

Handling Japan's Banking Crisis, 1997-98:
Gaiatsu or Not?

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The purpose of the paper is to discuss how Japan dealt with the banking crisis, with a focus on the political dynamics at work at the time of the crisis of 1997-98. The weakening of the Liberal Democratic Party caused the delay of the response, while the policy direction was determined by the conditions of the party system peculiar to the time. Despite the perception of many Japanese at the time, the pressure from foreign governments and international markets did not determine the policy outcome.

大手銀行や証券会社が相次いで破綻に追い込まれた 1997 年 11 月以降、日本経済は金融危機の様相を呈し、政府は迅速な対応を迫られた。98 年夏から秋にかけてのいわゆる「金融国会」における金融再生法の成立によって、長銀などが国有化された。

この対応をめぐる、しばしば外圧の役割が強調されてきた。事態打開に向けたアメリカ政府からの熱心な働きかけに加え、国際市場からの圧力も政策の方向性を決めた大きな要因になったとされている。しかし、金融再生法が成立するまでの過程を検証すると、むしろアメリカ政府の要求に逆行するかたちで「ハードランディング」路線が選択されたことが明らかになった。また、市場の圧力も具体的な政策の選択には大きな影響を与えなかった。本稿では、この方向性を決定付けたのは、当時の政党間競争の状況、および「政策新人類」と呼ばれた若手政治家の活躍であったと論ずる。

Introduction

November 1997 will be remembered as the month when the financial problems in Japan culminated into a full-fledged crisis. The month began with the bankruptcy of Sanyō Securities, a middle size securities firm. In mid-November, Hokkaidō Takushoku Bank, one of the nation's 19 largest commercial banks, went under. The situation worsened later in the month, when Yamaichi Securities, one of the "Big Four" securities firms, closed its doors on November 24. On November 26, a run on banks occurred all over the country, bringing the Japanese financial system to the verge of complete collapse.

The problems of the financial system lingered after that month. Among other banks heavily burdened by mounting bad loans, the Long Term Credit Bank of Japan went through tremendous difficulties. Eventually, the government took over two of the major banks, the Long Term Credit Bank (LTCB) and the Nippon Credit Bank (NCB) in 1998. The domestic crisis became a global concern, as other countries worried about the effects of Japan's recession on global financial markets, especially in other Asian countries, ailing after the Asian Financial Crisis.

Seen from abroad, policymakers in Japan were slow and indecisive to address the crisis. Irritated by Japan's faltering responses, the U.S. government tried to urge Japan to take bold steps during the course of the crisis. As the subsequent dissolution of the LTCB resulted in its sale to a consortium led by Ripplewood, an American investment fund, some in Japan speculated later that the handling of the financial crisis in 1998 was a part of a strategy of the American government to intrude into the Japanese economy.

This paper explores the factors that explain the Japanese government's responses to the financial crisis. By tracing the process through which the bank rescue plan was drafted and passed in the fall of 1998, I argue that the major factor that explains the policy outcome, which resulted in the collapse of the LTCB, was the dynamics of party politics specific to the time. The pressure from the U.S. government, as well as from the international markets, played a minor role in determining the course of the policy.

The paper is organized as follows. In the second section, it briefly reviews the financial policymaking in Japan and the possible role of *gaiatsu*. The following two sections describe the

process through which the bank rescue plan was made. Then it discusses the factors that explain the policy outcome. The final section concludes.

1. Financial Policymaking in Japan and Foreign Pressure

In order to understand the distinctiveness of the policymaking process concerning the handling of the banking crisis, it is necessary to know how the policymaking system had worked in Japan in ordinary times. The basic elements of Japan's current policymaking system had developed in the years of one-party dominance of the Liberal Democratic Party (LDP) since 1955.

The prominent role of bureaucrats has characterized the Japanese system of policymaking. Most bills have been government-sponsored, drafted by bureaucrats, and approved in the Diet mostly without any revision. Bureaucrats are also responsible for conducting extra-legal administrative guidance.¹ On the other hand, the policymaking power of the LDP had certainly increased since the 1970s, as the members of the ruling party have accumulated policy expertise in specific issue areas during the years of their one-party dominance.² This development did not necessarily mean decreased influence of bureaucrats, however. The relationship between the governing LDP and the bureaucracy is cooperative rather than adversarial. Private sector actors also worked together with them, providing their knowledge and political contributions in return for protective regulation and pro-business environment. Consequently, concerning businesses, related government agencies and interested conservative politicians have formed informal, issue-specific policy networks, which became the arena for policymaking. This system creates a strong status quo bias, although the input from the society has sometimes facilitated incremental adjustments to environmental changes.

It is in this context that the role of *gaiatsu*, or foreign pressure, has often been considered to be particularly important in Japanese politics as a major source of policy changes. Without being pressed from outside, it is difficult to implement reforms in Japan. According to Mulgan, the weak

¹ The power of bureaucrats is emphasized most notably in the "developmental state" model. Chalmers A. Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975* (Stanford: Stanford University Press, 1982).

² For the increased role of the LDP members in policymaking, see Satō Seizaburō and Matsuzaki Tetsuhisa, *Jimintō Seiken* (Tokyo: Chūō Kōronsha, 1986), especially Chapter 4.

political leadership in Japan, caught by the bureaucracy and vested interests, has used *gaiatsu* when it needs to overcome those obstacles.³ Calder also finds the main cause of Japan's reactive behaviors in international economic policy its domestic political structure. Together with bureaucratic turf battles, pressures from domestic interest groups with ties to the LDP, make decisive actions difficult without external forces.⁴

In the field of finance, the clientelistic policy networks did dominate the policy process. However, the politics of finance is rather exceptional in the extent to which the LDP politicians had detached themselves from the issue. While they were not indifferent to financial policies and financial industry had been one of the major sources of political donations to the LDP until the mid-1990s, the LDP politicians had mostly left the policymaking authority to the hands of the Ministry of Finance (MOF). There are some factors that raise the costs pertaining to financial regulations, leading to this exceptional silence of politicians. First, since regulating and supervising financial services requires a high amount of specialized knowledge on finance, it is costly for the politicians to assemble sufficient information. Second, the existence of competing interest groups within the finance sector, such as the banking industry and the securities industry, gives politicians incentive to delegate the policymaking authority to bureaucrats. Committing to one side would antagonize the other.⁵ Politicians also fear that too much involvement in policymaking concerning financial regulations may evoke suspicion of insider trading.⁶

³ Mulgan also cites some other factors that make Japan reactive to foreign pressure. First, due to the historical legacy of war, Japan is fearful of isolation in the international society. Second, her dependence on foreign markets and resource supplies makes Japan receptive to foreign criticism. Aurelia George Mulgan, "The role of foreign pressure (*gaiatsu*) in Japan's agricultural trade liberalization," Pacific Economic Paper No. 266, Australia-Japan Research Centre, April 1997, pp.8-11. Besides, Miyashita emphasizes Japan's security dependence on the U.S. Akitoshi Miyashita, "*Gaiatsu* and Japan's foreign aid: Rethinking the reactive-proactive debate," *International Studies Quarterly* Vol. 43 (1999), pp.695-732.

⁴ Kent Calder, "Japanese Foreign Economic Policy Formation: Explaining the Reactive State," *World Politics*, Vol. 40, No. 4 (1988) pp. 517-541.

