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Financial Liberalization and Reform of Japan's Ministry of Finance: Implications for Japanese Developmental State

Dennis Trinidad, Ph.D.
De La Salle University, Manila, Philippines
dennis.trinidad@dlsu.edu.ph

This study analyzes the impact of government reforms on the Japanese developmental state. In doing so, it examines the case of Japan's financial liberalization after the 1997 Asian financial crisis and its effect on the bureaucratic power of the Ministry of Finance (MOF). The new politics that emerged in the 1990s provided the backdrop of the reform movement. Along with the Ministry of Economy, Trade and Industry (METI), MOF had played a crucial role in Japan's catch-up industrialization by directing capital to favored industries and protecting weak players. The paper contends that by removing policy instruments like preferential credit and bank supervision that allowed MOF to intervene in the financial sector, the reform affected both MOF's intervening capacity and financial policy network which formed the structural basis of 'money politics' and institutional 'stickiness' of Japan's developmental state. Even so, the reform was not sufficient to completely dismantle it.

Keywords: Japanese bureaucracy, government reform, developmental state, East Asia

The notion of developmental state is perhaps Japan's greatest contribution to international development discourse. It facilitated Japan's post-war "catch-up" growth, entry into industrialized country club, and earned a moniker for Japan as an economic miracle nation (World Bank, 1993) and a development model. Japan's developmental state, which features interventionism and close coordination between government and business, has been imitated by neighboring countries in East Asia and elsewhere with mixed outcomes. However, most of its strong attributes were discredited after the 1997 Asian financial crisis and became associated with crony capitalism, inefficiency, and obsolescence. The Asian crisis was a critical juncture in Japanese government reform that began as early as 1979 with government efficiency as its central goal. In contrast, the reform agenda that emerged in the post-crisis era was one that sought to dismantle a collusion of government and business and an end to "money politics" in Japan. It was a clear shift of reform orientation from addressing market failure to one that addresses government failure.

The series of liberalization reforms introduced after 1997 led some observers to claim prematurely that Japan's developmental state was transforming into a liberal regulatory state (Walter, 2006), citing in particular Hashimoto's big bang reform which sought to level the playing field in the financial sector and Koizumi's flagship reform – postal deregulation. Nonetheless, the financial liberalization that was adopted from late-1990s did not completely eliminate the structural basis of Japan's developmental state. Part of the paper's assumption is that this was because Japanese preference for intervention in economic affairs has remained due to what Beeson (2009, p. 8) said as "consequence of path dependency, institutional 'stickiness,' and the interlocking patterns of political and economic power..." which persist in East Asia not just in Japan.

Also, Japan's post-Asian crisis liberalization reforms were selective. The Liberal Democratic Party (LDP) leadership appeared to have focused mainly on financial system instead of liberalizing investment and trade policies. As a result, two ministries involved in public fund management were affected—the Ministry of Finance (MOF) and the defunct Ministry of Post and Telecommunications (MPT). It is therefore interesting to understand why the reform agenda after 1997 increasingly targeted the financial sector in particular. There is also a question of why the reform agenda in the first place was couched in neoliberal terms like liberalization and deregulation when reformers could have opted to fine-tune the shortcomings of developmental state system instead of trying to undermine it. One of the arguments of the paper is that the set of incentives that were created by new politics that emerged in the 1990s explains LDP's behavior and preference toward the issue of reform.

This study is an analysis of the impact of government reforms on the Japanese developmental state. As discussed further in other section of the paper, a developmental state system has two major features. One is that it is commonly understood as a form of economic governance that is interventionist or one where the state is deeply involved in economic affairs (see for instance the seminal contributions of Johnson, 1982; Amsden, 1989; and Wade, 1990). Two, developmental state system is also a structure that comprises of formal and informal network of relationships between the state and society (Amyx, 2004). These informal and formal networks had served as glue that holds institutions attached to each other, thus the term institutional "stickiness." This also explains why reform is slow and difficult in Japan. It argues that the reform movement was directed more towards dismantling the second facet than the first. Due to institutional stickiness, the political objective of reform, which was to end money politics, pervaded the financial sector.

METHODS AND FRAMEWORK OF ANALYSIS

In order to analyze the impact of government reforms on developmental state, the study chose Japan's financial liberalization as one case of government reform while Japan's MOF was taken as an example of a powerful bureaucracy that is typical of developmental states. The paper combines individual (rational choice theory) and organizational (institutionalism theory) levels of analysis to examine the implications of financial liberalization to MOF's bureaucratic power and relational ties. As noted earlier, the developmental state as an institution has two structural features—as a system of economic governance and as a system of network of relational ties. It is argued that financial liberalization affected both MOF's interventionist function over Japan's financial system and its network of relations with politicians and businesses but failed to fully dismantle it. The primary data used in the analysis were sourced from MOF's official website and other official government publications. Most secondary data used in the study were collated from works of selected Japanese scholars.

Along with Japan's Ministry of Economy, Trade and Industry (METI, formerly Ministry of International Trade and Industry or MITI), MOF embodied the interventionist role of the Japanese developmental state. It had played a crucial role in Japan's catch-up industrialization by directing capital to favored industries and protecting weak players. But due to regulatory incompetence and scandals involving MOF officials in the 1990s, the reform agenda had increasingly targeted MOF and Japan's financial system. The reform had the effect of removing MOFs policy instruments like preferential credit and bank supervision that enabled it for many years to intervene in the Japanese financial sector.

During the high-growth period, the use of preferential credit could be extended through a variety of mechanisms such as through state-owned commercial or developmental banks, interest rate ceilings, controls on the lending practices and portfolios of banks, extension of local guarantees, and through a broad array of regulations that affect entry and the scope of bank business (Haggard & Lee, 1993). Without these policy instruments, the financial policy network that linked MOF and business, which formed the structural basis of money politics and institutional stickiness of Japan's developmental state, was undermined but not fully dismantled. However, instead of completely removing them, they were simply transferred to newly-created financial agency.

