

**Government, Business and Markets after the Lehman Shock:  
A Review of Aid to the Business Sector in Japan**

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Amid the unprecedented economic turmoil following the Lehman Shock, the policymakers went farther than ever before in their attempt to cope with the crisis. What is important to note, however, is the fact that such a policy action inevitably amounts to greater government interventions in free economic activity. Coping with the crisis by means of an extensive policy intervention involves the risk that such government intervention may also harm the free market's mechanism of allocating resources.

The bigger the crisis is, the greater the hopes are placed on policy responses. As a result, we tend to give inadequate consideration on the negative aspects of those policy measures. This is why it is important to have an exit strategy which brings such measures to end as early as possible while monitoring their impact on the crisis.

With these considerations in mind, an international debate has already begun regarding the exit strategies on the fiscal and monetary policies. This report will examine the governmental aid measures provided to "general business firms," meaning those outside the financial sector.

There are two reasons for examining the measures to assist general business firms. First, such measures were particularly exceptional even among the extraordinary actions taken in the wake of the Lehman Shock. Troubled banks can present a danger to the entire economic system because they hold deposits. For this reason, many have argued that the government must sometimes step in to support such financial institutions. The grounds for extending public assistance to ordinary business firms are however regarded as dubious.

Another reason is that the measures to assist business tend to cause problems concerning the relationship between the policy intervention and the market. This is important because free business activity is a key to the effective functioning of the market mechanism.

Thus, the question is whether it is advisable for government to intervene in fundamental areas of the market system in a way hardly conceivable in the past\*.  
[\*Note: This report was prepared based on discussions among Tatsuo

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Kobayashi, Shinji Takenaka, and Naoki Abe (currently at the Brookings Institution) at JCER and Kunio Saijo, senior and editorial writer at NIKKEI Inc. The author's thinking on these issues also benefited from the views of Kazuhiko Toyama, CEO of Industrial Growth Platform, Inc.]

## 1. Growing state intervention and the need for exit strategies

Following the Lehman Shock in September of 2008, the global economy as well as the Japanese economy fell into unprecedented turmoil. Investors pulled out of financial markets, and economic activity plummeted. The havoc in finance and real economic activity had international repercussions through financial markets and trade, so much in fact that some observers genuinely feared the possibility of another Great Depression.

Given the situation, nations around the world successively worked out some extraordinary policy measures in order to halt the economic chaos. Japan was no exception. The authorities took some unprecedented steps to cope with the unparalleled crisis. Their principal parts are composed of the following.

The first part consists of financial measures. Following the outbreak of the sub-prime crisis, the initial impact on finance in Japan was comparatively limited. After the Lehman Shock, however, the investors became increasingly risk averse. In particular, the borrowers found it very difficult to issue the corporate bonds and the commercial paper.

In response to these developments in financial markets, the Bank of Japan slashed its policy interest rate twice. In addition, the BOJ sought to stabilize financial markets and facilitate corporate finance through the "nontraditional monetary policies" which included extraordinary operations to support corporate finance through the purchase of commercial paper and corporate bonds. The Bank also bought the equities held by financial institutions with a view to stabilizing the financial system.

Second, the aggregate demand was stimulated through fiscal policies. Beginning in August of 2008, the government put together four packages of economic policies and three supplementary budgets. During these efforts, the government worked out the measures to spark demand, which includes the fixed-amount cash handouts, the mortgage tax breaks, and the subsidies for the purchase of fuel-efficient cars. Adding other employment and monetary measures to the above, the government expenditures amounted to about 26 trillion yen all told.

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The third group of policy measures aims to aid business firms. It is the central focus of this report and will be discussed below.

Assessing such an extraordinary spectrum of policy measures is no easy task, but if the economic conditions were to deteriorate so badly that another depression indeed threatened, the economic shocks would likely be unimaginable. As long as the measures prevented such a disaster and accomplished nothing else, they would be no doubt justified in the circumstances.

Even so, its true assessment has only just begun. The extraordinary policies are meant to be strictly temporary and should be unwound when the time is right. Those policy measures are, in fact, expected to have their negative side effects as follows.

First, they may undermine the future economic performance. For example, the current monetary easing measures, continued at exceptional scale, could sow the seeds of the inflation or the yen depreciation in the future.