⁵ Frances McCall Rosenbluth, *Financial Politics in Contemporary Japan* (Ithaca: Cornell University Press, 1989), pp.26-27.

⁶ Karube Kensuke and Nishino Tomohiko, *Kenshō Keizai Shissei* (Tokyo: Iwanami Shoten, 1999), p.349.

Thanks to the close relationship between the MOF and the regulated financial industry, financial institutions were protected from competition by heavy regulations. The main policy objective of the ministry was to maintain the stability of the financial system, and to that end officials were determined not to let any financial institution fail.⁷ This mode of regulation was called the “convoy system,” suggesting that the industry as a whole moved at the speed of the weakest financial institution so that no one would be left behind. When faced with troubled financial institutions, the MOF could save them quietly by arranging rescue mergers with other financial institutions. Although the ministry has reacted to the changes in the economic environment since the 1970s with gradual deregulation, it was careful not to destroy the order created by the regulations. Especially strong status quo bias exists in this policy area.

The role of *gaiatsu* could, therefore, be particularly important in the area of finance. Moreover, one other form of external pressure is also likely to be prominent in this issue area. In a globalized world, footloose capital can easily desert a country at a time of crisis. If investors do not like the policies, they simply pull capital out. That way, the argument goes, the markets have imposed discipline on policy choice,⁸ especially in the field of finance. Given these circumstances, we expect that the external pressure, both from foreign governments and from the markets, should play crucial role in determining the policy direction in the face of banking crisis in Japan. In the following sections, I will examine whether this expectation holds.

2. The Crisis and the Initial Reaction

Crisis and Policymaking Vacuum

The collapse of stock and land prices at the beginning of the 1990s left Japanese banks riddled with a massive amount of non-performing loans. Although some specialists, including then Prime

⁷ The personnel and career patterns created the bias toward stability of the financial order. See James Horne, *Japan's Financial Market: Conflicts and Consensus in Policymaking* (London: Allen and Unwin, 1985), Chapter 8.

⁸ For a discussion of the effects of massive international capital movement on the Japanese political economy, see T.J. Pempel, “Structural *Gaiatsu*: International Finance and Political Change in Japan,” *Comparative Political Studies* Vol. 32 (1999), pp.907-932.

Minister Miyazawa Kiichi, already recognized the problem of the financial industry by 1992,⁹ private financial institutions and regulators had thought that the recovery of asset price in the near future would solve the problem. While some small banks and a considerable number of credit unions went bankrupt, the sector as a whole had somehow held out until the middle of the decade. However, the prices continued to fall, and the amount of taxpayers' money used to help banks and farming cooperatives liquidate seven failed housing loan companies (Jūsen) in 1996 was far from enough to clean up the mess. In 1997, as the Japanese economy again went into recession, the plight of some of major financial institutions was evident.

When the crisis hit in November 1997, the Japanese government had a very limited set of measures to handle failed financial institutions. Until then, the regulators had been able to merge failed institutions into healthier ones and thus to ensure continuation of their operations. However, as the possibility of collapse of larger financial institutions loomed large, rescue merger without massive government assistance was no longer a viable option. Although a deposit insurance system existed, its size was obviously not sufficient to handle the crisis of the time. There was a pressing need to prepare a new scheme with which the government could take over the operations of the failed banks, maintain their services, and protect depositors and sound borrowers. Without such a scheme, the concern over the health of the financial sector could trigger a run on banks that eventually lead to a collapse of the whole financial system.

Nonetheless, at the time of the crisis, Japan was in a vacuum with respect to financial policymaking. As discussed in the previous section, in the sphere of finance, it was mainly the MOF officials who had usually taken initiatives in planning and implementing new policies. However, by the November crisis, the power of the MOF was greatly diminished. Although the bureaucrats began their attempt to stabilize the financial system before the 1997 crisis broke out, their traditional strategy of rescue merger had lost effectiveness in the face of serious trouble in the sector as a whole.¹⁰

⁹ Nihon Keizai Shimbunsha, *Kenshō Baburu: Han'i Naki Ayamachi* (Nihon Keizai Shimbunsha, 2000), pp.8-12.

¹⁰ The Banking Bureau of the MOF arranged a capital injection into the Nippon Credit Bank by other banks and insurance companies in April 1997. It also attempted to save Hokkaidō Takushoku Bank by supporting its planned merger with Hokkaido Bank, which eventually broke down. The Securities Bureau,

Moreover, because of a series of scandals involving MOF officials, as well as their failure in managing the economy, the public had lost confidence in the ministry's capability and neutrality. By 1998, corrupt relationships between MOF officials and major financial institutions were revealed. Some MOF bureaucrats, as well as Bank of Japan officials, were arrested on bribery charges.¹¹

As a result of these scandals, efforts were made to curb the bureaucrats' power. The opposition parties condemned the bureaucracy and criticized the ruling LDP for its close relationship with the bureaucrats. In the wake of the passage of *Jūsen* bills in 1996, the governing coalition of the time, composed of the LDP, Sakigake and the Social Democratic Party, decided to transfer authorities over inspection and supervision of private sector financial institutions from the MOF to the Financial Supervisory Agency (FSA), which was to be created in June 1998. Although the MOF retained authority over financial planning, it was demoralized and in disarray. Moreover, facing growing public outrage over its scandals, the ministry was incapable of dealing with the sensitive issue. They were reluctant to openly take bold steps that were necessary to stabilize the financial sector but would require the use of taxpayers' money, when public support for bureaucracy was extremely low. This meant that no one could take the initiative in financial policymaking at the time when Japan's economy was facing serious crisis.

Under the circumstance, some LDP members began to work out plans to deal with the situation in the midst of financial crisis. In November 1997, the LDP set up a special committee at the end of that month with former Prime Minister Miyazawa Kiichi as its chairman to discuss the plans. With the help of the MOF officials, the party eventually submitted a scheme to inject public money to re-capitalize banks,¹² which passed the Diet in February of the following year. One of the two banking measures that were passed would allocate 17 trillion yen to strengthen the deposit insurance fund to guarantee deposits. This 17 trillion yen would also be used to assist banks that had

on the other hand, tried to marry Sanyō Securities to Kokusai Securities over the summer of 1997, but in vain.

¹¹ For the details of the scandals, see, for example, Yomiuri Shimbun Shakaibu, *Kaichō ha Naze Jisatsu Shitaka* (Tokyo:Shinchōsha, 1998).

¹² Karube and Nishino, *Kenshō Keizai Shissei*, pp.307-327, Nishino Tomohiko, *Kenshō Keizai Meisō* (Tokyo: Iwanami Shoten, 2001), pp.9-32.

acquired failed institutions to meet capital adequacy standards. The other law would enable the government to buy 13 trillion yen worth of preferred stocks and subordinated bonds to be issued by banks to improve their capital bases. The government injected about 1.8 trillion yen of public funds into 21 major banks in March. The main purpose was to strengthen the capital positions of the banks as the accounting year of 1997 closed in March. Yet, as the banks were reluctant to come under control of the government, the amount of money actually injected at that time was much smaller than originally intended.