The new politics that served as backdrop of these reforms seemed to cater to the reform movement as well. After the LDP's collapse in 1993, political and economic reform became the central issue in Japanese politics. The coalition politics that followed also allowed the small but reform-oriented political parties like *Sakigake* and *Komeito* to participate in policymaking by coalescing with major parties. To ensure survival in a very volatile electoral system, the LDP was compelled to tackle the issue of reform and distance itself from the tarnished image of MOF.

It is assumed that external factors like economic crises and international norms and ideas were regarded as catalyst of change in Asia (see for example MacIntyre, Pempel, & Ravenhill, 2008). Cargill (2003) nonetheless saw the Asian financial crisis and financial liberalization in Japan as two independent events. This study acknowledges the crucial part provided by external factors to domestic change. By focusing mainly on domestic factors, this study complements other studies that highlight the role of international factors. According to Stallings (1992), international factors impinge on domestic policy choices in three ways: (1) understanding the effects of short-term and long-term trends in international markets on preference of domestic actors; (2) stressing the economic, political, and ideological linkage between domestic groups and international actors; and (3) focusing on leverage which involves direct use of power.

Of the international factors that affect economic and foreign policy choices in Japan, many scholars often point to *gaiatsu* (foreign pressure), particularly American pressure (see Calder, 1988 on foreign policy and Miyashita, 1999 on aid policy). Miyashita (1999) attributed Japan's vulnerability to U.S. pressure to asymmetry of dependence in which Japan is more dependent on the U.S. Meanwhile, the linkage between domestic groups and international actors can be created through close alignment between technocrats and international actor (Kahler, 1992). The appointment of neoliberal-minded technocrat like Heizo Takenaka in the Koizumi cabinet created an ideological linkage between neoliberalism and the reform movement in Japan. In terms of policymaking, international and domestic factors are assumed to be mutually reinforcing and serve as context of decisions of policymakers. Politicians and bureaucrats are engaged in a "two-level game" of sorts in which they have to satisfy both domestic and international constituents when they make decisions (Putnam, 1988).

Further justification is needed why the study focuses on MOF. One, together with METI, it occupies the highest tier in Japanese bureaucratic hierarchy. Both ministries have been considered by scholars as the backbone of Japan's developmental state model (Johnson, 1982; Brown, 1999). Two, MOF's power of the purse and direct supervision of banks fostered the creation of financial network with both politicians and businesses in the financial sector. With its vast linkage, MOF's function was deeply embedded within an intricate web of patronage and money politics. Three, MOF was also more vulnerable than other Japanese ministries to public scrutiny because it dealt primarily with public funds, an issue that was of particular interest to ordinary Japanese voters, industries, and politicians alike.

Why Reform Occurs? A Brief Theoretical Note

Broadly speaking, there are three plausible explanations on the sources of reform. The state-centered view sees reform as a top-down process originating from the state. In this perspective, reforms are initiated by independent groups or cliques within the state. They are called reformists, progressives, and radicals. They can be political parties, a group of retired military generals or a clique of young, dynamic politicians. While many instances of major reforms in Japan came from "above" (for example, the Meiji restoration, postal deregulation, privatization, and fiscal liberalization), this perspective, however, could not explain the policy preferences of the reform group. Why, for instance, a reform-oriented clique would prefer neo-liberal reforms over selective protectionism (or why Koizumi, a member of the old Japanese political establishment, decided to pursue liberalization). It does not also capture what economic policy is appropriate. Trimberger (1978) said that the appropriateness of policy may be "accidental."

The second perspective, which is the state-in-society view, sees reform as a compromise between the government and powerful societal actors (Migdal, 2001). When confronted with strong, influential societal actors, weak governments tend to adopt populist policies for their own survival at the expense of national interest. In Japan's case, particularly during the heyday of LDP dominance was that of collusion rather than confrontation among bureaucrats, politicians, and the business community. Moreover, while civil society groups in Japan have multiplied ever since the Nonprofit Organization Law (NPO) was enacted in 1998, their actual involvement as well as their success in shaping actual policies is still ambiguous. One survey indicates that only 14.3 percent of organizations in Japan have reported achieving success in influencing or changing policies (Tsujinaka & Pekkanen, 2007). This is why this view does not capture what this study intends to prove.

Finally, the third view, the rational choice model, holds that state and societal actors are rational. Policymakers weigh the costs and benefits that come with policy reforms and decide which policies to support or oppose. Geddes (1994) noted that politicians were generally interested in seeking re-election while bureaucrats were concerned with career promotion and security of tenure. In this perspective, reform occurs as policymakers and politicians respond to particularistic interests in exchange for political support. Haggard and Lee (1993) however argued that there were little empirical studies that showed that financial market policy was a result of political pressures, or whether it sprang from economic constraints or the projects of state officials. Noble (2010) also observed that particularism in Japan has declined and that since the time of Koizumi, politicians have supported reforms that have an appeal to median and floating voters. This explains the shift from "particularistic spending" to a more "programmatic spending" by the government recently (Noble, 2010). Further, the rational choice model does not take into account *gaiatsu* or foreign pressure which, in Japan, has considerable influence in the choice of both commercial and foreign policies.

The framework to be employed in the study is one that takes into account both individual and organizational levels of analysis and one that acknowledges the importance of external factors. This means combining the rational choice model and institutionalism as the study's analytical framework. As rational actors, the study assumes that politicians' support for reform is dependent on the benefits that they get from it. However their actions are constrained by institutions which North (1990, p . 3) defined as "humanly devised constraints, both formal and informal, which shape human interaction." The paper drew from the assumption of historical institutionalism which sees "actors' choices, interests, and preferences shaped by collective organizations and institutions that carry their own histories and rules, laws, norms, and ideas" (Rodan, Hewison, & Robison, 2006, p. 4). Viewing developmental state as a system of economic governance and network of relationships that evolved across time fits this characterization. The bonds created by this intensive network have made reformers both initiators and target of their own reform crusade. This helps explain why liberalization in Japan is slow moving and incomplete.

