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played significant role in attempts to stabilize the financial system as well as to prevent deflation from becoming a serious deflationary spiral. Providing ample liquidity is one way that would work both to stabilize the financial system and to stop deflation. This was implemented by increasing target amounts of the current account balance (held by financial institutions) at Bank of Japan in 2003 to 2004. The target amount of current account balance had become an instrument of monetary policy when the interest rate became zero in the spring of 2001.

The Nikkei 225 stock prices hit the bottom at 7,607 yen on April 28 and started a recovery. What made that turnaround may be interesting to discuss (in the future work). Whether new monetary policy contributed to this more than the Takenaka plan can be debatable.

The paper highlights the importance of the Takenaka plan, but further investigations in the future would produce a comprehensive assessment of the role of Minister Takenaka's role at the bottom of the financial crisis in Japan.

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Comment Randall Morck

This chapter is a useful addition to our knowledge of bank regulation. Its importance transcends Japan because it is really about how monetary and fiscal authorities should go about providing lender-of-last-resort services. But its importance also transcends macroeconomics because it is ultimately about how strategic thinking needs to guide economic institutions.

The framework the authors use to develop these issues is Japan's prolonged financial malaise around the turn of the twenty-first century. Successive capital investment, stock market, and real estate bubbles left the country's banks severely weakened. These bubbles played out roughly along

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the formula Kindleberger (1976) describes—genuine growth opportunities attract capital, but the attraction persists even after the opportunities are exhausted. Overinvestment and asset price inflation ensue until the dissonance with fundamentals becomes too obvious to ignore, at which point the house of cards collapses and liquidity evaporates. The economy is left without adequate credit for sound investments and a recession persists.

This synopsis, of course, grossly oversimplifies Japan's economic malaise, as it does the scores of other financial crises Kindleberger reviews. But this, like all the others, follows the basic pattern closely enough that same fundamental paradox is the rub.

As Kindleberger explains (1978, 9) "A lender of last resort should exist, but his presence should be doubted." If the economy develops a severe financial crisis, the central bank should step forth to bail out the collapsing financial system. But the owners, managers, and creditors of financial firms must not expect such bailouts, lest they grow lax and permit financial crises to develop. Kindleberger proceeds to write a book about how sustaining this essential time inconsistency is imperative to macroeconomic stability.

One path that sometimes leads through this logical morass is "secrecy": sustain the dead financial institutions on financial respirators, but let the public believe the bank is hale and healthy. Financial history shows this remarkably successful on occasion. For example, virtually all the major Canadian banks were technically bankrupt at the height of the Great Depression, but the government buried the evidence. Even as depositors queued for blocks to withdraw their savings from collapsing American banks, the major Canadian banks stood in quiet serenity. Half a century later, the records were opened and these facts laid out (Kryzanowski and Roberts 1998, 1999). The conventional wisdom that nationwide branch systems geographically diversified the Canadian banks, and thus stabilized them, was overturned. Financial forbearance to zombie banks, not geography, stabilized the Canadian banking system.

This sort of forbearance was precisely the strategy the Japanese authorities tried first. For about ten years, from the bursting of the bubble economy in the late 1980s to 1997, the government studiously avoided the issue—waiving regulations and injecting funds into clinically dead banks. But this meant the banks had to play along by feigning health and not recognizing their past errors. As the authors point out, this was not good for the economy because "The regulatory forbearance in helping undercapitalized banks allowed banks to roll over loans to nearly insolvent firms. . . . The subsidized lending led to credit misallocation from manufacturing firms with high productivity to nonmanufacturing firms with low productivity." Perhaps something similar happened in Canada in the 1930s—certainly the Great Depression there was no less calamitous than in the United States.

A second way through the paradox of the lender of last resort is to bail out innocent bystanders, while leaving banks' decision makers to the consequences of their decisions. This is the next path the Japanese government tried. In 2002, the government "requested" that banks disclose their nonperforming loans more honestly and ended its regulatory forbearance, but simultaneously established a system of deposit insurance to bail out households if their banks failed. This Takenaka Plan confirmed the existence of a lender of last resort—for banks' depositors, but not for their managers, shareholders, customers, or other creditors. There would be no U.S. Great Depression-style bank runs because the Japanese government would guarantee households' bank accounts.

But this worked little better—in part because of the unusually thick ties between Japan's banks and their client firms. Japanese banks, unlike banks in most countries, hold corporate shares as capital. As word spread of the mismanagement of major Japanese businesses, and of their banks' abetting that mismanagement, stock prices tumbled, reducing the banks' capital reserves and rekindling fears of a crisis. The government responded with further liquidity injections into the banking system plus a nontraditional monetary policy—the government purchased banks' shareholdings. This was another bailout, for the government almost certainly paid the banks higher prices than their shareholdings would have fetched had they all been dumped onto the open market.

Finally, the Japanese government adopted a third path—it let a misgoverned bank die quickly and painlessly. This final switch in policy is the focus of this chapter's empirical analysis. I would not have done some of the analysis in quite the same way. In particular, I worry that merging annual report numbers with daily stock returns to construct very large firm-day panels might bias some of the t-ratios in some of the tables. Nonetheless, the findings are useful.

On the news that the government both let a bank fail and offered no bailouts to its shareholders, it is reasonable that other banks' share prices adjusted up or down depending on each bank's financial health or frailty. In other words, watching an ill-run bank die clarifies the importance of a healthy balance sheet in the minds of other banks' shareholders.

The chapter deliberately closes with modest conclusions. This is appropriate because the findings are a preliminary first pass and are presented as such. But they clearly delineate directions for future work.

First, the chapter illustrates the utility of the event study methodology in clarifying directions of causation. These changes in policy—the government's actions in bailing out a bank's depositors but not its shareholders, and so on—clearly and unambiguously "caused" other banks' share prices to change. This is a much cleaner methodology for ascertaining the flow of causation than identification via instrumental variables in multistage regressions and might profitably be more widely used by macroeconomists.

Second, the study provides a concise chronology of the Japanese authorities' responses to their country's prolonged financial malaise. In particular, the problems Kindleberger (1978) highlights arising from an overly fervent belief in a lender of last resort are beautifully sketched out. Economists seeking to understand the panic of 2008 will learn much from the discussion of the political economy beneath these responses and how the expectations induced by each policy affected the next.

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