U.S. Pressure

However, this did not end the crisis. The amount of the injected money was deemed insufficient and several major banks were at risk even after the measures implemented in March. In the early summer of 1998, the liquidity problem of the Long Term Credit Bank (LTCB) surfaced as the most pressing issue. Its trouble came under the public eye after a monthly magazine reported its serious liquidity problem in early June.¹³ LDP leaders, together with the MOF and Bank of Japan, first sought to save the bank by merging it with Sumitomo Trust Bank and tried to assist the merger by injecting public money into the new bank.

The U.S. government called for fiscal stimulus to prop up the Japanese economy and the use of public money to clear banking problems, but was unhappy with Japan's attempts to strengthen moribund banks with public money. Fearing a spillover of Japan's recession to the rest of Asia and other regions in the world in the wake of the Asian financial crisis in the fall of 1997, the U.S. and other countries started to demand further fiscal expansion and tax cuts to spark a rebound of the stalled economy on occasions like the G7 meetings.¹⁴ Yet, they were also highly skeptical about Japan's

¹³ *Gendai*, July 1998. Even before the *Gendai* report, the influential *Economist* published an article that pointed out the serious problems long-term credit banks in Japan, especially the LTCB and the Nippon Credit Bank, faced. *The Economist*, May 2, 1998, p.69.

¹⁴ Before then, other countries, including the U.S., had accepted Hashimoto's emphasis on fiscal consolidation that began in 1996. As a result of the attempts to support the weak economy by a series of fiscal stimulus packages after the burst of the economic bubble, Japan's budget deficit had ballooned by the middle of the 1990s. In 1995, the government turned to fiscal consolidation. While other countries had demanded fiscal expansion in Japan out of concern for its trade surplus ever since the 1970s, they did not oppose Japan's move at that time, as they themselves were also putting priority to the reduction of budget

policy of strengthening major banks, believing that it would give Japanese banks unfair subsidies. They instead demanded closing undercapitalized banks and use public money to protect depositors, not weak banks. In December 1997, when the ruling party and the government were struggling to prepare a scheme to stabilize the country's shaky financial system, Treasury Secretary Robert Rubin and President Bill Clinton stated that Japan should not use public funds to rescue weak banks and their managers, as opposed to protecting the depositors and the financial system as a whole, in letters they sent to their counterparts in Japan. They stressed the need for further fiscal stimulus.¹⁵ In February next year, in a Congressional hearing, Charlene Barshefsky, then U.S. Trade Representative, expressed concern about "whether [the use of public funds in Japan] will lead to financial sector restructuring; which is to say will it lead to a clearing up of the banking system or will it simply protect not just depositors but also the banks."¹⁶

America's preference for a tough approach came from its own experience with the crisis of saving and loan associations (S&Ls) in the 1980s. After several years of procrastination, the U.S. government finally forced insolvent financial institutions to go bankrupt. Some American professionals who were involved in drafting legislation to bail out US saving and loans served as advisers to Japan. In the middle of February, a three-member U.S. team including Robert Glauber, who served as Under Secretary for Finance at the Treasury from 1989 until 1992, visited Japan to advise on the bank issue. After seeing Japanese officials both from eleven major banks and the government, they sent an eleven-page report on financial stabilization in Japan to Japanese politicians and people in the financial industry. The report urged caution in the use of public funds and

deficit. Junko Kato, "The transformation of Japan's fiscal orientation in the 1990s," in Gerald L. Curtis ed., *New Perspectives on U.S.-Japan Relations* (New York: Japan Center for International Exchange, 2000), pp.129-145.

¹⁵ Karube and Nishino, *Kenshō Keizai Shissei*, pp.304-306, Nishino, *Kenshō Keizai Meisō*, pp. 30-31. According to Nakai Sei, then Deputy Director-General of the International Bureau of the MOF, and Sakakibara Eisuke, Vice Minister of Finance for International Affairs, the U.S. Treasury had pressed them strongly from late 1997 to mid 1998 to liquidate ruined banks. The American officials sometimes raised specific names of particular banks and asked them why they would not shut them down. Nishino, *Kenshō Keizai Meisō*, pp.86-87.

¹⁶ Hearing of the Trade Subcommittee of the House Ways and Means Committee on Effects of Asian Financial Crisis on U.S. Trade and Activities of APEC, February 24, 1998.

recommended closing practically insolvent banks.¹⁷ L. William Seidman, the chairman of the Federal Deposit Insurance Corporation and the Resolution Trust Corporation until 1991, was also invited to Japan in June 1998. He laid out a tough plan to key LDP politicians, the central bank governor Hayami Masaru, and some MOF officials.¹⁸

U.S. government officials themselves put intense diplomatic pressure on Japan. In June, amid disordered depreciation of yen, Lawrence Summers visited Japan. He urged Japan to take advantage of a brief "window of opportunity" to revive its economy—a window that was opened by a multibillion-dollar intervention conducted by the two countries to prop up the weakening yen. He demanded fiscal expansion and liquidation of ailing banks.¹⁹ President Clinton himself repeatedly raised the issue.²⁰ The message from the U.S. was clear. The *Financial Times* summarized: "U.S. Treasury officials and other financial experts have urged Japanese leaders to move more aggressively to close failing banks, merge the weak with the strong and force the survivors to accept huge losses. Only then, these experts believe, will capital begin to flow again."²¹

The "Total Plan"

On July 2, 1998, the LDP released a "total plan" for a rescue of the banking industry, several days ahead of the original schedule. Most importantly, the plan adopted a "bridge bank" system modeled after the one the U.S. government had used to address the savings and loans crisis of the 1980s. Under the system, when a bank was found insolvent, administrators appointed by the Financial Supervisory Agency (FSA) would continue to extend loans to sound borrowers. These administrators would seek private financial institutions willing to take over sound loans and deposits of the failed institution. Its bad loans would be transferred to the Resolution and Collection Bank. If the administrators were unable to find a private institution, they would transfer operations of the

¹⁷ *Nihon Keizai Shimbun*, July 5, 1998, p.11, Nishino, *Kenshō Keizai Meisō*, pp.95-96.

¹⁸ He recommended establishing a RTC-like agency and closing insolvent banks and nationalize them under a so-called "bridge bank." *The Boston Globe*, October 11, 1998, E1. See also *Kinyū Bizinesu*, September 1998, p.45.

¹⁹ *Wall Street Journal*, June 18, 1998, A1. *Asahi Shimbun*, June 20, 1998, p.3, *Nihon Keizai Shimbun*, June 20, 1998, p.1, p.3.

²⁰ *Nihon Keizai Shimbun*, July 1, 1998, p.2.

²¹ *Financial Times*, June 19, 1998, A1.

failed company to a state-owned bridge bank. The bridge bank would have two to five years to find a commercial buyer for its sound operations.²² The government planned to submit related bills to the extraordinary session of the Diet that would start in late July.

