

# Activism Tempered by Reason: Lessons from Tokyo

## By Heizo Takenaka

**As the world struggles to cope with the effects of the financial crisis, policymakers would be well advised to look at the experiences of Japan during its crisis of the 1990s.**

**Heizo Takenaka, one of Japan's leading economic reformers, argues there are important lessons on what to do, and what not to do.**

THE DEBACLE CAUSED BY the collapse of the subprime mortgage market in the United States has brought financial instability to the whole world. The failure of Lehman Brothers and uncertainty over the effectiveness of the stimulus and bailout programs in the US last year raised enormous uncertainty about economic management and triggered global disruption.

Since then, however, many countries have acted. The US Congress passed a revised asset relief law, European countries injected public funds into banks and central banks lowered interest rates. Despite all this, markets remain uneasy, equities are down worldwide and trade and export figures have plummeted. Details differ, but virtually every country has been forced to take emergency measures.

The world faces a crisis of confidence. On top of the subprime crisis, there is a loss of confidence in both policy and the political process. This is a special case where government failure compounded market failure.

A similar crisis of confidence hit Japan in the 1990s, after the collapse of the late-1980s bubble. That crisis occurred because Japan hesitated to inject public funds and instead reacted solely with mistaken policies to expand demand. That is, government action was misdirected and too late. It took nine years from the collapse of the bubble until the first injection of public funds.

Once a crisis of confidence starts, there is only one thing to do. Both the government and the central bank must take all possible actions to quell the crisis. Crisis demands action.

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<sup>1</sup> Mark-to-market accounting is a technical accounting rule that pegs the value of balance sheet assets, or marks, to market sale prices. But with assets that are not as liquid as equities traded daily, such as some mortgage securities, this can be messy, especially with exotic securities whose value is hard to gauge accurately. This has become an issue in the current crisis, leading to calls to suspend the rule.

In Japan, the Diet session that convened in autumn 1998, eight years after the collapse, finally concentrated on financial issues. This session was labeled the “financial Diet,” and prepared the basis for the injection of public funds. Then, in 1999, a total of ¥7.5 trillion, or 1.5 percent of GDP, was injected into major banks.

It was not enough. The crisis of confidence continued until other measures were taken, and Japan’s crisis only subsided in 2003. Japan’s bitter experience has lessons for the rest of the world. Let me point out two.

#### **RESTRAINED ACTIVISM**

First, injecting public funds alone did not solve the problem. Rather, sequencing was important — there must be precise and strict asset appraisal at financial institutions. Only then should the necessary capital be injected — and quickly.

Lack of trust in balance sheets was the most important source of concern in Japanese financial markets at that time. Unfortunately, at the end of the 1990s, Japan injected public funds while bad assets were still being concealed. As a result, the financial crisis continued even after public money was spent. The solution came only in 2002, after the introduction of the “Financial Revitalization Program” under Prime Minister Junichiro Koizumi. Under this program, strict inspections were carried out, and necessary capital injections were made. Then, after public money was put into Resona Bank in 2003, the situation began to improve.

The second lesson is that activism can go too far. Activism is essential in a crisis, but there are some steps to avoid. When excessive protection is given to some institutions, the impact on others can worsen the crisis of confidence.

In this context, the world trend toward reversing mark-to-market accounting<sup>1</sup> is troubling. In order to prevent the financial condition of in-

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stitutions from appearing to worsen, the idea is to temporarily reverse some accounting rules. This is a mistake. Reversing mark-to-market rules increases investor worries about balance sheets. Confusion stemming from uncertainty over the true state of balance sheets deepens in such a climate.

It is easy to understand why some view reversal of mark-to-market accounting as an activist policy. But when activism is used for financial stabilization, the right sequence is, first, to enforce precise and accurate asset assessments, and, then, to show flexibility in financial oversight standards (such as capital ratios and listing standards on exchanges). Changing accounting rules is counterproductive.

The accounting issue is particularly delicate when a crisis hits at the time of an election. This has a tendency to push politics toward indis-

criminate activism. This issue triggered a major debate in Japan in 2003, when an election coincided with a financial crisis. At the time, many politicians and industry groups called for the suspension of mark-to-market accounting. These people saw the move as a way to stop banks from falling into capital shortages. In the end, the Japanese government, under the leadership of then-Prime Minister Koizumi, rejected this view. Had we done this, investors would have been even more confused, and would have lost even more confidence in financial statements. Had we reversed mark-to-market accounting at that time, bad loan disposal and economic recovery would have taken even longer.

When facing a crisis of confidence, both flexibility and boldness are crucial. That said, urgency is no excuse for recklessness. Distorting accounting standards is a classic example of indiscriminate activism. This issue will test the restraint and wisdom of political leaders.

#### MANAGING A NEW ASIA-PACIFIC

Based upon recent experiences in the US and Japan, new economic management of the Asia-Pacific region is now required. We should learn the following three lessons.

First, a bubble economy can occur anywhere and it influences other countries very easily. Especially in this region, where economies are deeply integrated, these influences are extremely volatile. So, it is necessary to provide mutual early warning schemes in the region to avoid overvaluing markets.

Second, once a crisis in confidence occurs, cooperation among fiscal and monetary authorities is indispensable. We urgently need a more solid framework for policy coordination not only in macroeconomic policy but also in banking policy and so on. Over-activism by government can be checked under such a cooperative scheme.

Third, decision making in the private sector also has a great impact on economic performance. In a crisis of confidence, distorted decision making by the private sector can sometimes cause serious economic damage. To avoid such trouble, the role of the media is quite important. Regrettably, in both the US and Japan, inaccurate information provided through the media distorted private sector decisions and worsened the situation. Disclosure of information should be accelerated to avoid this.

Considering what I have said, the establishment of something like an Asia Monetary Fund should be seriously considered in order to strengthen economic governance in the region. Also, based on the leadership of the US and Japan, we should again strengthen intellectual exchanges in the region, which is always the most important base for stable international relations.

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