loans to the bankrupt department store chain Sogo were classified as "good" (FT August 28, 2000)
[60] FRC merged with FSA in 2001.

has also spent a tremendous amount of public money in various forms of capital injection. The final accounts of the Japanese banking crisis cannot yet be settled however, as the full width of the bad loans is still unknown.

During 2001, the signs of deflation became more and more apparent. There is now a significant pressure on the Japanese government and the Bank of Japan to take measures against the deteriorating macroeconomic performance. On their part, the government and the central bank is now pressuring the banks to make a final and definitive writing off of all bad loans during the fiscal year ending in March 2002. At the time of writing, it is hard to appreciate how effective these measures have been.

5. Analysis

5.1 Communalities

Several common factors can be found between the Nordic countries and Japan in terms of development of their financial crisis. In earlier studies from U.S., credits tend to be relatively cheap during high growth years because of low unemployment and growth in disposal income, thus increasing the level of private loans[61]. In all three countries, these features were prominent and resulted in an excess demand for credits in both corporate and household sectors. However, the story does not end here. Naturally, it is not surprising that cheap credits have led to a dry-up of funds in the small, open economies of Sweden and Finland, but it is noteworthy that the same thing happened also in Japan, which suggests the size of the excess demand for credits there. The dry-up in domestic credits made both corporations and banks to seek for alternative ways to obtain funds, which typically meant foreign borrowing. At the same time, many lenders aimed to increasing their loan market share by actively looking for both new borrowers and increase the loans that existing borrowers had, which made the situation even worse. This process was sustained by low real interest rates, and the authorities' fear of disturbing the asset markets was greater than the will to hinder the situation to go out of hand.

Since the crisis, a wave of mergers has taken place both in the Nordic countries as well as in Japan. Furthermore, new smaller banks have been set up by non-financial

[61] Murto, p. 66.

firms without any previous experience of retail banking[62]. Thus, the post-crisis era has brought about larger entities of banking groups consisting of existing banks and financial firms. In addition, the entry costs for new actors to enter the banking market has been lowered.

All three countries are now also endowed with new independent authorities supervising the financial sector. For Sweden and Finland, this was a direct consequence of the measures taken during the first year of the crisis. In Japan, the FSA was not set up until 1998 as a part of the "Big Bang" reform. Since then, all three supervisors have proven to be tough and independent.

5.2 Differences

There are however a number of notable differences. Firstly and the most apparent difference of them all is the size of the Nordic countries' economies, which was and still is, significantly smaller than the Japanese.

Secondly, and the most important difference is the debt situation of these countries before the crises of the 1990's. While Sweden and Finland were net debtors, Japan was a net creditor. Differences in dependency on the international economy and the overall macroeconomic situation made the starting point for structural restructuring of these countries different. Being net debtors and small open economies, the governments of Sweden and Finland realized early that the need to support the ailing banks was necessary in order to keep the confidence in the financial sector intact and avoid runs[63]. The situation for Japan was different, where the strong macroeconomic position might have made the government as well as the financial institutions falsely confident and secure in the face of increasing credit losses, which eventually caught them off their guard in 1997.

Thirdly, Sweden and Finland had accomplished to a large extent the liberalization of their financial markets *before* their respective crisis occurred, which is another advantage in overcoming the banking crisis rapidly. The liberalization of the Swedish and Finnish financial markets helped these countries to clear off the bad loans by

[62] Examples are the Sony bank, set up by Sony, and the IY Bank, set up by Ito-Yokado Group.
[63] However, "small runs" affecting smaller financial institutions did occur.

having an efficient market which was both willing and able to absorb readily the assets which the asset-management companies sold off. In addition, even though the liberalization was somewhat ill-timed for the Nordic countries, the infrastructure for an effective financial sector was already laid out when the crisis was settled, which helped a rapid revitalization of the domestic financial markets. This is not the case for Japan, which has initiated financial deregulation as a reaction to a serious crisis in the financial sector.

Fourthly, the whole bank support program in Sweden was backed by nearly unanimous parliament and the plans did not meet any substantial opposition in public opinion either, thus helping the government to a fast conclusion of the banking crisis. In Finland, the political opposition laid some hinders in the parliament during the restructuring period. Despite this, and needing somewhat longer time compared to Sweden, the support process could still be concluded successfully. In Japan, the experience from the *Jusen* crisis in mid-1990's have made the government cautious in suggesting use of public funds in large-scale restructuring programs of the Nordic type.

Fifthly, Sweden and Finland have had long traditions in an open relationship between firms, government and the public. In addition, complete transparency in terms of bookkeeping has long been a legal requirement. External auditing has long been a natural part of corporate governance, and required of all major economic organizations. Japan did not have rules of this kind before the "Big Bang", and for being the second largest economy in the world, the lack of certified public accountants is surprising[64].

5.3 Agility in responding to the crises

The capability to respond quickly to crises depends on the institutional framework of the society. In many studies regarding the banking crises in the Nordic countries, timing and speed of the bank support has been raised as a crucial factor in bringing an economy back on track after a banking crisis[65]. Sweden and Finland acted fast,

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[64] According to an article cited in Anderson and Campbell (2000), there are only 12,000 certified public accountants (CPAs) in Japan (Anderson and Campbell, p. 210). As a contrast, Sweden has 4,100 CPAs despite having a GDP which is only 5% of Japanese GDP in 1999.