Unlike the usual pattern of financial policymaking, this detailed plan was discussed in the LDP's Financial Revival Total Plan Promotion Committee, led by Chairman Yasuoka Okiharu, not simply prepared by bureaucrats.²³ Within the panel, it was the group of relatively young and idealistic politicians who were in the center of drafting the plan. They were later called the "new breed" politicians or *seisaku shinjinrui*. How could those politicians, who had been criticized for their lack of policy expertise for decades, arrange a plan on such a technical issue? The plan was worked out based on thorough hearings with people from the financial industry. While it is common for policymakers to obtain information from relevant industries,²⁴ the fact that politicians themselves had held hearings indicated a departure from the earlier days when bureaucrats drew up the detailed policies. In the past, people from financial sectors had visited the bureaucrats very often in order to exchange information with them. In the area of finance, where the career bureaucrats' expertise was rather limited, they relied on the banks and securities firms for the policy-relevant information. The regulated, in turn, received favorable treatment from the ministry. Now that the close relationship between the regulators and the regulated was under severe attack from the public, there were no longer many visitors to the ministry. In contrast, banks and securities firms began going to politicians, especially the key LDP members, to convey information.

Notably, during the time in which domestic financial institutions were under severe criticism for their mismanagement and corruption, foreign players served as the main source of information for the politicians. Officials from foreign banks and securities firms were often witnessed visiting the

²² This bank would be established as a subsidiary of a holding company called Heisei Financial Revitalization Corp with the 13-trillion-yen public funds secured by legislations in February. If no buyer could be found within five years, the bridge bank would be liquidated.

²³ Yasuoka is a former judge and served as parliamentary vice-minister of the MOF in 1980.

²⁴ It is common to assume that an important function of contacts between policymakers and interest groups is information transmission. Lobbyists in American politics often serve as a source of policy expertise for legislators. Baure, Pool and Dexter, *American Business and Public Policy*, second edition (New York: Aldine Publishing Company, 1973).

LDP headquarters and Yasuoka's office.²⁵ Their concrete advice served as the basis for drafting the plan.

3. The Making of the Bank Rescue Plan

Electoral Loss of the LDP and Confrontation in the Diet

Despite the efforts of the LDP to show its determination to solve the banking problem quickly with the "total plan," the market did not welcome it warmly. The plan did not push up the stock prices of the banking industry. Knowing the pressure from the United States to liquidate the weakest banks, the market did not hesitate to go after the "prey" that was likely to fail, pushing down the stock price.²⁶ The trouble of the Japanese economy only deepened.

Yet, in the Upper House election held on July 12, the LDP suffered an unexpected loss. The result shocked the LDP. Despite the miserable situation of the Japanese economy, the LDP leaders had been optimistic before the election. The opposition was fragmented after the New Frontier Party, the major opposition party formed against the LDP in 1995, collapsed in January 1997. Even though the LDP's record of economic management was far from impressive, there was no party that could effectively replace it. Support for the Democratic Party of Japan (DPJ), which was the largest opposition party, hovered around five per cent. The LDP leaders therefore believed that they could recapture an upper house majority lost in 1989. However, far from recovering the majority, the LDP won only 45 of the 61 LDP-held seats contested. With this devastating result, Hashimoto immediately announced his resignation as the LDP party president and as Prime Minister.

Obuchi Keizō, Hashimoto's foreign minister, won the party election, backed by support from the party's major factions. Because the LDP was still the largest party in the Diet, he was confirmed as the new Prime Minister in the new Diet session opened at the end of July. His cabinet started to move with the LDP's plan to attack the financial-sector problems. Obuchi, who had little expertise in financial engineering, attempted to gain credibility from foreign markets with the nomination of Miyazawa Kiichi, a former Prime Minister with ample experience in the field of international finance,

²⁵ *Aera*, August 17, 1998, p.68, and *Nihon Keizai Shimbun*, May 3, 1998, p.1

²⁶ *Nihon Keizai Shimbun*, July 5, 1998, p.11.

as Finance Minister. This appointment was regarded as a sign that the administration would address the financial crisis decisively.

Counterproposal from the Opposition Parties

On August 5, the cabinet submitted six bills necessary to implement the party's "total plan." While the LDP controlled the Lower House, its failure to regain a majority in the Upper House election meant that the party needed the cooperation of the opposition to pass the legislation. It had to obtain the support either of the DPJ, the second largest party in the Diet, or of both Heiwa Kaikaku, the Lower House division of Kōmeitō, and the Liberal Party, led by Ozawa Ichirō.²⁷ With the DPJ stoutly criticizing the LDP, they tried to draw Heiwa Kaikaku and the Liberals away from the DPJ.

However, the opposition parties were firmly united against the LDP. Encouraged by the result of the election, they demanded more stringent treatment of the fragile banks and greater transparency of banks' bad loan situations. In an effort to demonstrate that they had enough capability to replace the LDP as the ruling party, the three opposition parties—the DPJ, Heiwa Kaikaku, and the Liberal Party—began to draft a counterproposal.²⁸ They submitted four bills that countered the LDP-sponsored bills to the Diet on September 3.

The differences between the government's plan and the opposition's can be summarized in three points. The first was the difference in methods for the resolution of insolvent banks. The government proposed a bridge bank system while the opposition advocated temporary nationalization.²⁹ While both were government-assisted resolutions of insolvent financial institutions, through which the government would take over their operation in order to maintain the stability in the

²⁷ Heiwa Kaikaku was a parliamentary group and the Lower House affiliate of Kōmeitō with support from the religious group Sōka Gakkai. An alliance with its former coalition partners, the Social Democrats and Sakigake, would have left the LDP short of majority support for its proposals. Together, those two parties held eighteen seats, while the LDP needed twenty-three seats to obtain a majority. Gerald L. Curtis, *The Logic of Japanese Politics* (New York: Columbia University Press, 1999), p.216.

²⁸ Their interim plan, unveiled on August 12, was more a collection of ideas proposed by each party, leaving some points unclear and incoherent. It reflected their need to maintain the unity of three parties with rather different interests. *Asahi Shimbun*, August 13, 1998, p.2, *JEI Report*, No. 31, August 14, 1998.

²⁹ The nationalization scheme was based on the way in which Sweden dealt with its financial crisis at the beginning of the 1990s. DPJ staff spent two years studying the system. Nishino, *Kenshō Keizai Meisō*, p.215.

financial system, they differed in the duration of the transition mechanism. Under the LDP plan, the bridge bank that would take over the operations would last up to five years to seek private buyers. Criticizing the long duration, the opposition insisted that the nationalized banks should be sold or dissolved within a year. Given this difference, the bridge bank scheme gave the impression that it was saving failed banks. The LDP plan also did not clarify the accountability of management. The opposition's counterproposal required failed banks to disclose all financial data.³⁰

The second point, which was more conspicuous in the debate, was the question of how to deal with the LTCB. While the government wanted to rescue the bank by marrying it to another bank, the opposition parties wanted to punish it for its mismanagement over the last decade. They wanted to let the bank fail, and adamantly opposed the use of public money to cleanse the bank's books of non-performing loans to help the rescue merger. Although it is technically a different issue from the first question of which method to employ for government-assisted resolution, in the process of political negotiations, the two issues were linked together.³¹

Thirdly, the LDP and the opposition parties also differed on the issue of the structure of the supervisory agency and about the role of the Ministry of Finance. Amid the public criticism of the bureaucracy, especially the MOF, the opposition sought to curb the influence of the ministry as much as possible. It proposed to create a new agency, completely free of the MOF, to replace the FSA.

