Financial Crises, Politics and Financial Sector Restructuring

A Comparison between Japan and the United States

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Abstract

This article analyzes and compares the financial sector restructuring process after the financial crises in Japan and the United States. As these financial crises deepened, countries shifted their policies away from postponing financial sector restructuring toward more thorough reforms. The impacts of different political structures are examined through the Small-N Case Study method. Cases include: the bursting of the financial bubble in the 1990s in Japan and the Savings and Loan crisis in the 1980s in the USA, both of which are analyzed through a review of academic literature, journalistic writings, and statistical data from the World Wide Web.

Keywords financial crisis • financial markets • financial sector restructuring • moral hazard • savings and loan crisis • the bursting of the Japanese financial bubble

A Shift in Financial Markets, Financial Crises and Postponement of Reforms

Since the 1970s, global integration, capital market development and the emergence of new financial products have undermined the customer base of banks in large economies, including Japan and the USA. As global financial markets became increasingly integrated and new technologies created new financial products, costs in the capital market decreased. This change in profitability drove money and business opportunities away from bank loans and toward securities activities. This shift of transactions from indirect financial markets to direct financial markets is called disintermediation. As a cheap Euromarket developed overseas, profitable corporations began to switch their financing from
bank borrowing toward the issuance of corporate bonds in the direct-capital market. For example, in Japan, big business reliance on bank loans decreased from 30.2 percent in 1973–7 to 17.5 percent in 1978–82 (Vogel, 1996: 173).

In addition, new financial products such as money market mutual funds (MMMFs), commercial papers (CPs) and negotiable certificates of deposit (CDs) developed during the 1970s and 1980s. Subsequently, papers sold and traded on the market began to replace bank loans. For instance, MMMFs in the USA were invested in high-quality funds such as Treasury Bills, CPs of profitable companies and large-denominated short-term CDs of commercial banks. Investors earned market returns on those investments, whereas bank depositors earned less, as regulations set ceilings for deposit rates lower than market rates. Although MMMFs, unlike bank accounts, were not federally insured, these funds were considered to be fairly secure due to the high quality of investments. In the USA, MMMFs came into existence in the financial market in 1972 and increased from $3.3 billion to $236.3 billion by the end of 1982 (Barth et al., 2004: 20).

Increased competitive pressure, the squeeze on profits and banks’ disadvantage compared to other capital-market players pushed banks into untraditional, high-return and high-risk businesses, including real estate, resort development and investment in junk bonds. When the market became shaky and real estate prices declined, these investments quickly turned into huge losses. Losses were often not revealed to the public in a timely manner, leading to delays in actions necessary for resolution.

When the value of liabilities exceeds the total value of assets and capital, banks become insolvent. Financial sector restructuring then becomes necessary in order to deal with nearly insolvent and insolvent banks, as well as weakened but still-healthy banks. Nearly insolvent and insolvent banks need to be acquired by healthy banks, liquidated or temporarily nationalized for a subsequent sale to healthy financial institutions. Weakened but still-healthy banks need to be recapitalized through public money to strengthen their balance sheets. Each of these measures for financial sector restructuring comes with high costs.

In the financial crisis of the 1990s in Japan and the Savings and Loan (S&L) crisis of the 1980s in the USA, losses accumulated and became greater than the amount of deposit insurance funds available to cover these losses. The deposit insurance system aims to protect deposits below a certain threshold when financial institutions fail and cannot repay deposits.1 The system is funded by an insurance premium paid by banking sectors. When the losses and expected costs exceeded the available amount of insurance funding, taxpayers’ money had to be spent. The deposit insurance system is often backed by the implicit or explicit government guarantee of repayment.

The rationale for the deposit insurance system and government guarantees comes from the contagious effects of bank failures, systemic risks of the payment network and exceptionally high negative social costs associated with bank runs.
One bank’s failure could lead to another bank’s failure due to concerns among depositors over banks’ solvency. Under such situations, depositors could withdraw money even from healthy financial institutions out of fear of insolvency. Moreover, a payment failure by one institution could lead to liquidity problems in other institutions and an eventual liquidity crisis through a network of payment and settlement systems. In addition, the shrinkage of funding supplies and credit contraction could heavily damage the real economy. In particular, loans to small and medium enterprises, which have higher risks, tend to be cut first, leading to bankruptcies of those companies.

Although these safety systems such as deposit insurance funds and government guarantees could serve as buffers to prevent the spread of credit contraction, they could also provide incentives for nearly insolvent institutions to increase high-risk and high-return investments in order to cover their losses. When banking industries know that insurance funds and the government will eventually cover their financial losses, desperate managers could make a bid for last-minute recovery.

The resolution of failed banks becomes politically difficult, especially when this resolution requires financial support not only from a deposit insurance fund but also from taxpayers. Regulators, policy makers and bankers would be reluctant to support a resolution in this case, since they would worry about possibly being blamed for inadequate supervision and mismanagement. To make things worse, postponement would likely increase the costs of resolution and increase incentives for bank managers to engage in even more high-return and high-risk business, hoping for a last-minute recovery of losses.