Second, such measures increase the burdens on future generations. The fiscal stimulus measures, needless to say, enlarge the government deficit and add another burden onto future generations. In addition, the BOJ's nontraditional monetary policy and the financial assistance by the government for business firms assume the firms' credit risk. In some cases, the taxpayers would end up shouldering their ultimate burden.

Third, over the long term, such measures can undermine the market's resource allocation function. Needless to say, the markets, based on free economic activities, have the function to efficiently determine the allocation of national income and balance the supply and demand. When the government stimulates the demand in a particular field, supports particular business firms or provides the funds to particular industries or companies, then it obstructs the market's function of efficient resource allocation.

Fourth, when monetary and financial aid measures are kept in place too long, the recipients tend to slacken their efforts to reform. That is, such assistance can breed "moral hazards."

The major task now, therefore, is to proceed with the exit strategy for gradually unwinding this series of exceptional measures while monitoring the economic conditions. This is a question of how to balance the short-term policy targets with

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the long-term ones. Considering the circumstances which followed the Lehman collapse, the government clearly needed to take various emergency measures for the short term. However, the strong and sustainable long-term growth requires a sound financial system, price stability, sound government finances and the markets in which an entrepreneurial spirit based on individual and corporate responsibility thrives. If the government continues emergency economic measures longer than necessary, they will damage those long-term goals. This is why an exit strategy is necessary. The historical assessment of this recent series of policies will thus rest on whether or not the exit strategy succeeds.

## 2. Support for business firms in Japan after the Lehman shock

Several types of business support measures were undertaken in Japan after the Lehman debacle. These support measures break down into the two broad categories as follows.

The first category is the monetary support. As a component of its emergency response to the crisis, the government established the system for providing emergency financial support to businesses through the Development Bank of Japan and the Shoko Chukin Bank. The outstanding loans through these means stood at about 2.7 trillion yen at the end of August, 2008. Its part of about 270 billion yen is, in addition, supported by the governmental guarantee against the events of default\*. [\*Note: Ministry of Finance, "Chuken-Daikigyo Muke no Shikinguri Taisaku to Shite no Kikitaio no Jisshi Jokyo (Hachigatsu Su-e Jiten) [Status of Policy Package to Address Economic Crisis via Measures to Support the Cash Flows of Medium-Sized and Large Firms (as of the end of August)]."]

The second category of measures is the support for the companies in their effort to rebuild their business. The representative examples include the policy actions based on the revised Industrial Revitalization Law, enacted in April of 2009. The amendments allowed the government, through the Development Bank of Japan, to provide the capital to companies in their temporary financial difficulties due to the financial crisis\*. [\*Note: Please see Table 1 at the end of this report for the details.] In June, Elpida Memory, Inc., the Japanese DRAM maker, qualified first. As an ad hoc measure, the Japanese government also continues to provide a generous financial assistance to Japan Airlines Corporation, guaranteeing the loans extended through the DBJ.

There are two conceivable factors underlying such measures. The first was likely the firms' difficulty in raising funds as the risk capital dried up in the wake of

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Lehman's collapse. Investors turned particularly risk-averse after the Lehman debacle, making it extremely difficult for business firms to raise capital through the markets. In principle, the governments are supposed to intervene in response to market failures; one could say the market had vanished rather than failed in this case.

The second factor was the unusually severe decline of production in the Japanese manufacturing industry following the Lehman debacle. The decline in Japanese manufacturing activities was far more severe than the one in the United States, where the crisis originated. A good reference to the case is the comparison between the auto industries of those two countries, discussed at the end of this report.

Any assessment of such measures by the Japanese government first requires the understanding of the principle; that is, such government interventions can be justified only in a market failure. In this regard, the government in some respects had no choice but to extend the bridge loans to avoid a crisis because the capital markets had frozen up in the immediate wake of the Lehman collapse. The government however needs to gradually withdraw its support as the capital markets return to the normal state.

At the same time, the measures to assist companies in rebuilding their business raise a number of concerns. First, the measures provided under the Industrial Revitalization Law were diverse; however, it was unclear what type of market failures they intend to address. One requirement for capital injections into a business firm was that it "holds its domestic employees of no fewer than five thousands" or that it "supplies such companies with at least 30% of any key component" and "its substitutes are difficult or impossible to find." This could be read as extending the principle of "too big to fail" to general (non-financial) business firms. The question is whether such measures virtually constitute any unwarranted government intervention.