Obuchi's "Soft-landing" Approach

At the time he was selected to become the prime minister, it seemed that the Obuchi administration might accept a tough approach to the banking industry. Obuchi and his finance minister Miyazawa once indicated that to pass the legislation they might make major concessions to

³⁰ The nationalization plan was also proposed from within the LDP. In his proposal dated on June 28, 1998, Shiozaki advocated both the bridge-bank system and the nationalization scheme. It was dismissed as possibly violating the Constitution. Interestingly, the adoption of the bridge bank scheme, which was modeled after the scheme used in the U.S. financial crisis in the late 1980s, reflected the intention of the LDP leaders to placate the U.S. While the U.S. government was closer to the oppositions' position in that they favored drastic closer of bad banks, the scheme it proposed was closer to the LDP's. See *Nikkei Kinyū Shimbun*, September 21, 1998, p.1.

³¹ This is probably the reason for the breakdown of the September 18 agreement. Both saving the LTCB and resolving it were possible under the agreed bills. The point was left ambiguous in the agreement.

the opposition parties, which called for tough measures for the failing banks. Earlier, some LDP leaders had also echoed the U.S. demand and suggested that some bank failure could happen.³² However, facing a “freefall” of LTCB’s stock price, which was aggravated by market speculation that the government might close the bank, the LDP leaders and Hayami, the governor of the Bank of Japan, shifted their priority to saving major banks by injecting public money—a so-called “soft-landing” approach.³³

Throughout the month of August, Obuchi and Miyazawa actively committed to a plan to save the LTCB by merging it with Sumitomo Trust Bank. Obuchi even invited president of Sumitomo Trust to his official residence to press for the merger, together with Miyazawa. In addition, they tried to help the LTCB clear its mounting non-performing loans from its books with government money. The spreading skepticism over the soundness of the bank’s assets was the main obstacle to the merger. Sumitomo Trust was not willing to accept the deal unless the government would commit to improving the balance sheet. On August 21, government officials indicated that they would inject more than 500 billion yen into the LTCB in exchange for the implementation of sweeping restructuring. On the same day, the LTCB announced plans to streamline its operations, including the removal of the bank’s senior management, the closure of overseas offices, and staff cuts.

These efforts were viewed as the bailout of the ailing bank with public money. Opposition parties fiercely criticized the LDP’s plan. While the regulators and the LDP insisted that the bank was still solvent, the opposition argued that it actually was insolvent, given the reluctance of Sumitomo Trust, and that, therefore, injecting taxpayers’ money into the bank was not allowed. Under the legislation passed earlier, only solvent banks could receive public funds.

The determination of the top government officials came mainly out of the fear that the failure of the bank would result in a meltdown of the financial system in Japan, which in turn would trigger a catastrophe in global financial markets. Although they tried to prepare a mechanism through which

³² In early May, Katō Kōichi, then Secretary General of the LDP, stated in his speech in Washington D.C. that as a result of giving up the convoy system of financial regulation, some other financial institutions might fall just like Hokkaidō Takushoku Bank and Yamaichi Securities.

³³ *JEI Report*, No. 30, August 8, 1998.

banks could be liquidated, they were skeptical that the mechanism could prevent spillover effects of bank failures when confidence in the financial system was extremely weak. Bank of Japan Governor Hayami, for example, urged caution in applying the new mechanism to major banks. He said in testimony in the Diet that invoking the bridge bank system could “trigger enormous confusion in domestic and overseas market.”³⁴ The gravity of the problem was uncertain, however, and some argued that they were simply citing the danger to justify their approach. The *Business Week* said that the Japanese government was misleading the opposition parties and the public in an attempt to convince them to accept its bank bailout program.³⁵ These critics had grounds. These government leaders had incentive to save the bank in order to avoid responsibility for their misjudgment about the previous injection of public funds into major banks in March.³⁶

America's Shift, Stalemate at Home

Remarkably, the U.S. government, which had pressed Japan toward a market-oriented solution of the bank problem, changed its attitude when the legislators in Japan were in the midst of a fierce debate. Over the summer, the American government came to recognize the systemic risk that was threatening the global financial market. The market conditions deteriorated. Russia defaulted in August and its economic crisis peaked at the end of the month, when a drastic fall in the value of the ruble forced Russia's central bank to suspend all ruble-for-dollar trades. Fearing that the Russian crisis would spread to other regions of the world, traders and international investors panicked. In the same month, Long-Term Capital Management, a large and prominent U.S. hedge fund, was found to be on the brink of failure. The U.S. Federal Reserve intervened and organized a rescue out of the concern for the possible dire consequences.

³⁴ The Budget Committee, Lower House, August 17, 1998. In early September, Hayami said that a rescue merger would be preferable to a bank failure. Special Committee on Financial Stability Lower House, September 4, 1998.

³⁵ The numbers presented by the government represented the contract value or face value of derivatives contracts, according to the article, which tells little about the real exposure or risks. *Business Week*, Sep. 21, 1998, p.35. See also *AERA*, September 7, 1998, p.62.

³⁶ *Nikkei Kinyū Shimbun*, September 21, p.1. Nishino also suggests that Miyazawa's preference for not closing the LTCB came from the close relationship between his party faction, Kōchikai, and the bank. Nishino, *Kenshō Keizai Meisō*, pp.198-99.

Under such a circumstance, the Clinton administration had changed its course and now preferred a more modest approach that echoed the LDP proposal. In early September, in his first meeting with Miyazawa held in San Francisco, U.S. Treasury Secretary Robert Rubin pressed Japan to use enough public funds to revitalize the banking sector, while continuously pushing for further economic stimulus. Other U.S. officials openly suggested that their emphasis shifted away from closing weakened banks to helping weak but viable banks. On his visit to Tokyo, Stuart Eizenstat, then Undersecretary of State for Economic, Business and Agricultural Affairs, told the Foreign Correspondents' Club that Japan should use "sufficient public funds to strengthen weak but viable banks, conditioned on stringent restructuring."³⁷ By then, the U.S. officials came to consider it is essential to inject government funds into weak but viable banks in order to revamp the banking sector.³⁸

While the American officials tried not to be seen as taking sides, they were obviously unhappy about the adamant opposition parties.³⁹ Rubin commented on Japan in the banking committee hearing held on September 16; "I'd like to express... that it is critically important that the opposition and the majority party work through this problem in such a way as to make provisions for substantial public funding for Japanese banks as they ... deal with the issue of weak banks and bad loans, and particularly with respect to weak but solvent banks."⁴⁰

Back home, however, Obuchi still faced sharp divisions among policymakers. As the Prime Minister made up his mind to strike a deal with the rival parties before he would see President Clinton in a summit meeting scheduled for September 22, the ruling LDP had reached a general agreement on

³⁷ *Bloomberg News*, printed in *The Ottawa Citizen*, September 17, 1998, E5.

³⁸ *Washington Post*, September 23, 1998, C14. For a description of the U.S. position by the then Vice-Minister for International Affairs of the MOF, see Sakakibara Eisuke, "Watashi ga tatakatta Beikoku Zaimushō shijō saikyō konbi," *Bungei Shunjū*, September 1999, pp. 126-36.

³⁹ *Asahi Shimbun*, September 24, 1998, p.3, *Nihon Keizai Shimbun*, September 24, 1998, p.3. The *Wall Street Journal* writes: "American officials are concerned that Tokyo may be preparing to get a little too tough on its banks" in order to meet the demand of the opposition parties. "Outside Japan, the worry is that bowing to the opposition demand to cut off a government credit line to the banking system could make the banking crisis worse." *Wall Street Journal*, September 18, 1998, p. A9.