This article compares financial sector restructuring after the bursting of the financial bubble in the 1990s in Japan, and during and after the S&L crisis in the 1980s and the early 1990s in the USA. In both cases, financial sector restructuring was postponed until financial crises significantly deepened. Postponement of reforms forced both economies to incur more costs than they otherwise would have. Major turning points for financial sector restructuring were in October 1998 in Japan, and in August 1989 in the USA. Each country’s case study is divided into two parts: the first addresses the initial undertaking of financial sector restructuring and the second addresses more critical reforms.

The Japanese Case

*Financial Crisis and Policy Responses Led by the Majority Party and the Government*

Beginning in the early 1990s, Japan started to show symptoms of a financial crisis. In the early stage of the crisis, officials in the Banking Bureau (Ginkō Kyoku) of the Ministry of Finance (MOF) arranged rescue mergers. The obligations of the failing banks were resolved mostly by funds from the Deposit Insurance
Corporation of Japan (DICJ) and the special uncollateralized loans extended by the central bank, the Bank of Japan (BOJ). The MOF officials arranged assisted mergers of a troubled mutual bank, Tōhō-Sōgo Bank by Iyo Bank and of a troubled credit union, Tōyō-Shinkin Bank by Sanwa Bank in 1992, drawing on funds from the DICJ. Moreover, when Tokyo Kyōwa Credit Cooperative and Anzen Credit Cooperative became insolvent, Tokyo Kyōdō Bank was established with funds from a combination of private-sector capital and special uncollateralized loans extended by the BOJ in December 1994 in order to take over the defaulted credit cooperatives. Similarly, the failed Cosmo, Kizu and Osaka Credit Cooperatives, and Hyōgo Bank were resolved through non-legislative means and without directly drawing on taxpayers’ money.

When larger financial institutions faced trouble, such as a consortium of seven housing-loan corporations called jūsen, MOF officials could not dispose of them through either assisted mergers or the voluntary creation of funds by the BOJ, the DICJ and commercial banks. The MOF was forced to ask directly for taxpayers’ money. When the price of land climbed dangerously high, the MOF put a restraint on financial channels flowing into the real estate business, including investments in real estate by banks and agricultural cooperatives. However, the financial channels from agricultural cooperatives through jūsen into real estate businesses were left unrestrained. This led to the expansion of non-performing loans and the insolvency of jūsen. After bitter political battles between the MOF, the Ministry of Agriculture, Forestry and Fisheries (MAFF), and the Liberal Democratic Party (LDP), which was the majority party of which farmers were a large constituency, a public fund injection of 685 billion yen ($6.3 billion) was approved for the resolution of jūsen in June 1996. This caused huge public criticism of the MOF, banks and agricultural cooperatives (Mabuchi, 1997; Nishimura, 1999; Nishino, 2003).

The political battle involving jūsen had a significant impact on subsequent restructuring of financial sectors. The use of taxpayers’ money for the disposal of the failed institution, jūsen, was perceived to be a clear sign of administrative failure. Public criticism of the financial regulator, the MOF, led to a political movement demanding the organizational restructuring of the MOF. This agenda became a keystone of the administrative reform led by Prime Minister Hashimoto. However, these political agendas led to an overly hesitant attitude within the MOF toward financial sector restructuring with further use of public funds. Many other troubled financial institutions that needed to be disposed of using public funds continued to do business; in the end, the cost of resolution was made even higher. The MOF did not want to launch unpopular programs relying on public funds, which would serve to magnify public criticism and strengthen calls for reform of the MOF.

Additional factors made timely public fund injection difficult. First, Prime Minister Hashimoto was bound by his campaign promise of fiscal structural
reform in the 1996 elections. This pledge prevented Hashimoto from proposing the use of taxpayers’ money for the resolution of insolvent financial institutions. Second, reliable estimates of the overall amount of non-performing loans were publicly unavailable. The public and political actors therefore did not recognize how serious the financial market was and how badly financial institutions were suffering. In particular, information on financial markets and financial supervision were too technical to attract attention from the public and from politicians. Third, financial institutions were also continuously hesitant to receive public fund injections since it could undermine their autonomous management and draw public criticism. Finally, the economy seemed to be recovering in 1996, and the size of non-performing loans was expected to shrink.

However, subsequent failures of larger financial institutions raised political awareness of the necessity of using taxpayers’ money to address the problems of the troubled financial market. The collapses of large financial institutions in November 1997, including Sanyō Securities, Hokkaido Takushoku Bank, Yamaichi Securities and Tokuyō City Bank revealed how seriously troubled the Japanese financial market had been and gave a huge shock to the market, the Government and politicians. These failures led to a fall in the share prices of all Japanese financial institutions. ‘Japan Premium’, which overseas investors imposed on Japanese financial institutions as an extra cost to raise capital in overseas markets, had been in place since the mid-1990s.