By 2000s, a new brand of politics characterized by diversity, coalition formation, competitive elections, and increasing involvement of civil society groups in politics has emerged in Japan (Rosenbluth & Thies, 2010; Kabashima & Steel, 2010; Stockwin, 2008; Pekkanen, 2000; and Pempel, 1998). The system of coalition that began in the 1990s resulted to compromises and concessions between parties (Rosenbluth & Thies, 2010). Coalition partners can shape policies in all stages from agenda setting to deliberation and approval. To politically survive, the LDP had to take into account the views of their coalition partners like *Komeito* in the policy process, and must frequently make concessions with opposition parties like the Democratic Party of Japan (DPJ) on various reform issues in the 1990s.

Two Features of Developmental State

As mentioned earlier, the developmental state model is often viewed as a form of economic governance in which state intervention in economic affairs is a key feature (Woo-Cummings, 1999; Wade, 1990; Amsden, 1989; and Johnson, 1982). In this light, one major concern in the study of developmental state is understanding the factors that underpin successful state intervention. Thus, the notion of state capacity and its underlying institutional designs to achieve it were raised. To this, Evans (1995) added the idea of "embedded autonomy" which was essential if state was to succeed in leading society's industrial transformation. According to Evans, the state should maintain a degree of "connectedness" to society (embeddedness) but must avoid being captured by its interests (autonomy). Here the role of bureaucracy comes into the picture. Painter (2005) and Root (1998) added that a "powerful bureaucracy" must be put in place and maintained through a system of merit and competence. Successful state intervention also depends on the availability of policy instruments that bureaucrats can utilize for implementing industrial policies (Johnson, 1982; Brown, 1999). Aoki, Kim, and Fujiwara (199 7) further added that state intervention was necessary in solving coordination problems arising from market and in facilitating the principle of shared growth (World Bank, 1993).

The other feature of developmental state is actually an outcome of the first facet described above. Over time, intervention and social embeddedness produce a system of network of relationships between bureaucracy and its supervised sectors. Root (1998) called it "state-business interface" or set of institutions (formal and informal) that establish close coordination between bureaucracy and business. Wade (1990) named it as "alliance capitalism." The relational ties produced from this network are often defined by two interrelated components that are both non-legal and informal (van Rixtel, 2002). In Japan, MOF's bureaucratic functions (particularly activities of its four bureaus: Budget, Tax, Financial, and Trust Fund) led to a financial policy network that built relational ties among politicians, MOF officials, private and quasi-governmental financial institutions, and other government agencies (Amyx, 2004). The study uses these two features of developmental state in analyzing financial liberalization's impacts to MOF's bureaucratic power. The next section explains the origins and decline of bureaucratic power in Japan. Because of policy instruments and relational ties, Japanese bureaucracy had often been depicted as powerful and efficient in several studies (Brown, 1999; Wade, 1990; Johnson, 1982).

The succeeding portion of the paper proceeds as follows. The first explains Japan's bureaucracy and its role in the country's economic success/failure. The second part discusses Japan's government reforms and the case of the MOF. The last portion concludes the discussion. The term liberalization was used throughout the paper to mean removal or reduction of barriers to free flow of goods, capital, and services into an economy. Deregulation pertains to policies that seek to eliminate or reduce government control and to introduce competition in specific sectors. Privatization on the other hand means transfer of equity ownership from the government to the private sector.

RESULTS AND DISCUSSION

The Rise and Decline of Bureaucratic Power in Japan

The involvement of Japanese bureaucracy in managing social and economic affairs can be traced back to both formal and informal institutions which have evolved since the Meiji era. Traditionally, bureaucrats have been involved in all stages of Japanese policymaking process. The bureaucracy owes its establishment to the Imperial Ordinance of the Emperor. Hence, it was regarded as independent and above partisan politics, enabling it to perform its functions with minimal intrusions from politicians. In the pre-war period, bureaucrats were said to have developed transcendentalism while the public perceived them as the only group with competence and skill to draft and formulate technical policies (Hori, 2005). Becoming a bureaucrat was a privilege because of the "highly competent self-image and reputation" associated with the position. Moreover, early bureaucrats had a sense of accountability only to the emperor not to the Japanese Diet because of the perception that they were "servants of the emperor." Bureaucratic power expanded under the Japanese military government from 1936 to 1945. During this period, the bureaucracy became more deeply involved in regulating social and economic activities because of the need to centrally mobilize all available resources to win a total war (Hori, 2005).

Due to lack of American civilian personnel, the United States, during its occupation of Japan, had employed the Japanese bureaucracy to indirectly govern the country. This was an opportunity for the bureaucracy to spare itself from various reforms that were instituted throughout the occupation. As a result, Japanese bureaucracy continued to enjoy its pre-war bureaucratic power throughout the post-war period. The most notable change at this juncture was only symbolic, that is, the change of status from that of being servants of the emperor to civil/public servants which was formally stipulated under the National Public Service Law. Scholars are divided as to the extent of power of Japan's modern bureaucracy. One perspective contends that politicians reign while bureaucrats rule (Johnson, 1982). On the other hand, some argued that the power of bureaucracy is overstated (Ramseyer & Rosenbluth, 1997). A more popular view holds that Japan is governed by a "tripod" leadership of politicians, the bureaucracy, and the business community. Nevertheless, the bureaucratization of the policy-making process throughout most of the post-war period was undisputedly evident (Pempel, 1974).

