How the Japanese Financial System and Its Main Bank System Have Dealt with Generic Issues of Financial Development

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I am delighted to be here with you today, to participate in the launching of the Arabic edition of the World Bank Study organized by Professor Aoki of Stanford University and myself on the Japanese Main Bank System.

The Japanese main bank system is one of very intensive relationships between a large commercial bank – the main bank – and its large industrial and commercial borrowers. It involves close monitoring by the bank of the company, gathering detailed information not otherwise available on company plans and performance. In return for this intrusive activity by the bank, if the company falls into financial distress the main bank has a special responsibility to rescue and restructure it if that makes economic sense.. This system developed in the early period of great difficulty and uncertainty following World War II, and developed and flourished up until the mid-1970s, the era of exceptionally rapid economic growth, high rates of investment, and huge needs for business fixed investment.

Part I of the English version of the study has 10 chapters which go into considerable detail on the Japanese main bank system... they are definitive, and probably tell you more than you want to know. Part II is comparative in its focus. I have written a chapter which places the main bank system in the broader context of the development of the Japanese financial system, and addresses how Japan has dealt with generic issues that are relevant for all developing and transforming economies moving to a more market-oriented financial system. My talk today is based on, but somewhat different from, that Chapter.

In the English edition, there are then six chapters written by specialists of other countries as to what they find relevant from the Japanese main bank experience. For each country the answer is somewhat different of course. First there is a chapter on Germany, the other major case of a banking-based financial system, in contrast to the capital-market oriented systems of the U.K. and the U.S. The remaining chapters are on Korea, India, Mexico, China, and Poland.

Introduction

Let me begin with some basic points about Japan, simply to remind you.

First, Japan is the world's second largest economy – larger than France and Germany combined, with an advanced, high tech industrial structure, relatively equal income distribution but with wider productivity differentials by sector than any other advanced country. Manufacturers, especially for exports, are very efficient; services much less so; and agriculture economically very inefficient and high cost.

Second, Japan is the first non-Western, non-Christian, non-Caucasian country to achieve such a successfully high level of development.

> Culture is by far too vague a term to use as explanation, at least as used by economists. Nonetheless, most Japanese are
> – hard-working
> – well educated

– ambitious and competitive
– practical and pragmatic rather than ideological
– and materialistic – they are big consumers as well as savers

Third, Japan differs from the other East Asian success stories of rapid development in two major ways –

1. Industrialization started far earlier
   – by WW II Japan was a significant industrial power
   – by the end of the war, Japan had a European-level labor force in terms of education and skills but a per capita income below Malaysia at the time, or perhaps Morocco today – due to wartime devastation of its physical capital and a widened technological gap

2. The Japanese population is far larger than that of South Korea or Taiwan, or any Southeast Asian economy except Indonesia.
   – a large population with a rapidly growing economy means a huge domestic market

   – so while Japan has always been export oriented, it has been <u>less</u> so than other Asian economies, and has a far more broadly based industrial structure

   – nonetheless, in order to reconstruct the economy following World War II, the national slogan was "Export and Save"

   Export not simply to provide aggregate demand but to earn foreign exchange to pay for imports of machinery; raw materials – ranging from cotton to iron ore; energy – Japan has no oil; and, increasingly, basic foodstuffs despite its continuing protection of rice and selected other agricultural products.

   And <u>save</u> – to provide the means for productive investment, the building of new factories embodying new, imported technologies, and the infrastructure essential for an industrial economy.

My purpose here is to explain how Japan has dealt with the basic problems and issues all economies must face

– how to transfer savings efficiently and effectively to investors
– how to alleviate credit efficiently
– how to maintain financial system safety and also achieve efficiency in credit allocation and financial intermediation

Basically, the Japanese approach has been to rely predominantly upon private ownership of banks and other financial institutions, and upon the operation of financial markets – but with a rather high degree of government regulation and intervention.

And, until recently Japan has developed a banking-based financial system – somewhat like

Germany, though there are many differences. This is in distinction from the Anglo-American model of finance, which emphasizes capital markets – stock and bond markets – though in practice banks are very important, too. My focus here will be on Japanese banking, not on the more recent developments in the stock and bond markets.

Development of the Japanese Banking System

Modern Japanese banking can be divided into 4 historical stages.

The first is from the 1870s, when modern banks were first created based on Western models, until the Banking Crisis of 1927, in which a number of banks failed. During this period banking developed very rapidly. Entry was very easy, with only modest capital requirements and limited supervision. Many small local banks were established all over Japan; by the early 1900s there were more than 2300 banks, only a few of which were of substantial size.