As a result, on 25 November 1997, the majority party, the LDP, created the Headquarters on Urgent Countermeasures to Stabilize the Financial System (Kinkyū Kinyū Shisutemu Anteika Taisaku Honbu). LDP politicians started proposing concrete programs for the resolution of troubled institutions through public fund injections. Three major proposals were launched by LDP politicians, including Yoshimi Watanabe, Kiichi Miyazawa (Chairman of the Headquarters on Urgent Countermeasures to Stabilize the Financial System) and Seiroku Kajiyama (the leader of the anti-executive group within the LDP). Multiple policy proposals were competing with each other within the LDP. The MOF’s Budget Bureau (Shukei Kyoku) resisted Kajiyama’s proposal, which clearly contradicted fiscal structural reform. Seiroku Kajiyama’s initiative represented the political movement of the anti-executive group within the LDP, which included Tarō Asao and Kaoru Yosano. Miyazawa coordinated and negotiated different proposals and brought coordinated bills to the Japanese Parliament, the Diet (Nishino, 2001: 9–46; Nishino and Karube, 2004: 195–344).

The Diet passed the Law Concerning Emergency Measures for the Stabilization of the Functions of the Financial System (Financial Stabilization Law: Kinyū Kinō Anteika Kinyū Sochi Hō) on 16 February 1998. This law granted the Government the authority to supplement bank capital and provide a safety net for creditors. It authorized the use of 30 trillion yen ($238 billion) in public funds, which strengthened the financial base of the DICJ. In order to
restrain administrative discretion, the Financial Crisis Management Examining Board (Kinyū Kiki Kanri Shinsha Iinkai), called the Sazanami Council, was established.

The Sazanami Council approved the injection of 1.8 trillion yen ($14 billion; 0.36 percent of 1998 nominal GDP) into 21 financial institutions on 12 March 1998. Financial institutions initially were hesitant to receive public funds because of a concern that public fund injections would make them look weak in the market. After initial acceptance of public funds by a fairly healthy institution, Tokyo Mitsubishi Bank, other institutions received public funding in March 1998. However, the injection of 1.8 trillion yen was considered insufficient, given that the MOF’s estimation of bad debt was 77 trillion yen ($598 billion) (Amyx, 2004: 184). Moreover, a large share of the funds went to support financial institutions whose sustainability was questionable, including 60 billion yen ($466 million) to Nippon Credit Bank (NCB) and 177 billion yen ($1.4 billion) for Long-Term Credit Bank (LTCB) (Nishino, 2001: 101–40). Both banks became insolvent and were nationalized at the end of 1998.

**Bipartisan Handling with Financial Sector Restructuring**

In the election to the upper house in July 1998, the LDP lost the majority, receiving only 105 seats in the 252-seat chamber. Economic depression, the credit crunch and Hashimoto’s undetermined attitude toward his initial pledge on fiscal structural reform led to his declining popularity. The Hashimoto cabinet took responsibility for the loss of the upper house elections and resigned. Keizo Obuchi of the LDP became prime minister, defeating Kajiyama, who had proposed radical economic structural reforms and financial sector restructuring in a so-called ‘hard-landing course’, which could have resulted in an immediate recession but also in a strong economic recovery in the long run. Obuchi prioritized expansionary fiscal policies and immediate economic recovery. These expansionary fiscal policies included a permanent tax cut and a 10 trillion yen ($71 billion) supplemental budget to support the real economy. Reflecting the LDP’s prioritization of the survival of small and medium businesses and firms, which were a large constituency of the LDP, immediate fiscal and financial spending was favored.

The victory of the opposition parties in the upper house elections enabled them to push radical financial sector restructuring forward with their own proposals. After a capital injection in March 1998, the governing party, the LDP, and its non-cabinet allies including the Social Democratic Party of Japan (SDPJ) and the New Party Harbinger (Sakigake), cooperated with the Government to create the Committee for the Promotion of the Revitalization of Finance. The Government and these parties worked on a ‘Total Plan’ to resolve the problem of bad loans. The plan included measures to invigorate the real estate market
and create a bridge-bank scheme that set up a bank to assume performing loans of a failed banking institution. The Total Plan was made public in the summer of 1998, and, based on this plan, the Government submitted six bills called the Financial Rehabilitation Bills to the Diet in August 1998 (Toya, 2006: 225).

In response to the Financial Rehabilitation Bills submitted by the governing party and its allies to the Diet, the Democratic Party of Japan (DPJ), the Heiwa-Kaikaku Party and the Liberal Party proposed their own bills providing schemes for the legal liquidation of failed banks and the temporary nationalization of insolvent financial institutions. This latter scheme was based on the proposals by Yoshito Sengoku of the DPJ. Those bills also included the abolition of the Financial Stabilization Law, which was enacted in February 1998. The focus of the government bill of the bridge-bank scheme was the protection of bank borrowers, whereas the focus of the opposition parties’ bills of the temporary nationalization scheme was the maintenance of the payment system (Amyx, 2004: 203).

To address political confrontation, the bipartisan negotiation table was established by the younger generation of politicians, called ‘Young Turks’ (Seisaku Sin Jinrui), whose members included Nobuteru Ishihara and Yasuhiisa Shiozaki of the LDP, and Yoshito Sengoku and Yukio Edano of the DPJ. The resolutions of non-performing loans and of the LTCB, in particular, were discussed repeatedly. On 29 September 1998, the governing and the opposition parties decided to put the LTCB under temporary state control. Most of the proposed plans by the DPJ were accepted and codified in the Law Concerning Emergency Measures for the Revitalization of the Functions to the Financial System (Financial Revitalization Laws: Kinyū Kinō Saisei Kinkyū Sochi Hō) on 12 October 1998 (Amyx, 2004: 200–08; Toya, 2006: 224–29).