One of the sources of bureaucratic power is the so-called administrative guidance or the regulatory, reconciliatory, and advisory functions of each ministry over individuals, corporations, and organizations (McVeigh, 1998). Through administrative guidance, a ministry concerned can (1) point to illegality of action of a party and requests voluntary action to correct it before resorting to legal recourse; (2) reconcile conflicting interests and (3) give advice to a party (McVeigh, 1998). The threat of a sanction can be used for non-compliance. Administrative guidance facilitated the relationship between the regulator and the regulated and has created extensive distributive and developmental networks that tied government with businesses. Distributive network is formed by the dependency of businesses upon government expenditures while developmental network is created from government regulation of businesses (Kawabata, 2006).

The existence of these networks and the unique roles of bureaucrats in Japanese policy-making process are at the core of Japan's developmental state. For the past decade, however, this bureaucratic model has been under serious criticism following major fiscal crises and series of administrative failures (see, for instance, Painter, 2005 in the case of Hong Kong; Ha & Wang, 2007 in the case of South Korea). Japan's own bureaucracy is not an exception. Ginsburg (2001, p. 598) correctly pointed out that in Japan, the "bubble economy called into question the competence of the bureaucratic management." In the case of East Asian developmental states, government reforms were mainly instituted either to address inefficiency and mismanagement of the public sector or as a response to the Asian financial crisis of 1997-98 or both (Wu, 2007; Painter, 2005; Haque, 2004; Kim, 2000).

Politicizing Japan's Financial Reform Agenda and the Role of *Gaiatsu*

For the past three decades or so, reforms in Japan have been couched in neoliberal ideology of liberalization and marketization. Yet interestingly, the nation has to reach a consensus on liberalization (Genba, 2011). Moreover, much of the contentious reforms that were advanced were not in trade or investment sectors but rather in the financial sector as reflected in the "six plus one" reforms articulated by the government.[1] The six areas targeted for extensive reforms and deregulation were the public sector, economic structure, fiscal policy, social welfare, financial structure, and education while the plus one referred to decentralization (Maswood, 2002). There are two possible reasons for this. One is that the trade sector has performed relatively well as reflected in the surpluses that Japan had accumulated from the export sector over the years. Also, while there is generally strong resistance to trade liberalization, commercial banks generally welcomed financial liberalization to enable them to compete on equal footing with Postal Banks as will be discussed later.

Two, the financial sector has been problematic. Public finance has been in deficit for years. In fiscal 1980, government expenditure was 42% of national income and of this only 24% was covered by taxes (Shumpei, 1984). In 2012, public debt in Japan was 237% of its Gross Domestic Product (GDP). Japan's ageing population is also increasing the cost of pension system against a backdrop of declining budget and huge public debts. The MOF had failed miserably in preventing insolvency and bankruptcy among financial institutions in the 1990s. The banking system was in doldrums and suffering from huge pile of bad debts. Hoshi and Kashyap (1999) noted that the problems in the banking sector have created a serious drag on the economy's ability to recover. Thus, it can be said that the surplus accumulated from exports has been used to recapitalize noncompetitive industries, particularly banks. But the Japanese government cannot hold on to trade surpluses to offset the losses in the financial sector. In 2011, the economy experienced a trade deficit for the first time since 1980. The deteriorating terms of trade is projected to grow in the coming years (Kanno, 2012).

From the foregoing, Japan's liberalization is a selective one with financial sector reform at its center. The intellectual basis of Japan's liberalization reform can be traced back to the emergence of the free market fundamentalism that was propagated in the early-1980s by U.S. President Reagan and Britain's Prime Minister Thatcher. Simply put, this economic thinking suggests that free market economy can solve social and economic problems and that unfettered market is the best means of achieving economic growth. Because raising taxes is divisive and politically costly the then Prime Minister Nakasone, who was a close friend of Reagan, adopted a policy of "financial reconstruction without a tax increase" through reorganization and rationalization of government agencies. This policy called for significant reductions in public spending, including government subsidies and privatization of huge state-owned businesses including the Nippon Telegraph and Telephone Corporation (NTT) and Japan National Railways (JR). The eventual success of his privatization program would become an impetus for succeeding administrations to follow. Soon after deregulation was acknowledged as an essential component of structural economic reform under the Takeshita administration. In 1993, the *Hiraiwa* report called for more deregulation in the Japanese economy.

The U.S. trade deficit with Japan would eventually open the floodgates for more liberalization reforms in domestic economy. As the Japanese were reluctant to open up its trade sector, Japan's initial response to trade dispute was exchange rate adjustment. The government agreed to strengthen the yen under the Plaza Accord in 1985. In 1986, the report of the *Maekawa* commission highlighted the need for structural enlargement of demand in the Japanese market to accommodate more imports in response to U.S. demand for opening markets and increasing domestic demand. The mounting domestic pressure to liberalize trade was further reinforced by the enactment in the United States of the 1988 Omnibus Trade and Competitiveness Act (or, Super 301) which mandated the US government to retaliate against countries engaged in unfair trade practices (Rosenbluth & Thies, 2010). To this the Japanese government's response was a Keynesian approach of deficit spending which only led to more debts.

Between 1989 and 1990, Japan agreed to a series of dialogue with the United States, which later became known as the Structural Impediment Initiatives (SII). Thus, by early-1990s, deregulation and liberalization were firmly embodied in the LDP's reform agenda with the main objective of reducing budgetary deficit and improving government efficiency. These reforms however came at a crucial time when LDP dominance ended and new politics based on coalition and single-member constituency in the lower house of the Diet emerged. The collapse of the 1955 system also meant that the LDP no longer monopolized decision making, which proved to have profound influence in the actual outcomes of reform efforts later.