The positive aspects were that financial markets were free and competitive; ordinary Japanese developed the banking habit, as they earned competitive interest on savings deposits; and local and regional financial markets were integrated into a national financial system. The weaknesses were that the smaller, local banks were prone to difficulty and collapse – because of local economic distress of their industrial borrowers, or because the bank owners lent disproportionately to their own business activities. This risk was insufficiently diversified – by borrower and by region.

One consequence was a series of individual bank failures leading to bank runs and occasional financial panics. 1927 was the occasion of a major banking crisis as several large and many smaller banks failed and depositors lost their money. Deposits quickly flowed to the large bank: Mitsubishi, Mitsui, Sumitomo, Yasuda and others – and to the postal savings system.

The monetary authorities – the Ministry of Finance and the Bank of Japan – were deeply seared by this expense, and ever since they have placed a high premium on financial system safety, even to the extent of preventing the bankruptcy of individual banks until very recently.

Thus, 1927 ushered in the second stage, running to 1945. It was a period both of bank consolidation and, with the advent of World War II, increasing direct control over the allocations of credit. It was not so different from planned economy systems of resource allocation.

In the 1930s, the monetary authorities reduced the number of banks to about 300, and as war developed they decreased it even further – to a small number of more-or-less nationwide banks with branches, called the city banks, and then a small number – in principle one in each prefecture, in practice about 60 local or regional banks. During World War II the financial system, like all other parts of the economy, were brought under government control in order to allocate resources to military production. Interest rates were fixed, saving was compulsory, goods were rationed, banks were told what companies to lend to, and how much.

The loss of World War II resulted in bombed out cities and factories, demoralization, huge inflation rates (at least by Japanese historical standards – by the time of the 1949 price stabilization the price level was 300 times the prewar level, an Allied, predominantly American, occupation, and a financial system in shambles. The government was forced to repudiate loan guarantees to munitions industries by banks and inflation wiped out the value both of deposits and government debt.

The third stage in the development of Japan's banking system is the period from postwar reconstruction to super-fast growth in the 1950s, 1960s, and until the oil crisis of 1973-74. This is the phase most directly relevant to developing and transforming economies.

During this period the contemporary financial system was firmly established, especially the banking system and the rise of the main bank system. Like everything else the banking system grew very rapidly. Deposits poured in, and the business demand for funds to investment were even greater. It was a highly regulated system, market-based, but one in which the rules of the game were that all banks would grow at more or less the same rate – the convoy system – and, when necessary, the stronger banks would help out the weaker.

It is this stage that probably is of greatest relevance to economies moving from high degrees of state planning and government intervention to a more market-based financial system.

However, before turning to that historical period in more detail, let me note the fourth stage of Japanese financial development, from the mid-1970s until the present, and indeed until the year 2000 when the Japanese so-called Big Bang of financial deregulation is supposed to be completed.

This is the era of deregulation: the ending of controls over interest rates, allowing banks and other financial institutions to enter each other's segmented markets, and to create – although somewhat slowly – new financial instruments. Equally important, it has been a period in which the capital market has thrived, especially the corporate bond market which has attracted the major industrial companies away from their traditional reliance on loans from large banks.

It has also been an era of three major mistakes, two by the monetary authorities and by the participants in financial markets.

The first mistake of the monetary authorities was to deregulate the banking system, and the financial system more generally, without instituting at the same time an effective system of prudential regulation and supervision.

– While BIS capital adequacy requirements applied to larger banks doing international business, they did not apply to smaller banks or credit associations
– supervision was poor, especially of smaller banks and institutions
– the previously opaque system of lack of disclosure and transparency was allowed to persist, so it has been difficult to know the actual condition of banks in trouble
– while a deposit insurance scheme was finally introduced in the 1970s, and increased to 10 million yen (roughly $80,000 U.S. dollars), in practice depositors have assumed that all deposits are guaranteed by the government, and indeed the Ministry of Finance in 1995 made explicit such a guarantee, to end only by the year 2000.

The second mistake of the monetary authorities was to pursue a very easy, low interest rate monetary policy in the late 1980s, precipitating a major asset price boon even while goods and services prices – the inflation rate – was very low and stable. The result was the creation of stock market and especially urban real estate bubbles in the late 1980s.