Second, the capital injections, going beyond the loans, are unusual in any countries. In order to prevent its intervention from distorting the resource allocation, the government needs to avoid selecting particular industries and companies in an arbitrary manner. The concern is whether the way of capital injections were excessively arbitrary.

Third, any government intervention is supposed to be temporary; on the other hand, it will be difficult to adhere to this principle when the structural problems of a business firm count as the reason. The slumping performance of the Japan Airlines, for example, was not just due to the economic crisis but mostly to the

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long-term loss of its competitiveness. If the government financial assistance continues without addressing its structural problems, the intervention will drag on, raising the chances that taxpayers end up bearing the burden in the end.

Fourth, the Japanese bureaucracy can impair the transparency of the overall policy structure, leading to the self-justification and excessive lengthening of government intervention. In the Japanese regulatory bodies, the constituent members are fixed in each ministry or agency; in addition, the authority is vertically arrayed in each section. For this reason, there is a strong tendency for the regulators to keep strengthening the function of their organization and expand their own roles.

Looking at the Industrial Revitalization Law before and after the recent amendments, the amendments have allowed a deeper and more extended intervention of the government. It results in a growth of the government organization and a strengthening of its roles.

Moreover, the above intervention scheme is administered by several different ministries including the Cabinet Office, the Ministry of Economy, Trade and Industry and the Ministry of Land, Infrastructure, Transport and Tourism. As a result, the overall policy structure is in some respects more difficult to observe from the outside of the government.

Thus the concern is that, once the authorities have initiated their policy measures and keep the operation, the government intervention becomes increasingly self-perpetuating because of the bureaucracy. Those policy measures would then become more unlikely to end even though they lost their purposes.

In a time of great economic turmoil like the one following the Lehman shock, the anxiety regarding finance and employment intensifies. Consequently, people can tolerate any policy measures as long as they stabilize the economy. However, we must keep in mind the principle that business activities should be as free as possible in a free-market economy. Any government intervention must be also minimal and limited to the cases of market failure.

If the government makes light of those economic principles and intervenes for dubious reasons over a long period, three main problems can result. First, the superannuated industries and firms will exit too slowly and instead be perpetuated. Second, the moral hazards will arise, weakening the self-help efforts of business firms. Third, those two outcomes can lead to a trade protectionism indirectly, undermining the global trend toward free trade.

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Such problems can be exacerbated by "political leadership." If the policy debate remains at a mere political level, a long-term government intervention can be justified for some emotional reasons including the negative impact of a large corporate failure on employment and the preservation of Japanese core industries.

For coping with the above issues, the prior enunciation of an exit strategy on the public assistance for Japanese firms should acquire its significance. From this perspective, any assessment of the recent series of policy measures in Japan should be based on the common criteria among the ministries and carefully reviewed on a regular basis to evaluate its necessity.

### 3. Government aid for business firms in Japan and the U.S. compared

In the course of the recent economic crisis, the U.S. government also extended the support to businesses, mainly in the automobile industry. Observers were particularly interested in the financial aid given to the Big Three automakers. It is true that the measures prevented their collapse and the subsequent economic turmoil and thereby played a role in mollifying the economic crisis to some extent.

If we compare the measures taken in the U.S. and the interventions in Japan, the following issues come to the fore. First, the Japanese government intervention above in support of general business firms was not focused on specific industries. In contrast, the measures taken by the U.S. government were mostly on the automobile industry. The US government is therefore thought to have intervened not only in business management but in the structure of industry.

Second, the measures taken in the U.S. had significant international repercussions, leading in some respects to the competition among the auto-producing nations in protecting their own auto industries.

In response to the U.S. government's action to rescue the Big Three automakers, a large number of other countries also took measures to rescue their own automobile manufacturers. According to the Center for Automotive Research, a US think-tank, such government supports in 2009 amounted to a massive scale on the globe, beginning with the largest sum of 90 billion dollars in the United States and 60 billion dollars in Europe. The Nihon Keizai Shimbun



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estimated the total worldwide amount at 164.2 billion dollars (about 15.6 trillion yen)\*. [Note: Nihon Keizai Shimbun morning edition, August 9, 2009.]