The Financial Revitalization Laws created the Financial Revitalization Account within the DICJ, which was given 18 trillion yen ($148 billion) from public funds for financial revitalization including the establishment of bridge banks, and the temporary nationalization and purchase of assets of failed financial institutions. After the LTCB (now the Shinsei Bank) and the NCB (now the Aozora Bank) were judged as insolvent by the newly created financial supervisory authority, Financial Supervisory Agency (FSA), those institutions were temporarily nationalized based on Article 36 of the Financial Revitalization Laws. Moreover, the Financial Revitalization Laws established a highly independent financial supervisory authority, the Financial Reconstruction Commission (FRC), which oversaw the FSA. The FRC had the authority to declare insolvency and decide upon nationalization and disposal through the Resolution and Collection Corporation (RCC), a newly created government-backed asset management corporation. The FRC was more effective than the Sazanami Council, since the FRC had the authority to inspect and supervise financial institutions as a parent organ of the FSA (Nakaso, 2001: 14).
The LDP’s original bills, known as the Financial Rehabilitation Bills, were accommodated within other new laws. Based on proposals by the LDP, the Heiwa-Kaikaku Party, and the Liberal Party, the Diet passed the Financial Function Early Strengthening Laws (Kinyū Kinō Sōki Kenzenka Hō) on 16 October 1998. These laws specified conditions and rules to recapitalize banks that were weak but still viable. This law established the Financial Function Early Strengthening Account at the DICJ with 25 trillion yen ($206 billion) from public funds to recapitalize the troubled institutions. This 25 trillion yen fund replaced the 13 trillion yen fund called the Financial Crisis Management Account, which was established out of 30 trillion yen fund reserves for recapitalization in the Financial Stabilization Law. Together with the remaining 17 trillion yen fund approved by the Financial Stabilization Law for depositor guarantee and the 18 trillion yen fund approved by the Financial Revitalization Laws for revitalization, the DICJ was allowed to use up to a total of 60 trillion yen ($495 billion). The amount of public funds used in 1999 was 8.025 trillion yen (approx. $78 billion, 1.6 percent of 1999 nominal GDP), including 7.45 trillion yen put into 15 banks in March 1999, and an additional 575 billion yen. Together with the public funds used in 1998, the amount totaled 9.8 trillion yen (approx. $95 billion) by 1999 (1.97 percent of 1999 nominal GDP).

When it became clear that LDP leaders could not manage the deepening financial crisis, the Young Turks started to exert their power. The LDP’s diminished political power resulting from the 1998 upper house elections expanded political opportunities for new actors within and outside of the LDP to enact policy initiatives. Subsequent bipartisan handling of financial troubles expanded the size of public fund reserves and injections, increased the number of options for the resolution of the failing financial institutions and tightened the application of rules to measure the health of financial institutions.

The US Case

Worsening Problems, Forbearance Policy and Insufficient Handling by Congress

The Savings and Loan industry (S&Ls) in the USA had been experiencing a squeeze of profits during the early 1980s due not only to development of capital market but also to inflation. In the 1970s and early 1980s, inflation pushed up interest rates and decreased the attractiveness of low-return deposits relative to high-return securities. Regulation Q, which put ceilings on interest rates paid on deposits, prevented S&Ls from raising their interest rates, leading to disintermediation. In response to the S&Ls’ losses from 1980 to 1982, Congress undertook a series of deregulatory measures. The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 and the Garn-St...
Germain Depository Institutions Act of 1982 (Garn-St Germain Act) phased out Regulation Q. Subsequently, S&Ls increased their deposit rates, but this increase pushed up their costs. Since most of the assets of S&Ls were fixed-interest-rate home mortgages, interest rates were fixed in the long term at their pre-inflation levels. Thus, fixed-rated income could not offset increasing costs.

Moreover, the Garn-St Germain Act included other deregulatory measures: expansion of direct aid for troubled S&Ls and relaxation of quantitative restrictions on commercial real-estate lending and on the combined holdings of consumer loans, commercial paper and debt securities from 20 percent of assets to 40 percent. Representative Fernand J. St Germain (Dem Rhode Island) was Chairman of the House Committee on Banking, Finance and Urban Affairs (House Banking Committee) in the Democratic-controlled House, and Representative Jake Garn (Rep Utah) held the chairmanship of the Senate Committee on Banking, Finance and Urban Affairs (Senate Banking Committee) in the Republican-controlled Senate. Deregulation of federally chartered S&Ls drove the states toward deregulation for state-chartered thrifts in order to prevent the state-chartered S&Ls from switching to federal charters (Brumbaugh, 1988: 47–8; Day, 1993: 112–26). The state-chartered S&Ls often were allowed to have more diverse and riskier investments, even though these investments were federally insured.