While structural reform and government efficiency were the major thrusts of government reforms in the 1980s, a new agenda which increasingly undermined the intervening capacity of Japan's developmental state began to take shape during the era of coalition politics. In 1993, a coalition of eight parties headed by Prime Minister Hosokawa Morihiro of Japan New Party (JNP) came to power. But unlike their LDP predecessor, the coalition shifted the focus of reform away from bureaucratic rationalization to electoral reform. The new administration regarded the cost cutting objective as less fundamental than the goal of increasing accountability in the government (Nakano, 1998). Hosokawa asserted that the main purpose of government reform should be to "break the collusive relationship between (sic) politicians, bureaucrats, and business" and that "the goal of making government more accountable to the people and their elected representatives rather than making it less costly" must be a top priority (as cited in Nakano, 1998, p. 291). Hosokawa also adopted deregulation that was recommended earlier in the *Hiraiwa* Report, as the main pillar of his administrative reform (Masujima, 2005).

It was not the non-LDP coalition that eventually undercut the state's monopoly over finance. Quite paradoxically, it was the workings of the LDP which posed the greatest challenge to state interventionism particularly in the financial sector. As explained in the next section, two neoliberal reform policies were put forward in succession which affected the intervening capacity of Japanese bureaucracy, specifically MOF. The first was the "big bang" reform of the Hashimoto administration and second, Koizumi's postal deregulation. Although these reforms have the effect of reducing policy tools available to MOF to maintain effective control over finance, the goal was not to weaken intentionally the interventionist role of the state but rather to assert political authority over bureaucracy. In the past, the LDP depended heavily on the bureaucracy's bottom-to-top policy formulation. With the aim to distinguish leadership style from his predecessors, former Prime Minister Nakasone chose to introduce policies through his deliberative councils or *shingikai* (Muramatsu, 1987). The image of the bureaucracy was also tainted by many scandals and succession of misdeeds and policy misconduct, which it has never recovered fully from. Politicians had taken advantage of this by promising to reform the bureaucracy in their campaigns. In this vein, Prime Minister Hashimoto chose administrative reform as the top priority of his reform (Ko, 1998).

The big bang reform was recommended by PM Hashimoto's Administrative Reform Council (ARC). The concept was obviously copied from the Thatcher government's reform of the same name, which deregulated the financial market in Britain. It was an ambitious program that sought to liberalize Japan's highly protected financial market by converting it into a more transparent, market-based financial system similar to those of London and New York. Hashimoto proclaimed that the big bang reform was intended to "bring the Tokyo market up to the level of London and New York by 2001" (as cited in Ikeo, 2007, p. 20). Moreover, the big bang did not just aspire to introduce competition in the Japanese capital market. It also sought to organizationally reform several important players in the financial sector. MOF became inherently among its first casualty.

Financial Reform and MOF's Bureaucratic Power

The finance ministry, together with METI, had been the quintessence of state interventionism in Japan. Whether this intervening capacity was an outcome of the ministry's overarching power that is legally mandated by law or it emanated from the system of networks that it developed within Japan's financial institutions, it was hugely important in successfully coordinating policies between the government on one hand and banks, securities, private lending institutions, and brokerages on the other. This ability to coordinate and build consensus from all interested groups had been a key feature of Japan's economic miracle (Brown, 1999). By effectively developing consensus through consultation, the ministry also provides a mechanism where contentious issues can be informally settled amicably (Hori, 2005; Brown, 1999). MOF also provided expertise to government planning and shared technical knowledge with LDP's Policy Advisory Research Council (PARC).

The finance ministry, particularly its Budget Bureau, is vested with budgetary power while the Tax Bureau implements taxation laws. Both functions have made the finance ministry politically influential. During budget preparations, politicians would normally approach ministry officials to request funds for pet projects in their local constituencies while the power to implement tax provides discretion to the ministry to go after politicians who evade tax payments. Since the late-1970s, the ministry has also served as a training ground for future Japanese leaders. Among the prime ministers who had served as finance ministers were Fukuda Takeo, Ohira Masayoshi, Takeshita Noboru, Miyashita Kiichi, and DPJ's Yoshihiko Noda to name a few.

The finance ministry through its Financial Bureau also performs regulatory functions. Financial stability was largely maintained by regulating competition among banks and financial institutions (Rosenbluth & Thies, 2010). It also promoted the interests of weak players by ensuring their solvency. MOF had always promoted the interest of the banking sector. For example, it clashed with the now defunct Ministry of Post and Telecommunications (MPT) over postal banks' practice of offering higher and more secure yield for short and long-term savings. MOF's supervisory power over banks had enabled it to shape the lending patterns and priorities of financial institutions. In so doing, it made funds available to favored sectors and specific industries of the economy. Thus, with METI, MOF was jointly responsible for identifying potential industry winners during Japan's high-growth era. In essence, the finance ministry during its peak had performed the functions of a central bank and financial regulatory agency in Japan's highly protected financial system.

Observers also noted the importance of informalities in the performance of MOF's regulatory and coordinating functions (van Rixtel, 2002; Brown, 1999). These informalities are in the form of administrative guidance and *amakudari*. As previously mentioned, administrative guidance is a policy guidance which allows the finance and other ministries to point to illegality of action of a party and requests voluntary action to correct it before resorting to legal recourse, to reconcile conflicting interests and to give advice to a party (McVeigh, 1998). *Amakudari* on the other hand pertains to the institutional practice of reemploying ministry officials retired from the government into senior management positions in private companies (Suzuki, 2004). There are a number of reasons why ministries in Japan are engaged in this practice including knowledge transfer, network creation for the purposes of monitoring industries, and as an incentive system for government officials who worked hard (Suzuki, 2004, pp. 5-9).

Amakudari essentially provided the backbone of state-business relationship in the Japanese financial sector. Retired finance ministry officials were appointed to senior level positions in various organizations including the Bank of Japan, Exim Bank, Japan Development Bank, and regional banks. This practice became the object of public criticism at the height of financial liberalization reform in the mid to late-1990s. In 1998, Motohisa Ikeda of DPJ called for an end to the practice of *amakudari*, arguing that it had been the cause of collusion between the government and the financial sector ("Ministry's *amakudari* list," 1998).