⁴⁰ Hearing of the House Banking and Financial Services Committee on the world economic situation and the U.S. economy, September 16, 1998. See also *Shūkan Diamondo*, October 3, 1998, pp.138-40.

September 18 with Kan Naoto of the DPJ and Kanzaki Takenori of Heiwa Kaikaku. The agreement included plans to establish a scheme to nationalize insolvent banks and to curb the powers of the Finance Ministry. However, the deal still remained unsettled over the interpretation of the terms, which was intentionally left vague. At the heart of the dispute was whether and how taxpayers' money would be used to save the LTCB, which the DPJ regarded as already bankrupt. The September 18 agreement stipulated that the LTCB was to be handled by measures “such as nationalization.” After the agreement, however, the LDP was apparently seeking ways to skirt around the terms of the deal with the DPJ to save the LTCB with public funds.⁴¹ Hatoyama Yukio, the acting secretary general of the DPJ, told reporters that the opposition might call for dissolution of parliament and a new election if such reports were correct. The agreement broke down.⁴²

Differences existed not only between the LDP as a whole and the opposing group. Disagreement within the LDP also was a significant obstacle to a compromise deal. Some junior party members, who had participated in the team that worked out the party's “total plan” in July, entered the stage. It was Mori Yoshirō, secretary-general of the LDP, who allowed those junior players, such as Shiozaki Yasuhisa and Ishihara Nobuteru, to negotiate directly with the opposition parties to forge an agreement. Mori believed that working-level consultations would produce an agreement without causing political upheaval. To the surprise of the LDP executives, however, those players started to echo the opposition parties in their support for a hard-landing approach to the LTCB and strong mistrust towards the Ministry of Finance.⁴³ Those LDP politicians negotiated directly with their counterparts in the opposition parties over the details of the bills, bypassing the traditional LDP policymaking apparatus. Because of their shared distrust in the MOF bureaucrats, they

⁴¹ Some speculated that Obuchi was trying to appease the U.S., which did not want Japan to abolish a fund for boosting weak but viable banks. *The Washington Post*, Sep. 22, 1998, p.A14.

⁴² For the disagreement over the terms, see the exchanges between Obuchi and Minezaki Naoki of the DPJ in the plenary session, Lower House, September 24, 1998.

⁴³ *Yomiuri Shimbun*, October 21, 1998, p.5. *Sankei Shimbun*, October 18, 1998, p.1.

intentionally excluded the MOF bureaucrats from their negotiations that month, leaving the bureaucrats without any information on their agreement.⁴⁴

Through such direct negotiations, these politicians reached tentative agreements, which were close to the proposal of the opposition parties. However, as such, their approach created a sharp internal division inside the LDP between those junior politicians and the party executives who preferred soft-landing approaches. The latter group, led by Finance Minister Miyazawa and Ikeda Yukihiro, Chairman of the Policy Research Council of the party and a former MOF official, claimed that drastic measures would trigger further crisis. They did not approve the agreements younger politicians had made. On the other hand, the junior group openly criticized the bureaucrats and the party leaders on air. Both the party leaders and the “new breed” groups became highly frustrated.⁴⁵

In the summit meeting held on September 22, President Clinton again requested that the Obuchi administration inject public funds into weak but viable banks. Although still skeptical about another flat injection of money into Japanese banks, the U.S. administration stressed the importance of avoiding any shock that could shake the global financial system. In the context of heightened confrontation in the Diet, Clinton’s remark in effect supported Obuchi’s side, although the president carefully avoided provocative words that might incite either the opposition parties or the markets.⁴⁶

⁴⁴ *Yomiuri Shimbun*, October 18, 1998, p.5, October 22, 1998, p.5. Since Diet members, not the cabinet, submitted the bills, it was in principle the Legislative Bureau of the Lower House that would help the legislators with the amendment of related bills. However, because the amendment of the financial bills required a large amount of expertise, the Ministry of Finance was indeed involved in the process, which irritated the politicians. See Fujii Yoshihiro, *Kejime wo Tsukero: Nakabō Kōhei no Owarinaki Tataikai* (Tokyo: Nihon Keizai Shimbunsha, 1999), pp.29-30.

⁴⁵ *Asahi Shimbun*, September 18, 1998, p.3, *Nihon Keizai Shimbun*, September 27, 1998, p.2. For politicians’ own account of the Diet session, see Nemoto Takumi, “The Successful Handling of the Financial Crisis” and Furukawa Motohisa “The Financial Diet of 1998” in Gerald L. Curtis ed. *Policymaking in Japan* (Tokyo: Japan Center for International Exchange, 2002) and Shiozaki Yasuhisa “Changes in the Japanese Policymaking Process” in Thomas E. Mann and Sasaki Takeshi eds., *Governance for a New Century: Japanese Challenge, American Experience* (Tokyo: Japan Center for International Exchange, 2002).

⁴⁶ *Asahi Shimbun*, September 24, 1998, p.3, *Nihon Keizai Shimbun*, September 24, 1998, p.3. At the same time, Clinton took a softer tone in pressing Japan, as the administration started to fear that the economic issue might damage the security relationship between the two countries. *The Wall Street Journal*, September 23, 1998, A3.

Bank Rescue Plan and Re-capitalization of Banks

On September 25, Chief Cabinet Secretary Nonaka Hiromu suggested in a press conference that the LDP would concede to the DPJ and other parties. That day, Japan Leasing Corp, a non-bank affiliate of the LTCB, filed for bankruptcy. This development signaled that the LTCB was more likely to be liquidated than to be saved through a rescue merger, because one of the prerequisites of the planned rescue merger of the LTCB was to write off debts of its three non-bank affiliates, including Japan Leasing, and to cover the loss with public funds before the merger.⁴⁷

The next day, the LDP and the three opposing groups reached a new agreement. The LDP mostly accepted, or “swallowed,” the plan originally submitted by the DPJ and Heiwa Kaikaku. They agreed that the LTCB would be nationalized and in effect liquidated. They also agreed later to separate the budget and financial oversight by January 2001 to curb the power of the MOF.

Based on this agreement, the Lower House approved the Financial Revitalization Plan, or the bank rescue plan, that would create a legal structure for dealing with bank failures, on the evening of October 2.⁴⁸ The package was to establish a new, cabinet-level Financial Resuscitation Committee, resulting in a separation of policymaking and fiscal responsibilities within the Ministry of Finance. It established three ways to deal with failed banks, as the Financial Resuscitation Committee would have power to nationalize the banks that fail or that seek government protection, liquidate them, or convert them into “bridge banks”. The legislation also included reporting requirements for banks. The bills were sent to the Upper House.

As the bank rescue plan advanced, the next issue was how the government would assist weak but still solvent banks with public money. The 13-trillion-yen bank re-capitalization account established in February was abolished by the bank rescue plan. However, as the situation of the

⁴⁷ See *JEI Report, October 2*, Nishino, *Kenshō Keizai Meisō*, pp.222-23. With the general liquidation of Japan Leasing, all the lenders from big banks to rural cooperatives would share the losses proportionally. Thus, it also marked a departure from a government-led rescue model in which big banks absorb a large part of losses in order to protect small cooperatives.