The government aid for business activities does not amount to a trade-restricting measure in and of itself, but its net result is consequently to give the domestic industry a competitive advantage. As a result, it does interfere with the trade of other nations indirectly. In this sense, the support for industries is linked to trade protectionism. The support for the US Big Three automakers therefore risks moving the world in the direction of protectionism.

Third, there is a concern that the measures to aid the U.S. auto industry will drag out. If their deteriorating performances were a temporary phenomenon associated with the economic crisis, then the firms could get back on its feet following a temporary government rescue. But the problems of US carmakers are, in fact, long-term and structural to a substantial degree.

The U.S. automakers were late in addressing the environmental concerns; the failure led to the decline in their market shares over the long term. In the absence of solutions to such structural issues, the government intervention will drag on and on.

#### 4. Toward a desirable exit strategy

In view of the above considerations, both Japan and the United States should bear the following points in mind regarding the governmental aid for business firms.

First, they must remember the basic principle that any impact of rescuing businesses through a government intervention is destined to be short term. Over the long term, only self-help efforts by the business firms will rescue themselves.

Second, as is the case with the fiscal and financial policies, the governments need to clarify beforehand the exit strategy on any government interventions.

Third, any exit strategy needs an international coordination. When each country monitors the actions of other nations and chooses their options, the first nation to exit should face a competitive disadvantage. As a result, no single country wants to be the first to exit, which could prolong the interventions in all the countries.



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## Appendix: The Downturn in the Auto Industry: A Japan-U.S. Comparison

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The downturn experienced by automakers was far more severe in Japan than it was in the United States. In the first quarter of 2009, the year-on-year decline in the auto production (ex-trucks) was 570,000 cars in the United States but 1.37 million cars in Japan. Why should this happen? In order to understand the underlying causes, let's compare the changes in overall supply and demand in the markets. In this case, the total demand is the sum of domestic sales, exports and inventory increases. The total supply is the sum of domestic production and imports. The total demand then equals the total supply. In the first quarter of 2009, the Japanese auto demand fell 1.39 million cars on a year-to-year comparison. The domestic sales fell 320,000; the exports declined 1 million; the inventories decreased 70,000. On the supply side, the domestic production fell 1.37 million while the imports decreased 20,000 (Figure 1).

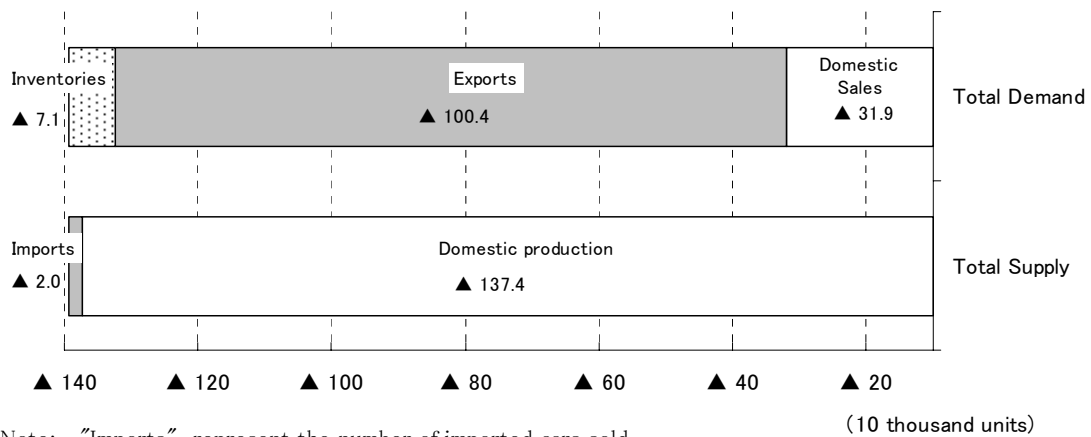
In the US market, meanwhile, the demand for cars fell 710,000 over the same period. The domestic sales fell 520,000 cars; the exports decreased 70,000; the inventories declined 120,000. On the supply side, the domestic production fell 570,000 cars while the exports decreased 140,000 (Figure 2).