The successive failures of huge financial institutions, including the Hokkaido Takushoku Bank and Yamaichi Securities in the 1990s, had challenged the credibility of MOF in monitoring the solvency of financial institutions. It also called into question the ability of MOF in preventing such failures. Contrary to arguments in support of *amakudari*, reemploying retired MOF officials to public and private organizations did not necessarily led to transfer of knowledge and skill and obviously failed at monitoring the performance of regional banks. On the other hand, the very nature of politics in the 1990s that was characterized by coalition formation undermined MOF-LDP cooperation in implementing schemes that could have saved failed institutions through injection of public funds (Hori, 2005). The failure of huge financial institutions had eventually tarnished the public reputation of MOF officials and was therefore instrumental in the successful passage of big bang reform.

However, the big bang reform did not address the practice of *amakudari*. It in fact continued to this day but the number of retired MOF officials that were reappointed to regional banks has declined (Suzuki, 2004). In 1995, there were 92 *amakudari* executives occupying senior level positions in various Japanese regional banks. In 2000, the number was reduced to 47 (Suzuki, 2004). The issue of *amakudari* was tackled in the reform of the Civil Service System which led to the revision of the National Public Service Act in 2007. Under the revised law, the practice was not completely eliminated but rather the law stipulates that officials from Cabinet office or ministry are prohibited from assisting in the placement of retired officials to profit or non-profit organizations. Beginning 2008, the Government-Private Sector Personnel Exchange Center has been in-charge of providing placement service to officials after leaving public office (National Personnel Authority, 2012). The revised law also emphasized the meritocratic basis of appointments to public service.

Thus, in spite of the financial sector reform, the system of network that was created by MOF through informal practice like *amakudari* has remained in place. Nonetheless, the placement service which used to be in the hands of the ministries was transferred to a new agency, the

Government-Private Sector Personnel Exchange Center. In a way, this will retain MOF ties with financial institutions. It can be argued hence, that the change of rules (on *amakudari* practice) was not intended to question governance through intervention per se, but rather it targeted the officials in the finance ministry. It also indicates that regional banks that received *amakudari* executives have lost confidence on their competence following MOF's failures.

Due to shortcomings of MOF, government reform also sought how public accountability could be further enhanced. In this respect, one major objective of MOF reform under the big bang program was the transfer of regulatory and supervisory functions over financial institutions to another agency and the strengthening of independence of Bank of Japan. To achieve these, the Bank of Japan Law was revised. Regulatory power of MOF over banks and other financial institutions was transferred to a newly created agency, the Financial Supervisory Agency (FSA, later renamed Financial Services Agency). The law mandates FSA to ensure the stability, facilitation, and protection of users of Japan's financial system, and to strengthen the competitiveness of the Japanese financial and capital market (Financial Services Agency, 201 0).

The big bang reform also undercut MOF's ability to interfere in finance allocation and credit when the Fiscal Investment and Loan Program (FILP) reform was introduced. The FILP is a system of long-term, low-interest financing, and credit administered by various government agencies. Its funding was sourced mainly from an integrated fund, managed by MOF's Trust Fund Bureau, which consisted of Postal Savings Fund (PSF), the Postal Life Insurance Fund, the Industrial Investment Special Account Fund, and government-guaranteed bonds. The largest of these was PSF, the collective postal savings or deposits from Japan's postal system.

After the FILP reform, the mandatory transfer of these funds under the Trust Fund Bureau's management was eliminated. The procurement of FILP funds is now based on market principles done through bond issuance. The new FILP scheme has led to significant decreases in the amount of funds. In 2005, FILP funds amounted to 299,584.9 billion yen. It went down to 215,968.2 billion yen three years later. In 2010, the amount of FILP fund procured was 189,161 billion yen (Ministry of Finance, 2011). Nowadays, FILP bonds are used for providing low-interest financing to small and medium-size businesses and financing of welfare-promoting local government projects. By changing how FILP funds are sourced, the reform effectively inhibited MOF's ability to influence lending patterns. It also enabled private financial institutions to compete with state financial institutions in capital lending business.

Due to involvement of Japan's postal system in PSF,[2] the liberalization of Japan's financial system inevitably required the reorganization of the now defunct MPT and deregulation of the postal service. Prior to dissolution, MPT supervised Japan's postal services. The government established the PSF in 1875 to "encourage citizens, who were used to feudalistic economic transactions and unfamiliar with capitalism, to save money" (Kawabata, 2006, p. 94). PSF deposits had steadily expanded throughout the post-war period despite efforts to liberalize Japan's financial system and tax reforms (Kawabata, 2006). The big bang reform program also originally included the privatization of Japan's postal system but because of huge opposition from various sectors, Hashimoto was forced to abandon it. Instead, it was reorganized into a public corporation to enhance public accountability (Ko, 1998), under the Postal Services Agency (PSA) or *Yusei Jigyocho*. In April 2003, PSA was renamed Japan Post (JP) or *Yusei Kosha*. JP is composed of four divisions—the JP Bank Co. Ltd., JP Insurance Co. Ltd., JP Holdings Co. Ltd., and JP Services Co Ltd. (for mail and delivery services).

In 2005, total savings deposited in JP Bank was 214.1 trillion yen or about a third of the total savings in Japan. This was also larger than the total savings deposited in Japan's four biggest banks (Japan Financial Research, 2005). This makes the JP Bank the largest bank in the world.