⁴⁸ The package consisted of eight bills, four of which provided how to deal with failed banks. The other four bills, submitted by the government, were designed to make it easier for banks to collect debts, boost securitization and sales of assets, help banks sort out conflicting claims on collateral and expand the powers of the bureaucracy to deal with the bad-loan situations.

banking industry got even worse with the already weak stock market shaken even further, the need to strengthen the capital base of major banks became widely recognized. Foreign countries, most notably the United States, had pressed Japan to establish a new scheme as soon as possible. In the communiqué of G7 meeting of finance ministers and central bankers, held on October 3 in Washington D.C., called for Japan to enact measures to inject public money into ailing banks.⁴⁹

At the end of September, the LDP began preparing a plan to re-capitalize shaky banks through government purchases of their common and preferred stocks.⁵⁰ The LDP leaders excluded the “new breed” politicians in making the bank re-capitalization plan. Instead, the party took full advantage of the help of MOF bureaucrats. Senior members of the party had been annoyed with those “new breed” politicians, who ignored seniority rules and openly criticized the party leadership. They tried to restore the order within the party.⁵¹

The DPJ decided to go against the LDP scheme and countered with its own plan, released on October 5, which would set more stringent conditions for the injection of public funds into barely solvent banks. It demanded much tougher consequences for managers and shareholders of banks that sought government assistance and also required lowest cost accounting as a valuation method of securities. While those measures would help to increase the transparency of the financial system, such stringent conditions were likely to discourage banks from applying for injections, which would leave their capital base weak and result in further credit crunch. Its consequences for the economy as a whole could be severe.⁵²

In reaction, the LDP chose to seek ways to forge compromise with other opposing groups. While the opposing parties had maintained unity in their struggle with the LDP over the bank rescue plan, in the midst of deep trouble in world financial markets, some of the parties began to worry about the consequences of any delay in Japan’s action. Another, and more enduring, motivation behind the

⁴⁹ *Nihon Keizai Shimbun*, Oct 4, 1998.

⁵⁰ *Asahi Shimbun*, October 1, 1998, p.2, *Nihon Keizai Shimbun*, Oct 2, 1998.

⁵¹ *Yomiuri Shimbun*, October 22, 1998, p.5, *Sankei Shimbun*, October 18, 1998, p.1.

⁵² To avoid the problem, forcible injection of capital was also proposed. However, the idea was eventually abandoned out of concern that it would give too much power to the state over private financial institutions. See, for example, *Nihon Keizai Shimbun* October 5, 1998, Oct 6, 1998.

cooperation was the new electoral rule introduced in 1994. Under the new system, which incorporated single-member electoral districts, smaller parties found it difficult to win seats on their own. They needed to cooperate with larger ones.⁵³

Heiwa Kaikaku and the Social Democratic Party (SDP) acknowledged that legislation to deal with the problem of weakened banks should be enacted as soon as possible, indicating that they might support the LDP. The LDP tried to win their support mainly by making the conditions for capital injection somewhat stricter. It eventually managed to secure cooperation from those two parties. The Liberal Party also joined the coalition. Those concessions disappointed the financial industry. The financial institutions complained that the conditions for receiving public money were too tight to accept, making the bills unrealistic and ineffective.⁵⁴

The Upper House approved the eight bills that constituted the bank rescue plan on October 12. The next day, the bank re-capitalization plan was approved in the Lower House with support from the LDP, Heiwa Kaikaku, the Liberal Party and the SDP. It moved to the Upper House and passed on October 16, the final day of the special Diet session.

The Democratic Party voted against the bank re-capitalization bills. However, the party did not criticize the LDP as harshly as it did in the debate over the bank rescue plan, even though the LDP's plan set looser standards for capital injection than the DPJ's. It even proposed a drastic expansion of the amount of funds to be used for nationalization of insolvent banks and injection of capital into viable banks over the 10 trillion yen set in the LDP's plan. The LDP accepted the proposal quickly. The bills eventually established a 43-trillion-yen fund – 25 trillion yen for re-capitalization and 18 trillion yen for nationalization and other uses. Combined with the existing deposit insurance funds of 17 trillion yen, it would make a 60-trillion-yen framework to handle the banking crisis.

On October 23, the LTCB applied to the Financial Supervisory Agency for temporary nationalization, based on the bank rescue plan. The Agency announced that the bank was insolvent as of September 30 and the ownership of the bank's common shares was transferred to the Deposit

⁵³ Curtis, *Logic of Japanese Politics*, pp.216-221.

⁵⁴ *Nihon Keizai Shimbun*, October 10, 1998.

Insurance Corp. The bank was eventually sold to a consortium of about 10 investors, led by the U.S. private investor group Ripplewood Holdings. The decision was announced in September 1999 and the new bank, Shinsei Bank, began operation in 2000. In addition, another ailing bank, the Nippon Credit Bank (NCB), was nationalized in December 1998. A consortium of Japanese companies led by Softbank took it over in 2000.

4. What Explains the Bank Rescue Plan?

In this section, I first evaluate the policy outcome briefly. Then I discuss how external pressures, from both market and foreign governments, worked in the making of the bank rescue plan, and explore the factors that determine the policy outcome.

Policy Outcomes

Comparing the costs and benefits of possible alternatives is an extremely difficult task. The hard-landing approach, which was eventually applied to the LTCB, might have ruined the bank's assets and weak but viable borrowers. In March 2000, Tanigaki Sadakazu, then Chairman of the Financial Reconstruction Commission, publicly admitted before a Diet committee that it would have been less costly if the LTCB were merged with Sumitomo Trust Bank instead of being nationalized and then sold.⁵⁵ On the other hand, it is also possible that the rescue of banks would have simply deepened the mistrust of the banking sector as a whole.

The delay in forging the policy undoubtedly had negative effects. As time passed after the LDP announced its own proposal in July 1998, sound customers and talented employees left LTCB, further eroding its assets. This raised the cost the government would have to bear in either saving or liquidating the bank.

Market Pressure and Gaiatsu

In handling the crisis, two kinds of external pressures are often said to have pushed the Japanese government: market pressure and *gaiatsu*. Analysts have often stated that the policymaking concerning the crisis differed from the conventional Japanese-style policymaking because it was

⁵⁵ The Committee on Financial Affairs in the Upper House, March 15, 2000.

mainly pressure from international markets that drove it. The old “convoy system” of financial regulation, in which the regulators orchestrated the system slowly and cautiously so that no one would be left behind, no longer worked, because the mobile capital did not wait to see the results.

The markets indeed ruthlessly urged Japan to move. Under the market pressure, politicians could not leave the severely undercapitalized, probably already bankrupt, financial institutions untouched in the hope that economic recovery would eventually revive them. In November 1997, Sanyō Securities was unable to raise enough capital to meet the debt-capital ratio. Hokkaidō Takushoku Bank and Yamaichi Securities had difficulty to finance their operation. The market also drove the turmoil in 1998, as the LTCB and the NCB also had trouble raising capital and their stock prices declined sharply. Moreover, the crash of the value of the yen in June that year and the continuous decline of stock prices over the summer were perceived as a non-confidence vote from the financial markets on Japanese economic policies.