However, deregulation of the S&Ls was problematic, since deregulation was not accompanied by increased supervision of bank activities and their risks. Rather, regulators eased oversight standards and practices and enabled the troubled S&Ls to stay in operation, with the implicit support of Congress. First, the minimum net worth requirement for thrifts was lowered. Before 1980, the ratio of net worth to liabilities had been 5 percent. The DIDMCA set ratios between 3 percent and 6 percent. The S&L regulatory body, the Federal Home Loan Bank Board (FHLBB), lowered net worth standards to 4 percent in 1980 and to 3 percent in 1982 (White, 1991: 82). Second, the FHLBB modified accounting rules to allow the S&Ls to report higher asset values and net worth than they could have through Generally Accepted Accounting Principles (GAAP). Those rules are the Regulatory Accounting Principles (RAP), which allowed the S&Ls to spread the reporting of losses over a period of 10 years after the sale of assets (Brumbaugh, 1988: 36–49; White, 1991: 82–3). Third, the deposit insurance fund for the S&Ls, the Federal Savings and Loan Insurance Corporation (FSLIC), introduced the concept of supervisory goodwill, which refers to intangible but measurable values, such as the establishment of a customer base. Acquiring S&Ls can create a goodwill asset to cover the difference between the value of the insolvent S&Ls' assets and its liabilities. Based on this notion, S&Ls can count assets more than their actual worth in the market at the time of the merger (White, 1991: 84; Day, 1993: 97–9).
Despite the squeezing of profits and the increasing number of insolvent institutions, S&Ls continued to expand. S&L assets more than doubled between 1980 and 1988. The eventual decrease in interest rates was expected to solve the problems of ailing S&Ls. Even though the situation for the S&Ls looked a little better in 1985 due to falling interest rates, the estimated costs to dispose of all insolvent thrifts still overwhelmed the FSLIC’s reserves, which were less than $5 billion in 1985. Estimated costs of disposal differed among agencies: the Office of Management and Budget (OMB) estimate was between $15 billion and $25 billion, whereas that of the FHLBB was just $8 billion and later re-estimated at $16 billion (Day, 1993: 191).

Faced with the drain of reserves within the FSLIC, then-Chairman of the FHLBB Edwin Gray asked repeatedly for help. Secretary of the Treasury James Baker made a proposal that allowed the use of $15 billion in zero-coupon bonds to recapitalize the FSLIC and resolve the problems of the ailing S&Ls. This fund was separated from the federal government’s regular budget. Since the Reagan administration had made a political pledge to maintain small government and to enact fiscal restructuring, injection of public funds had to be achieved in a less obvious way. A $15 billion recapitalization proposal was put under discussion in the 99th Congress. Although the FSLIC urgently needed recapitalization in order to dispose of the troubled S&Ls, the vote was postponed and recapitalization was not approved before adjournment for the year.

Postponement of the recapitalization vote was due to a controversial political intervention by the powerful House majority leader (and the then soon-to-be Speaker of the House), Jim Wright (Dem Texas). On 24 September 1986, Wright postponed the House vote on this $15 billion recapitalization bill, which had been set for 29 September. By putting the bill on hold, he was applying pressure to dismiss one of the S&L regulators, Scott Schultz, who was about to foreclose a real estate developer in Texas. After Schultz was fired on 3 October, Wright rescheduled the vote and the House approved the bill. However, the Republican-controlled Senate failed to pass the bill before Congress adjourned for the year on 18 October (Pizzo et al., 1989: 202–19; Adams, 1990: 210–33; Day, 1993: 230–4).

The 100th Congress convened on 6 January 1987 and the $15 billion recapitalization plan was discussed again. The S&L League officially voiced its opposition in a hearing in the House Banking Committee, since it feared that capital supplements to the FSLIC could mean the closure of a number of S&Ls. It offered an alternative plan of $5 billion. Treasury Secretary Baker met Wright and threatened a presidential veto of the recapitalization bill if it contained only $5 billion. However, many Democrats and Republicans who had ties with the S&L League via campaign contributions, including House majority whip and head of the Democratic Congressional Campaign Committee Tony Coelho (Dem California), supported the $5 billion plan (Day, 1993: 254–5).
After discussions between leaders in Congress and those in the Treasury, and after negotiations in the House–Senate Conference Committee, Congress passed the Competitive Equality Banking Act (CEBA) in August 1987, approving $10.8 billion in borrowing from public reserves. The conferees agreed on recapitalization by $11 billion with the condition that the White House had to pay $800 million directly to healthy thrifts as a refund of some of the premiums they had paid to the FSLIC. Treasury officials insisted that the amount should be $10.8 billion, rather than $11 billion, as a reminder that the S&L industry was given a subsidy of $0.8 billion. The unusual number was meant to elicit questions from the press (Day, 1993: 247–58). Skeptics abounded among politicians about this resolution, including Jim Leach (Rep Iowa) and Henry Gonzalez (Dem Texas).9

The delayed passage of the recapitalization bill increased the costs of resolution of the troubled S&Ls. Moreover, the amount of recapitalization was too small to address the sharp downturn of S&Ls. It was clear that the S&L debacle had not been resolved. The S&L crisis, however, did not become an issue in the 1988 elections because both Republicans and Democrats had ties to the S&L industry. Because each party was afraid that blaming the other for the handling of the S&L industry would initiate retaliatory accusations, both remained silent. Moreover, because the S&Ls were regionally concentrated in Texas, California, Illinois and Florida, political support derived from regional representation rather than from partisan or ideological affiliation.