[65] See among others Drees and Pazarbasioglu (1998) and Nyberg (1995).

although the first stage was not a part of any planned or carefully measured policy, but rather a panic reaction to a situation perceived at the time as one that threatened to get out of control. This picture is supported by how the first reactions were: in Finland, the central bank rapidly stepped in and instantly assumed control over a major defaulting bank and in Sweden, the government quickly made a proclamation of a general guarantee to all depositors. Later, the commitments of the Swedish and Finnish governments were approved by their national parliaments, and special organizations handling the banking crises were set up.

In retrospective, Sweden was the most successful in handling the crisis among the Nordic countries. In comparison with Finland, a few factors were in Sweden’s favor. First, there was a broad political consensus about the measures to take in order to cleanse the banking system of bad loans. Second, the authority supervising the restructuring, the Bank Support Authority, was set up from the very beginning as an authority independent from the Ministry of Finance and the Bank of Sweden. Third, the role of the new authority was clearly spelled out in its statutes. Thus, the responsibility of all the administrative institutions such as the government, the parliament, the Ministry of Finance, the Bank of Sweden and the Bank Support Authority was clearly set.

Considering that the Japanese crisis was developing at the same time as its Nordic counterpart, one need to ask oneself why the Swedish and Finnish governments were so fast in responding to their crises compared to the Japanese government. One answer is the more acute situation in Sweden and the Finland at that time, because of their size and nature of the economy. Being net debtors to the outside world and depending on exports, Sweden and Finland were vulnerable to sudden revaluation of asset markets and currency crises. The threat to the whole financial system of their countries were very concrete to governments, financial actors and the public, and it was necessary to make rapid moves in order to preserve the confidence in the system.

Besides not being net debtors, the situation after the burst of the “bubble” was certainly the same in Japan as it were in Sweden and Finland, but still the Japanese authorities' response to the crisis has been surprisingly slow. From an earlier example, we know that the two financial supervisors, Bank of Japan and Ministry of Finance, were aware of the development of a “bubble” in the 1980's. However, before 1998 when a new central banking law was introduced, Bank of Japan was not as independent as it formally is now. According to the central banking law at the time, which was introduced in 1942, the role of Bank of Japan was to "further the economic interest of the country"[66]. Since the governor of the central bank was responsible to the Ministry of Finance and not to the parliament, it is no exaggeration to say that the World War Two central banking law made Bank of Japan more or less dependent on the will of the bureaucrats at the Ministry of Finance. Therefore, it is better to ask why the powerful Ministry of Finance, which had a central role in the Japanese administration as the coordinator of government's policy, did not take any serious measures. Having both the power and the resources, the ministry could have taken decisive steps to cool down the overheated Japanese economy. Instead, they choose weak measures, maybe in fear of the consequences a drastic tightening would have on stock and real estate markets – and in the end, the stock portfolios of the banks[67].

The timing and the nature of the measures eventually taken by the government were exceptionally bad. Realizing that a “bubble” was developing, the interest rates were increased continuously by the Bank of Japan between 1989 and 1990. At the same time, in 1990, the Ministry of Finance imposed a weak regulation on real estate lending[68]. On top of this, a new land value tax was introduced in 1991 in order to moderate the land price increases[69]. All these measures, however, did not curb the pace of lending to the real estate sector, and for some years, the speculation activities continued, however on a smaller scale compared to the peak year of 1987. There were also no public signs of any credit troubles in the financial sector.

Another clue can be found in the incentives for city banks to cover their credits. As we have seen, the privileged position of this type of bank had at the Bank of Japan led to a situation where the banks could grant industrial loans and get the money from the central bank[70]. This was a form of government subsidy to the banks, and could have

[66] Martin and Truedsson, pp. 39-40.
[67] If the stock portfolios of the banks is allowed to fall under a certain level, the banks’ debts would have put them into a financial distress.
[68] Two years after the introduction of lending regulations, over 26% of the total banking lending volume were in the real estate and non-bank sectors.
[69] The introduction the land value tax was also an empty gesture. In combination with generous basic deductions, the low tax rate did not affect the real estate speculations.
[70] Ozawa, p. 355.

been interpreted by the banks as an implicit bank guarantee. Ozawa (1999) has described the view held by the city banks and the Ministry of Finance as[71]:

> "[...] there was no possibility of bank failure, as far as major keiretsu banks were concerned; they were strategically too significant to fail."

In this view, the reluctance of the authorities to intervene early and decisively in the bank sector can be comprehendible – the Ministry of Finance did not want to interfere too much in order to protect the banks, and trusted (or hoped) the banks to clean up the bad loan mess in due course by themselves.

6. Conclusions

An interesting question here is whether the financial crises in Sweden and Finland really were a result of the deregulations in the 1980's, while very much of the same phenomena could be observed in Japan where the financial crisis developed without any large-scale deregulation.

Three factors influencing the Nordic and Japanese banking crises can be raised.