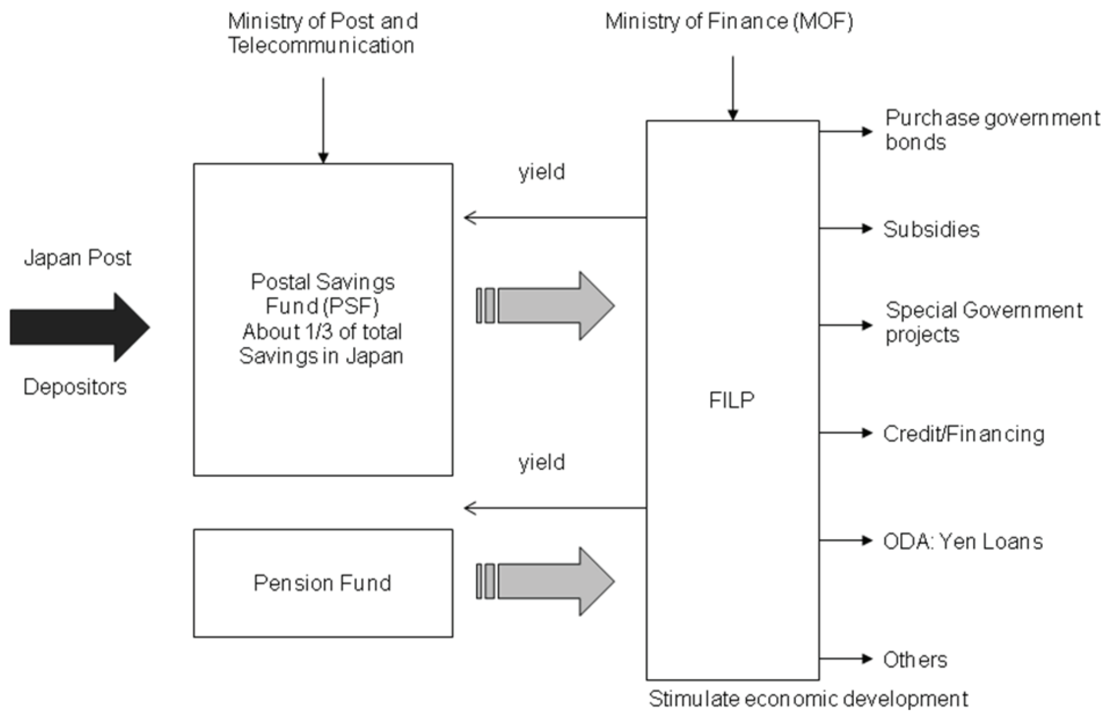
Kawabata (2006) mentioned two reasons why the Japanese prefer to deposit their money at postal branches. One is that the terms are better. Postal savings such as *teigaku* or fixed rate long-term account yield a much higher interest than prevailing commercial rate. Two, it is more secure because it is government insured. For a number of years, interests on postal savings deposits were also tax-exempt. The PSF received favorable treatment from the government because it was a valuable source of public finance throughout the post-war era and was also used to finance pork barrel projects of Diet members. Moreover, postmasters had close political relationship with bureaucrats and LDP members. During elections, commissioned postmasters often served as leaders of political support groups or *koenkai* of senior LDP members (Maclachlan, 2004).

Because of these features, PSF enjoyed financial market advantage and undermined the operations of commercial banks and private lending businesses. When Koizumi became Prime Minister, he identified postal deregulation as his flagship reform program. The LDP leader believed that postal deregulation would not just help level the playing field in the financial market; it would also help end pork barrel and "clientelistic" politics (Scheiner, 2006 as cited in Rosenbluth & Thies, 2010, p. 134). Koizumi viewed "the postal system as symbolic of key problems within the political-economic system: electoral corruption, the power of vested interests over the LDP, and the bureaucratic mismanagement of public funds" (Maclachlan, 2004, pp. 309-310). Through the FILP scheme PSF was utilized as a form of "investments and loans both directly to specific projects and industries and indirectly through government-affiliated financial organizations" (Kabashima & Steel, 2010, p. 115). Under the scheme, PSF became the main source of pork funneled by politicians to pet projects in their respective constituencies.

During the era of high growth, several infrastructure projects across the nation were funded under the FILP scheme. Using funds from PSF/FILP, *shinkansen* or fast bullet trains were built, roads and airports were constructed, and town halls were put up. Concerned with re-election, LDP politicians used their influence and connection to intervene in many occasions, to get their projects funded under the FILP. Figure 2 below is a simple illustration of how PSF/FILP worked prior to big bang. But as Japan experienced diminishing returns from infrastructure development over time, the PSF became virtually a source of wasteful spending. Koizumi knew that a significant number of LDP members still rely on this clientelistic scheme to win the support of their constituents.

Crucially important to Koizumi's reform effort was the appointment of Takenaka Heizo, an academic economist from Keio University, who became very influential in shaping the economic policies of the Koizumi regime (Stockwin, 2008). In a pamphlet issued by the Council he headed in 2001, seven programs of structural reform were identified including the privatization of Japan Post and a review of the roles of the public financing. The deregulation plan was to split JP into four separate, independent units and privatize each eventually. As expected, the proposal was met with strong resistance from postmasters, several LDP members, and policy tribes (*zoku*) in the Diet who were affiliated with the postal system. During the final voting, 37 LDP Diet members voted against the Koizumi/party-sponsored privatization measure, resulting to the bill's narrow defeat. Koizumi's perception of the profound implication of this bill to his reform agenda was summarized in a speech in 2005 in which he asserted that privatization of the postal services was at the very "heart of the reforms" which would lead to structural reform in all kinds of fields including public and fiscal administration, economy, and finance (Koizumi, 2005). He dissolved the Diet and called for a snap election in 2005.

The outcome of the election vindicated Koizumi. Not only did the LDP win a huge share of seats, Koizumi also succeeded in removing LDP Diet members who voted against his postal deregulation bill. During the election, Koizumi denied these "rebel" members party endorsement



Source: Based from the MOF FILP Report with some modifications by the author

Figure 1. PSF and FILP prior to reform

and fielded candidates to run against them in their own constituencies. The LDP's overwhelming victory also provided a new clear mandate to Koizumi to proceed with his postal deregulation plan. The bill was eventually passed stipulating the privatization of JP within 10 years beginning 2007. By 2017, government shares in JP are expected to be sold completely to the private sector. Whether or not the Japanese people really desire Koizumi's neo-liberal reforms or they were just swayed into it by his popularity and charisma is open to debate and this paper will not attempt to discuss in detail. However, when Koizumi stepped down as prime minister in 2006, the momentum for deregulation and privatization also died down.