The Change in Political Leaders and Progress in Restructuring of Financial Sectors

After the 1988 presidential election, Republican George H.W. Bush Sr became president. The change of administration provided an opportunity to address the S&L problems. On 6 February 1989, immediately after his inauguration, Bush publicly announced a plan that would use taxpayers’ money to close the troubled S&Ls. Bush’s announcement included a proposal to abolish the FHLBB and tighten supervisory standards.

The political defeat of influential individual politicians, who had supported the S&Ls, including St Germain and Wright, created favorable conditions for a more thorough resolution of the crisis. Chairman of the House Banking Committee, St Germain, who championed the S&L industry in 1982, was replaced by Henry Gonzalez in 1989.10 St Germain failed in his bid for re-election in 1988 after a criminal investigation by the Justice Department into his questionable relationship with the S&Ls. The new chairman, Gonzalez, was one of the few legislators who had opposed the 1982 Garn-St Germain Act. Furthermore, the Speaker of the House, Wright, who had been a strong supporter of the S&Ls and had contributed to postponing and curtailing the $15 billion recapitalization
plan, was forced to resign by late spring of 1989. His resignation resulted from an accusation of his intervention on behalf of the S&Ls in Texas and the criminal record of his aide, John Mack (Day, 1993: 321–3).

Moreover, the fact that different parties controlled Congress and the Presidency led to partisan battles over blame for the S&L problem and drew public attention toward the issue. Debate over the use of public funding to solve the ailing S&L industry intensified these battles. Congressional Democrats including Gonzalez began to accuse President Bush and Republicans of mishandling the S&L crisis. Republicans fought back by arguing that it was the Democratic Congress that had approved deregulation of the S&Ls (Kakeya, 1993).

The amount of taxpayers’ money to be used for the S&Ls was initially announced at $40 billion. The total estimated cost was $90 billion, including money from the resale of the S&Ls and a special charge on S&Ls. However, as the estimated cost increased, the amount of taxpayers’ money needed for resolution increased further. Based on a bill drafted by the Bush administration, Congress passed the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) in August 1989. FIRREA authorized an initial use of $50 billion; $20 billion of which was to be spent by 1 October and $30 billion more to be spent from 1990 to 1991. The Act also tightened lending restrictions on the S&Ls through a ban on the holding of below-investment-grade (junk) bonds and raised capital requirements to make them commensurate with those applicable to commercial banks. The FSLIC was also abolished, and the Federal Deposit Insurance Corporation (FDIC) absorbed the deposit insurance function for the S&Ls (Day, 1993: 307–27).

Since $50 billion was insufficient, Congress enacted subsequent legislation authorizing an additional $30 billion in March 1991, $6.7 billion in December 1991 and $18.3 billion in December 1993. Between 1989 and 1995, $91 billion of the approved $105 billion was spent (Curry and Shibut, 2000: 29). The FSLIC Resolution Fund used $41 billion from 1986–95 and the Resolution Trust Corporation (RTC), which was newly created by FIRREA to clean up insolvent S&Ls, used $75.6 billion from 1989–95, totaling $123.8 billion (1.67 percent of 1995 nominal GDP), including other indirect costs (Curry and Shibut, 2000: 31; Mikitani and Posen, 2000: 50; Barth et al., 2004: 250).

Compared to Japan, the USA used a proportionately larger portion of taxpayers’ money, considering the fact that the size of the financial crisis in the USA was smaller. The sum of loans overdue by 90 days or more and those in non-accrual status totaled $80.28 billion in the USA at the end of 1992 (1.27 percent of 1992 nominal GDP) and 25.01 trillion yen ($206 billion) in Japan at the end of the fiscal year 2000 (4.96 percent of 2000 nominal GDP). The magnitude of taxpayers’ money to be used was 1.67 percent of 1995 nominal GDP by 1995 in the USA and 1.97 percent of 1999 nominal GDP by 1999 in Japan.
Furthermore, FIRREA mandated that the Treasury undergo a major study of the deposit insurance system by February 1991. Based on that study, the Treasury published ‘Modernizing the Financial System: Recommendations for Safer, More Competitive Banks’ and proposed a comprehensive banking reform program called the Brady Plan, named after Secretary of the Treasury Nicholas Brady. This plan included deposit insurance reform aimed at resolving the S&L debacle as well as other structural reforms on the geographical and functional powers of banking. The Treasury’s reform proposal was supported by the bipartisan Bank Study Group in the House Banking Committee that was led by Druie Douglas Barnard (Dem Georgia), and supported by Chairman of the House Banking Subcommittee on Financial Institutions, Frank Annunzio (Dem Illinois). Congress introduced similar bills and approved only the proposals relating to deposit insurance reforms by dropping proposals of structural reforms on banking. A deposit insurance scheme was enacted as the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in December 1991. Compared to the FIRREA, the FDICIA incorporated more detailed schemes for financial supervisory practices (Glauber, 1993: 33–41; Reinicke, 1995: 120–33).