In other words, given the US higher dependency on imports, the drastic decline in demand cut sharply into both the domestic auto production and the imports. On the other hand, the Japanese auto industry highly depends on exports; thus, the exports fell sharply, in addition to the decline in the domestic sales. In this way, the decline in Japanese automobile production was much greater than that in the United States.

The fall in automobile production value brings down the value of domestic production overall through the spillover effect on other industries. The change in overall production value induced by a 1-unit change in the value of automobile demand, based on the input-output table, was estimated to be 2.38 units for Japan and 2.10 for the U.S. The cause of the lower figure for the U.S. is thought to be the greater leakage through the imports, compared to the Japanese auto production at large.

In the first quarter of 2009, the industrial production activities fell at an annualized rate of 34% in Japan and 11.6% in the United States from the same quarter of 2008. The contribution from the auto industry was -9.2% in Japan and -1.6% in the United States (Figure 3). The share of the auto industry is relatively larger in the whole Japanese production, compared to the U.S. The decline in the Japanese automobile sector thus made a greater contribution to the decline in the overall production activities than the US counterpart.

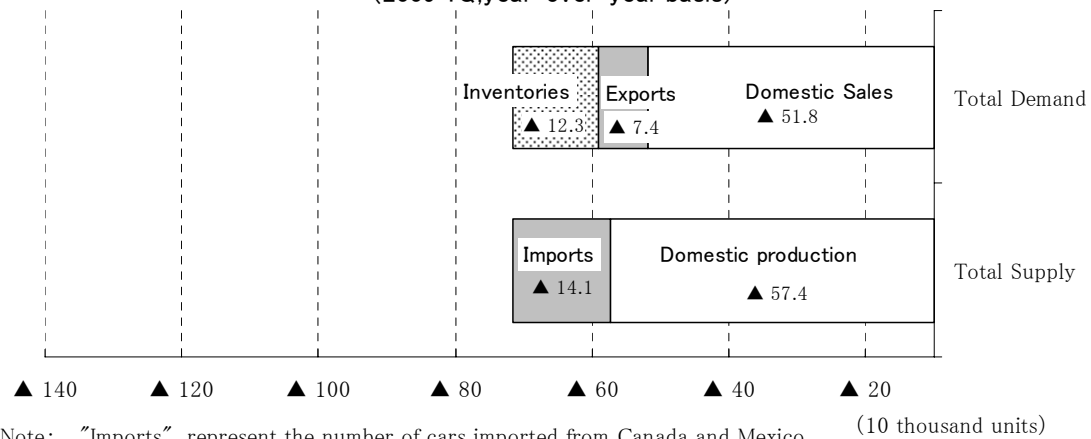
Figure1 Decline of Supply and Demand in Japanese Passenger Car Market  
(2009 1Q, year-over-year basis)



Note: "Imports" represent the number of imported cars sold

Source: Japan Automobile Manufacturers Association

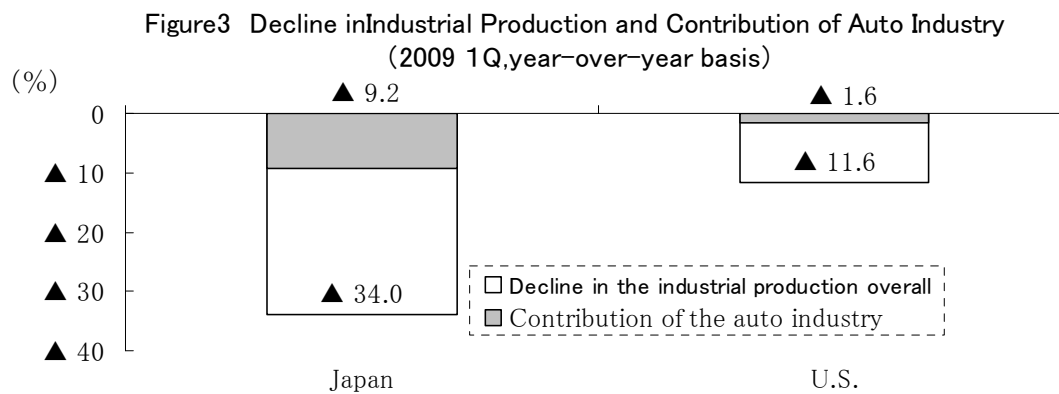
Figure2 Decline of Supply and Demand in U.S. Passenger Car Market  
(2009 1Q, year-over-year basis)