The post-Koizumi administrations have been less committed and cautious on the postal reform issue and liberalization in general. Moreover, the consistency of the reform agenda has suffered from the frequent change of leadership since 2006. Then PM Shinzo Abe readmitted 11 of the 37 LDP members who were expelled for voting against the postal deregulation bill. The postal lobby group formed the People's New Party (PNP, *Kokumin Shinto*). The victory of the Democratic Party of Japan (DPJ) in 2009 has further sidelined the momentum for postal deregulation in two ways. One, the PNP became a junior coalition partner of the DPJ. Since then, the ministerial position for Postal Service Privatization was held by a PNP member. Former Prime Minister Noda appointed PNP's Secretary General Mikio Shimoji to that position. Two, the DPJ had openly supported attempts at reversing if not postponing indefinitely Koizumi's postal deregulation (Heizo, 2010).

In 2010, the former minister in-charge of postal services reform, Shizuka Kamei, proposed to roll back the ongoing privatization process of the Japan Post group, which former DPJ kingpin Ozawa Ichiro endorsed for legislation ("Ozawa endorses postal reform bill," 2010). Two years later, a law was passed by both houses of the

Diet which essentially reverses the privatization of postal services ("Postal privatization review bill passed," 2012). The bill, jointly submitted by DPJ, LDP, and *Komeito*, allows the government to "review" the postal privatization law passed in 2005, to delay the selling of government's shares of more than 1/3 of Postal Holdings' equity, and to allow the Postal Bank and Postal Insurance to enter into new business ventures.

The focus of reform agenda under DPJ had also shifted away from liberalization to reform of Japan's policy process. The goal was to centralize responsibility for macroeconomic policy in the hands of political leaders. In this vein, PM Hatoyama created the National Policy Unit, which reported directly to the prime minister and acted as a command center to promote cross-ministerial planning and coordination. This attempt was a clear departure from the 1955 system in which bureaucrats lead in the policy formulation. This was not, however, the first instance in which politicians tried to wrestle power away from bureaucrats. Under the third Hatoyama cabinet (1955-56), a plan for administrative reform was presented which, if implemented, would transfer MOF's jurisdiction over budget compilation to the Office of the Prime Minister (Hori, 2005, p. 119).

CONCLUSION

The attempts of Hashimoto and Koizumi cabinets to institute a liberal financial system in Japan gave an impression initially that the country was intent to veer away from developmental state and headed towards an Anglo-American type of capitalism. The reform agenda was couched heavily in neoclassical terminologies like "level the playing field," privatization, deregulation, and so on. It was Koizumi who realized the political implications of postal deregulation reform, that it was not just about privatizing Japan Post but confronting as well the main source of money politics that beset the Japanese political system. Postal deregulation and money politics are linked by Japan's institutional stickiness.

The reform focused mainly on the financial sector due to confluence of domestic and international factors. The occurrence of the 1997 financial crisis discredited much of developmental state's appeal. Prior to this, Japan and the U.S. were also engaged in a dialogue to address bilateral structural problems. Domestically, the worsening public sector debts, ageing society, pension fund problems, bad debts, MOF's inept handling of failed financial institutions, scandals and allegations of corruption involving MOF officials, and so on justified the necessity of financial sector reform. MOF's crisis of credibility came at a time when electoral contest was volatile and where LDP was no longer the dominant party in the Diet. For its own political survival, it was imperative for LDP to dissociate itself from MOF's tarnished image and to include reform in its campaign and agenda.

To some extent, government reform had undermined the interventionist role of the state in financial affairs. Many policy instruments utilized by MOF, particularly those of Financial and Trust Fund Bureaus, in its official functions were removed. MOF's supervision over banks were transferred to a newly created agency – FSA – while MOF's Trust Fund Bureau lost its oversight function over PSF which was used to fund projects under the FILP scheme. The reform also granted the BOJ more "independence" through legislation. But such independence was raised when re-elected Prime Minister Abe threatened to revise the law that guarantees BOJ's independence if it would refuse to set a 2% inflation target ("Yen weakens as Abe threatens," 2012).

On the other hand, the other facet of developmental state—that of system of network of relational ties—has remained although it can be suggested that MOF's ties with LDP had been severed during the reform process. Moreover, by transferring most of its financial regulatory functions to FSA, MOF's relational ties with banks and financial institutions waned. The practice of *Amakudari* has remained in place although as shown earlier, in 2000 the number of *amakudari* executives from MOF assigned to regional banks decreased.

The about-face attitude of politicians from postal deregulation after Koizumi stepped down is indicative of lack of general consensus on liberalization in Japan. Moreover, the economic recession that beleaguered the U.S. economy in 2008 again exemplifies that a certain level of regulatory measures are still needed to curb corporate greed and that public sector involvement as demonstrated by the bailout packages in the U.S., Japan, and the European Union are necessary in assisting private sectors in times of difficulty. In response the U.S. and other countries were forced to take extraordinary "Japan-like" measures in both fiscal and monetary policy, including large budget deficits and quantitative easing to increase the money supply (Aronson, 2011).

The state-market debate is indeed far from over.

ENDNOTES

[1]A few months after his re-election as Prime Minister, Abe unveiled his 'three-arrow' strategy which is intended to revitalize Japan's economy. The third arrow proposes reforms that would make the domestic setting more conducive to foreign investment.

[2]It should be noted that the Japanese post offices were not only engaged in mail collection and delivery but also performed functions that were similar to banks and insurance companies such as selling insurance and receiving deposits/savings, wire transfers and money orders. A typical post office in Japan therefore was like a bank, an insurance firm, and a courier service firm rolled into one. This was Japan's postal system.

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