An Institutional Explanation for Reform Patterns: A Comparative Perspective

In both Japan and the USA, the restructuring of financial sectors through the use of public funds was delayed. The postponement of reforms increased resolution costs and exacerbated the crises. In the initial stage, the depth and seriousness of the crises were unrecognized, and either gradual economic recovery or declining interest rates were expected to boost financial industries. Two political factors help explain this postponement: (1) hesitancy within the Government due to its contradictory policy goal of fiscal reconstruction; and (2) opposition from the financial sector, financial regulators and congressional representatives.

First, hesitation in restructuring financial sectors using public funds came from conflicting principles between financial sector restructuring and fiscal reconstruction. Since both countries had espoused a commitment to fiscal reconstruction, it was politically difficult to shift priorities toward public fund injections. In Japan, spending taxpayers’ money to stabilize the financial market contradicted the policy keystone of the Hashimoto administration, as seen in the enactment of the Fiscal Structural Reform Laws (Zaisei Kōzō Kaikaku Hō) in November 1997. Similarly, the Reagan administration, because of an increasing budget deficit in the early 1980s, could not authorize large financial expenditures to solve the S&L crisis. Injection of public funds conflicted with its key policy commitments to small government and deregulation. The Reagan
administration wanted to avoid any spending increases, especially before the 1988 election.

Second and more importantly, the use of public funds would have led to political accusations against targeted market players and relevant authorities. Based on that reason, financial institutions in both countries were hesitant to receive public funds. S&Ls in the USA were afraid of forced closures by the Government, whereas Japanese banks were also afraid that public fund injection would signal their financial weakness to the capital market. Moreover, authorities in both countries had an incentive to postpone any resolution process, waiting for the excitement and crises to disappear. In Japan, this was the MOF’s role. The MOF was mostly concerned with the possibility that public fund injection could magnify criticism and intensify reform forces toward its organizational restructuring. In the USA, powerful politicians in Congress filled that role. For example, Chairman of the House Banking Committee St Germain and Chairman of the Senate Banking Committee Garn exercised strong influence to avoid and postpone confronting the S&L problem. This is partly because they were involved in the deregulation of S&Ls, which would later be blamed for contributing to the S&L crisis.

In both countries, the momentum for reform started to grow when a sense of crisis developed among political actors and the public. Reform-oriented politicians intensified their accusations toward former regulatory authorities and policy makers, eventually leading to reforms. However, the ways in which political opinions differed among politicians on the issue of financial sector restructuring and in which reforms emerged varied between the two nations. In Japan, political cleavage was initially based on partisan groups within the majority party, the LDP, and later on, generational groups across governing and opposition parties. In the USA, political cleavage was initially based on regional and personal political connections rather than being partisan-based. After the 1988 elections, political cleavage developed because of party politics and increased divisions between the White House and Congress.

Diverse reform patterns in these two countries originated from their differing political institutions. The strength of party backbenchers, stronger party discipline and the parliamentary system explain Japanese reform patterns. As Peter Cowhey and Mathew McCubbins (1995: 10) argue, in Japan, ruling party leadership is limited in its range of policy options due to party backbenchers. Chairman of the Headquarters on Urgent Countermeasures to Stabilize the Financial System Miyazawa coordinated different proposals given by diverse groups within the LDP. Once consensus was formed within the majority party, the legislative branch, the Diet, was easily able to cooperate with the executive branch, the Hashimoto cabinet, due to Japan’s parliamentary system, passing the Financial Stabilization Law in February 1998.
After the LDP’s loss of power in the upper house, proposals from opposition parties gained greater power. Because the LDP did not have a two-thirds majority in the lower house, bills that were rejected in the upper house would have not been approved. Thus, the executive, the Obuchi cabinet, had to cooperate with opposition parties in the Diet. Since the executive in the parliamentary system all but relies on the political authority of the majority party in the legislative branch, diminished political power of the majority party in the Diet directly led to weakened political power of the executive. Moreover, one obstacle to reforms in Japan was a lack of knowledge about financial issues among top political leaders. The younger generation of politicians in governing and opposition parties, who had recent experiences and knowledge of the financial system while working in law firms, the finance ministry and the central bank, was able to exercise influence over financial issues.

In contrast, weaker party discipline and the presidential system explain reform patterns in the USA. According to John Chubb and Paul Peterson, historically, conflicts between the legislative and executive branches intensified as the Democratic Party solidified its majority power in Congress. The Democratic Party controlled the House for all but four years between 1930 and 1990. Although the Republican Party occasionally controlled the Senate, particularly during the first six years of the Reagan administration (1980–6), they more often held the presidency (Chubb and Peterson, 1991: 39). Although a divided government underlay the entire process of dealing with S&Ls, the role of partisan politics involving a divided government differed depending on the political context, thus making an impact on policy outcomes.