Note: "Imports" represent the number of cars imported from Canada and Mexico

Source: U.S. Department of Commerce

"National Economic Accounts ---Supplemental Estimates Motor Vehicles"



Source: Ministry of Economy, Trade and Industry, "Indices of Industrial Production."  
Federal Reserve, "Industrial Production and Capacity Utilization"

**Table 1. Industrial Revitalization Support by the Government of Japan: An Overview of Frameworks**

	Industrial Revitalization Corporation of Japan (IRCJ, 2003-2007)	Act on Special Measures for Industrial Revitalization (the Law to Partially Amend the Act on Special Measures for Industrial Revitalization and Other Laws to Foster Innovation in Industrial Activities in Japan)	Enterprise Turnaround Initiative Corporation of Japan (expected to last for five years from 2009)
Methods of financial support	Purchase of the company's bonds held by financial institutions except for the main financing bank (and sales of the bonds at the end), additional financing, capital investment, trusts, guarantee	(1) Debt guarantee through Organization for Small & Medium Enterprises and Regional Innovation, Japan; (2) Facilitation of finance, backed up by the compensation guarantee of the government financial institutions, against the possible losses of capital investments	Purchase of the company's bonds (and sales at the end), capital investment, funding loans
Problems in the supported companies	Unable to revive on their own because of difficult circumstances e.g. the bond holders' conflict over their complicated interests	The qualifications for the loss compensation noted above: (1) Rapid deterioration in the business; (2) Need for capital contributions in addition to the loans; (3) Substantial impact on domestic economy (the possible job loss of 5,000 employees or the abandonment of supplying 30% of key components or more to a firm of the equivalent number of employees); (4) Eligibility for a syndicated loan from the financial institutions other than those of government sectors.	Medium-sized, heavily indebted firms of important role in local economies (except for public corporations and third-sector of a regional government)
Examples of supported companies	Kanebo, Ltd. & Kanebo Boutique Co., Ltd., Daiei Group companies, Kyushu Industrial Transportation Co., Ltd.	Elpida Memory, Inc., Isetan Mitsukoshi Holdings	
Requirement for the support provision (must be achieved within three years)		(Below, the qualification for the support on business restructuring)	
1. Productivity improvement (Any of the following requirements must be satisfied.)			
Return on equity (ROE)	By 2 percentage points or more	By 2 percentage points or more	
Tangible fixed assets turnover	By 5 percentage points or more	By 5 percentage points or more	
Value added per employee	By 6 percentage points or more	By 6 percentage points or more	By 6 percentage points or more
Other criterion	An improvement equivalent to the above three		
2. Restoration of financial affairs (Both of the requirements must be satisfied.)	(1) The ratio of interest-bearing debt to cash flow lower than or equal to 10; (2) Ordinary revenue exceeding ordinary expenditure.	(1) The ratio of interest-bearing debt to cash flow lower than or equal to 10; (2) Ordinary revenue exceeding ordinary expenditure.	(1) The ratio of interest-bearing debt to cash flow lower than or equal to 10; (2) Ordinary revenue exceeding ordinary expenditure.
3. Business innovation (any one of those at right)		New products or services account for 1% of sales or more. Manufacturing cost and sales expenses fall by 5% or more. Sales growth rate exceeds the industry average by 5% or more.	
4. Consideration on Employment			
Labor-Management consultations	(1) Discussion on the business revitalization plan, or (2) Schedule to discuss the plan	Discussion on the contents of their business revitalization plan	Discussion on the contents of their business revitalization plan
Number of employees		Number described clearly in the business revitalization plan	
Secondment, transfer, layoff		Breakdown of secondment, transfers and layoffs clearly described in the business revitalization plan	
5. Change in business structure	No detrimental impact on the elimination of excessive supply in the industry overall	Any of the following requirements must be satisfied: (1) startup, growth and efficiency improvement of the core business or (2) downsizing or abandonment of non-core businesses.	
6. Others	Value of bonds after the revitalization plan must equal or exceed the value at the initial IRCJ's purchase. The bonds must become highly likely to be sold within three years.		Management must draft plan, apply for the aid and revitalize the business within three years