However, it is too simplistic to conclude that the market determined the policies, for it was not obvious what the market really wanted in this case. The confusion arises from the trickiness of the term "market-oriented." In its ordinary use, "market-oriented" approaches mean less government intervention in the market. While smooth functioning of financial markets requires adequate regulation, the regulation should be neutral so as not to distort market mechanisms. Governments should let the market decide who will survive and who will not. The "hard-landing" approach, advocated mainly by the “new breed” politicians in both the LDP and the DPJ, was consistent with this interpretation of the term. Their approach assumed that the government should not save weak banks and that all it should do was to minimize the shock on the market brought by bank failures, although their scheme of nationalization might well have entailed government’s heavy involvement in the clean-up process. Injection of public money into failed banks seems to be just the opposite of the “market-oriented” approach, because such measures would save banks that had made bad management decisions.

When a financial system is facing a prospect of systemic crisis, however, the definition might be different. In the case of Japan in 1997 and 1998, some believed that, in order to restore the normal functioning of the financial markets, it was necessary for the government to take more active

roles. As the crisis deepened, those people claimed that the market mechanism itself would be damaged should the government fail to save fragile banks and to calm down the market. In the sense that its principal aim was to keep the market functioning, it could also be dubbed “market-oriented.” This dual meaning of the term demonstrates that the market pressure alone could not determine the policy direction.

How about the role of *gaiatus*, or pressure from foreign governments? Some people believe that the Japanese government was slow to move in the face of the banking crisis and was able to take necessary steps only when pushed by American government. The pressure from the U.S. was evident throughout the process. Out of fear that the failure in Japan would quickly spill over and trigger another crisis in fragile financial markets all over the world, the U.S., together with other countries, had put massive pressure on Japan.⁵⁶

Advocates of Realism would argue that the U.S. forced Japan to implement those actions most favored by the U.S., through the U.S.’s superior military capabilities. In reality, frustrated by Japan’s inability to follow its directions, it used more subtle ways to influence Japan’s bank policies. One important means was the provision of relevant expertise. The role of ideas and knowledge in policymaking has been debated in political science.⁵⁷ In this case, the U.S. government, as well as specialists currently in the private sector, presented very detailed plans to Japan, which were based on America’s own experience with financial crisis a decade earlier. Advices from those sources served as a basis for the debate. This type of influence was particularly powerful at that time because the Japanese bureaucracy, which had served as the main think tank for policymakers, was dysfunctional,

⁵⁶ Many MOF officials reportedly considered the American pressure on Japan as a means to cover its own policy failure. They believed it was the U.S. that triggered the international financial crisis by overly restrictive conditionality for loans through the International Monetary Fund. See Karube and Nishino, *Kenshō Keizai Shissei*, pp.294-95. Sakakibara Eisuke also insisted that the initial opposition of the U.S. administration to the injection of public funds was based on American private interests rather than on sound policy grounds. Sakakibara, “Watashi ga tatakatta.”

⁵⁷ See, for example, Judith Goldstein and Robert O. Keohane, *Ideas and Foreign Policy: Beliefs, Institutions, and Political Change* (Ithaca: Cornell University Press, 1993). Recent literature in game theory has also shown the importance of information.

and domestic interest groups were also impotent due to the financial scandals in which they were involved.

In the formation of the bank rescue plan, however, the effect of the U.S. pressure, or *gaiatsu*, was limited in determining the policy direction. This paper observes that the shift in the U.S. position, which became obvious by September 1998, did not shift the dynamics of Japan's party politics immediately. The policy outcome was closer to the opposition parties' position than to the U.S. demand. It was tough on weak banks despite the concern of the Clinton administration that being too strict on the ailing financial institutions might cause a total collapse of the world financial system.

Party Politics

What explains the sluggish response the best, I argue, is the new dynamics in Japan's domestic politics. Interestingly, in the midst of the stalemate, much of the American press associated the inability of Japan to act swiftly in this crisis with the traditional Japanese-style politics based on consensus building. For example, the *Los Angeles Times* wrote that "Despite the near panic in world financial markets this week," Japan was handling "its political gridlock Japanese-style, meaning painstaking multi-party negotiations, face-saving compromises and much more time than an impatient world would like, politicians and analysts here say."⁵⁸ Nevertheless, the gridlock was in fact rather a result of unusually contentious, open disagreement among political parties, which was caused by the end of one-party dominance of the LDP.

The institutional characteristic of the Japanese political system that led to the stalemate was its bicameral system, in which the two houses have nearly equal power. The Lower House cannot overturn the decision of the Upper House to reject a bill without two-thirds or higher approval. Despite the fact that Japan has a parliamentary system, the strong Upper House in effect functions as a divided government when the two houses are dominated by different parties, or by different coalitions of parties. The Upper House has veto power over most bills proposed by the cabinet, whose head is selected by the coalition that dominates the Lower House.⁵⁹

⁵⁸ *Los Angeles Times* September 5, 1998, p.A16. See also *Washington Post* September 6, 1998, p. A24.

⁵⁹ Moreover, unlike the Lower House, the cabinet cannot dissolve the Upper House in Japan.

Before the Upper House election in 1998, the LDP, in cooperation with bureaucrats, could make policies to handle the crisis rather quickly. One month after the November crisis of 1997, the government announced a new measure to inject public money to major banks, although the size turned out to be insufficient. By contrast, after its electoral loss, the LDP fell far short of majority. As the opposition group, especially the DPJ, attempted to show its capability to replace the LDP as a ruling party by countering the government with its own policy proposals, the severe confrontation stalled the bank bill debate, since the opposition group had power to block the LDP-supported bills.

On the other hand, what determined the direction of the policy was the sudden activism of politicians from younger generation, who did not have much influence before the event. The “new breed” politicians of the LDP echoed their counterparts in the DPJ in their distrust in the old convoy system of financial regulation, and worked together to draft bills that were oriented toward the hard-landing approach, breaking the status quo bias in the Japanese policymaking mechanism. However, it is premature to conclude that this marked the sea change in the Japanese politics. Those “new breed” politicians gained influence only because the party leaders delegate negotiating authority to them without expecting this result. After the party leaders recaptured control, the younger politicians lost power. And after the LDP went to form coalition governments with some small parties, the power of opposition parties also disappeared.⁶⁰

5. Conclusion

In the process of making policies to deal with the fragile banking sector of Japan, market pressure and *gaiatsu*, or foreign pressure, appeared to have tremendous influence. However, at a closer look, their effects turned out to be limited. Market pressure alone could not determine policy directions, since it was not clear what the markets really wanted. Besides, the actual policy outcome does not precisely reflect the detailed demands from the U.S. government. Instead, it was forged in a new dynamics of party politics, in which some relatively young and idealistic politicians within the LDP worked together with the opposition parties. The policy details reflected the beliefs of those

⁶⁰ The LDP and Liberal Party formed a coalition government in January 1999, and Kōmeitō joined them in October that year.

newly active players in a tough approach. Although the beliefs were originally influenced by foreign sources of information, they took on their own life and remained influential even after the U.S. government had shifted its focus.

This does not mean that the Japanese financial system has gone back to the old convoy system. Recognizing the need to adjust to the changing economic environment, the Japanese government is moving forward to establish a more competitive financial system. Yet, the process is not an automatic reaction to the market pressure. The pace and direction of reform depend on the will of political leadership.