Democrats regained the Senate, controlling both the House and the Senate in 1987. However, political cleavages did not develop along party lines before and during the 1988 elections. Congress was initially overwhelmed by regional concerns and individual politicians’ political connections with S&Ls rather than partisan affiliation, reflecting the weaker party’s discipline in the US political system. Moreover, since the S&L debacle was a regionally concentrated problem, it did not become an electoral platform in which politicians competed with the other party’s candidates in each region. In 1987, bipartisan coordination in Congress led to the enactment of the CEBA by dealing with the conflicts between Congress and the White House. Political connections with S&Ls rather than party affiliation determined attitudes toward this recapitalization bill.

Once the 1988 elections were over and reforms were announced, party politics intensified the inherent tensions of a divided government, creating competitive pressures toward thorough restructuring of S&Ls. Under the Democratically-controlled Congress and Republican presidency in 1988, partisan confrontation was intensified between the President and the Chairman of the House Banking Committee, leading to serious investigations into the S&L debacle. Due to the obvious need to resolve the S&L debacle, partisan confrontations led to
competition for thorough resolution of the S&L debacle by increasing the amount of public money used, investigating the problem and introducing deposit insurance reforms.

In conclusion, initial restructuring of financial sectors was more compromise-oriented in the USA, where regional interests overwhelmed Congress and a divided government curtailed the content of proposals put forth by the executive branch. In Japan, the majority party was able to launch a relatively comprehensive plan even at the initial stage of restructuring, although this resulted in limited implementation. Later, however, in the USA, the presidential system and the divided government intensified partisan conflicts and created competitive pressures toward more thorough financial sector restructuring. In Japan, the parliamentary system and the loss of political power by the governing party in the upper house led to greater political cooperation between the governing and opposition parties. Thus, the policy outcomes in Japan incorporated various proposals from different party coalitions.

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Notes

1. The threshold is currently 10,000,000 yen/depositor/insured bank in Japan and $100,000/depositor/insured bank in the USA.
2. In October 1996, the LDP won the election after promising financial and administrative reforms. The second Hashimoto administration took office in November 1996.
3. The MOF Budget Bureau had consistently been the most powerful actor in support of fiscal structural reform and increased taxes, including the introduction of a consumption tax.
4. This was the name of the upper house arm of the New Komeito.
5. This policy coalition reflected political struggles between opposition parties. The largest opposition party, the DPJ, was not included in this coalition.
6. In 1986, the FSLIC was classified as insolvent.
7. Texas was one of the states most seriously affected by failing S&Ls.
8. After the 1986 elections, Democrats retained the majority in the House and recaptured the Senate. The chairmanship of the Senate Banking Committee went to William Proxmire (Dem Wisconsin), replacing Jake Garn.
9. Gonzalez opposed the deregulation of S&Ls in the early 1980s and conducted a thorough investigation when he became chairman of the House Banking Committee.
10. In 1989, chairman of the Senate Banking Committee William Proxmire (Dem Wisconsin) was replaced by Donald Riegel (Dem Michigan).

11. In the 1988 elections, the Democrats captured both the House and the Senate.

12. During the Reagan administration, then-Vice President George Bush Sr led the Task Group on Regulation of Financial Services.

13. In 1995, most of the disposal of S&Ls was completed, and the RTC ceased operations.

14. The numbers were calculated based on data from the websites at the FDIC (http://www2.fdic.gov/SDI/SOB/) and at the Bureau of Economic Analysis, US Department of Commerce (http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=5&FirstYear=2005&LastYear=2007&Freq=Qtr).

15. The numbers were calculated based on data from the websites at the Financial Services Agency (http://www.fsa.go.jp/news/newsse/e20000728–1b.html) and at the Economic and Social Research Institute (ESRI), Cabinet Office, Government of Japan (http://www.esri.cao.go.jp/jp/sna/qe073-2/gdemenuja.html (in Japanese)).


List of Acronyms

BOJ: Bank of Japan
CDs: Negotiable certificates of deposit
CEBA: Competitive Equality Banking Act
CPs: Commercial papers
DICJ: Deposit Insurance Corporation of Japan
DIDMCA: The Depository Institutions Deregulation and Monetary Control Act
DPJ: Democratic Party of Japan
FDIC: Federal Deposit Insurance Corporation
FDICIA: Federal Deposit Insurance Corporation Improvement Act
FHLBB: Federal Home Loan Bank Board
FIRREA: Financial Institutions Reform, Recovery and Enforcement Act
FRC: Financial Reconstruction Commission
FSA: Financial Supervisory Agency
FSLIC: Federal Savings and Loan Insurance Corporation
GAAP: Generally Accepted Accounting Principles
LDP: Liberal Democratic Party
LTCB: Long-Term Credit Bank
MAFF: Ministry of Agriculture, Forestry and Fisheries
MMMFs: Money market mutual funds
MOF: Ministry of Finance
NCB: Nippon Credit Bank
OMB: Office of Management and Budget
RAP: Regulatory Accounting Principles
RCC: Resolution and Collection Corporation
RTC: Resolution Trust Corporation
SDPJ: Social Democratic Party of Japan
S&L: Savings and Loan
S&Ls: Savings and Loan industry

References


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