- *Cheap loans*
  - Rather than the liberalization itself, the availability of cheap loans during an economic boom seems to have fostered the banking crises under study in this paper. In real terms, the credits were cheap in all three countries. Sweden and Finland had generous deductibility rules for interest payments and relatively high inflation, while Japan had extreme overliquidity, which led to lending rates that was perceived as cheap by borrowers.
- *Bad governance by firms and authorities*
  - The corporate governance of the banks in Sweden, Finland and Japan during the 1980's proved to be exceptionally bad. In fight for increased market shares, the striving for increased lending volumes overshadowed ordinary risk assessment. Furthermore, the bad timing of policy measures in the Nordic countries and the failure of supervising authorities in all three countries to take proper action before the crisis emerged also fostered the process towards a banking crisis.

[71] Ibid.

- *External shock and its impact*
  - Various external shocks affected the three countries negatively. Sweden experienced a major currency crisis, which also hit Finland. The disintegration of USSR and the sudden end of the important COMECON trade also had a significant negative impact on the Finnish economy. For Japan, the Asian Crisis revealed one of the most costly banking crises in its history.

Even if the situation in Japan is disregarded, it is apparent that macroeconomic factors in combination with practices or corporate governance within the individual firms are prominent factors in explaining the causes for the crises. The liberalization was an important factor in the development of the crisis, but only so after the timing of events is taken into consideration. Introduced during a high growth period, the liberalization helped the economy to put in top gear instead of making it more efficient. However, there are no doubts whether liberalization is needed or not. Rather, timing is important and it is therefore important to emphasize the long-term effects of a deregulation instead of the short-term effects.

For Japan, the banking crisis turned into a time bomb that needed an external shock like the Asian Crisis to go off. Much owing to the strong macroeconomic performance of the country, Japan was able to survive the lingering banking crisis until 1997. Japan was a net lender to the outside world, and had accumulated vast amount of reserves during the years of strong economic growth. The contemporary view seemed to be to "wait out" the recession, and live on the reserves until the economy picked up the pace again. This can explain why the authorities were reluctant to take any serious measures, and trusted the existing financial regulatory system to continue to be a support rather than a hindrance to an economic recovery.

It is apparent that the weaknesses of the institutionalized control mechanisms in Japan for organizations both on government level as well as firm level have had important influence on speed in taking proper action in time. Maybe, it is to a certain extent possible to blame the crisis on bad luck. But it is equally important to ask whether the regulatory structure and a piecemeal liberalization can have a role in the drama. The experiences from the three countries under study in this paper suggest that incentive structures, good and bad, are important factors in the evolution of these countries' banking crises. Equally, making incentives are also important when new structures are built in order to ensure that the actors on a financial market – financial institutions, firms, household and supervising authorities alike – can and want to follow the new rules of the game in a desired manner.

The road Japan has chosen to restructure its economy seems to be one of the most difficult to enter. Many crucial measures have not been taken in time, or have not been taken at all. The lack of government intervention and enforcement of a full disclosure of the credit losses from the 1980's was a significant mistake made by the Ministry of Finance and the Bank of Japan. In addition, the close fraternizing by their supervising officials and the top managers of the financial firms fostered a corruption-like atmosphere. Taken together, the Japanese people's confidence in the government and financial system was badly hurt and the continuing recession caused by low domestic consumption is only an expression of this lack of confidence.

Specifically from the Swedish experience, we can see that prompt action, backed by political consensus and setting up of an independent bank support authority operating under a set of clearly defined rules, seems to be a viable way to vitalize an ailing banking sector which is burdened by a significant amount of non-performing loans. However, it would be too easy for Japan just to copy the Fenno-Scandinavian model, simply for the reason that the will to change was not there from the very beginning, and it is too late to settle the banking problems in Japan by merely setting up asset-management companies. It is also necessary to fully implement the "Big Bang" reforms and take macroeconomic measures of a different kind than those presented so far by the government. With low levels of consumption, industrial investments, industrial production, credit crunch and deflation, the conditions have deteriorated so much that a massive and holistic reform package including the whole economy is a necessity. The insight of the government to include the whole economy in the reforms is therefore crucial. This applies also to the opposition parties, which so far have used the efforts of bank reconstruction by the FRC as a short-term political weapon.

Thus, Japan has no choice but to continue the reform process with further deregulation of the economy and to continue the cleansing of the slough that the bad loans constitute. Restoring public confidence in the system is a necessary condition in order to vitalize the much-needed domestic consumption and the economic recovery.

The revival of the Japanese economy is not only a problem for Japan, but for all countries that have claims on Japan and its financial institutions. In other words, the economic and financial problems in general and the bad loan problems in particular is indeed a problem not only for Japan, but also for the whole world. Hence it would be fair to say that Japanese banks are drag anchors of the whole world economy.

Earlier in the history we have seen that financial markets, like an unstably constructed ship riding on rough waves, turn shaky in an environment of fast economic growth combined with cheap and easily obtained loans. Regulations fulfilling its purposes combined with transparent markets and strict supervision by independent authorities should make markets more efficient and thus lower the cost of raising funds for both companies and individuals.

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