The mistake of participants in financial markets – bankers, borrowers, real estate developers, households, the monetary authorities – was to believe that the price of land and real estate would never go down very far or for a sustained period of time. After all, it had been the safest form of collateral ever since World War II – easy to sell if a loan was defaulted and without a loss. This collective myopia led to the real estate speculative boom of the late 1980s, fueled by loans from banks, their non-bank financial institution subsidiaries and affiliates, and others. The rise in urban land prices intertwined with a doubling, then tripling, of stock prices in the stock market.

That is, until 1990, when the twin stock and land bubbles burst. Stock prices declined by more than 60%, and now, 7 years later, are still 45% below their previous peak. More seriously, urban commercial real estate prices have fallen by about two-thirds, and perhaps only now are reaching their bottom. They are the primary source of the huge bad loan problem afflicting both large and small Japanese banks.

But that is another story. It nonetheless provides two cautionary lessons:

1– When regulators deregulate and liberalize, they should simultaneously impose effective prudential regulatory and supervisory measures.

2– When greed dominates – when the willingness to take risk increases and the objective reward prospects decrease – all should beware.

Banking in Japan's Postwar High Growth Era

Let me return to Japan's third phase: the two decades of postwar financial development that successfully intermediated between burgeoning new saving and huge investment opportunities and activities in what was a period of great uncertainty and limited information. In the 1950s particularly, when Japan was classified as a less developed country and its future growth prospects seemed uncertain, how Japan handled some of the generic problems to achieve efficient and effective finance is of particular relevance for other developing and transforming economies, including those in the MENA countries and the Middle East.

Most importantly, by the early 1950s Japan had achieved macroeconomic stability. Inflation had been halted, the government was required to run a balanced budget so there was no deficit spending (or government bond issue), and monetary policy – the cost and especially the availability of credit – was the main macroeconomic policy instrument. The exchange rate was fixed at a rate which made exports of, first, labor-intensive products and then more sophisticated products, competitive –from textiles to ships to steel.

Private markets and private ownership predominated. The government owned the national railroad system and the telephone system, but not much else. Inefficient state enterprise was not the albatross around the neck of government that it is elsewhere. There was an adequate institutional infrastructure to support domestic markets – a legal system, enforceable contracts, and property rights – through often disputes were and are resolved through negotiated compromise rather than going to lawyers. Japan is not a litigious society.

There were many new investment opportunities, due to the lag in Japanese technology from American and European levels – plus large numbers of entrepreneurs, managers, engineers, and skilled workers geared to increasing production, improving productivity, and developing new products – in competition with other firms for the domestic market. And entry was easy. Good examples are consumer electronics, and the 9 Japanese automobile producers. Profits remained high even as investment rose dramatically as a share of GDP. This meant that the demand for funds to finance investment was strong. Huge amounts of technology was obtained, mainly by technology licenses and overseas education. As the economy grew, the savings rate increased dramatically. The household saving rate went from 5% of household income to 10%-15% – peaking at 24% in the mid-1970s. Corporations saved as much as they could, too, paying out low dividend rates. And the government was a net saver, financing its infrastructure projects out of tax revenues.

The government decided early on to use the banking system as the mechanism to transfer savings to business investors. It restrained the development of the stock and bond markets. Its rationale was that

– stocks were too risky for ordinary savers, and hence demand would be low

– the bad experience with postwar inflation and the loss of government bond values meant that individuals also thought bonds were too risky

– on the other hand, savings deposits in banks would be the safe way to attract the funds of savers. And they were right.

The banking system was designed to specialize, by size of customer and by term and type of loan. Thus, segmentation among the various categories of banks was the mode of operation.

The core of the banking system was the 20+ big banks –

– the 13, now 10, city banks operating throughout the country

– the 7 trust banks, accepting longer term deposits and specializing more in commercial real estate finance

– the three long term credit banks, financing the building of factories and purchase of equipment, being funded by issuing their own one-year and 5-year bonds.

These big banks were expected to finance the needs of large industrial firms, based on their creditworthiness and growth prospects. The 60 or so local and regional banks were to finance small and medium-sized enterprises in their area. Below this existed a whole panoply of deposit-taking institutions: mutual savings and loan banks, credit associations, credit cooperatives, agricultural credit cooperatives. Their purpose was to accept deposits from and make loans to small businesses and farmers. There were a large number of them, but most were quite small – and some very poorly managed.

In retrospect, these small institutions constitute a great vulnerability in today's deregulated system.

– On the one hand, as deposit-taking institutions, they are susceptible to bank runs if depositors lose confidence in them, which could quickly become panics of systemic proportions.

– On the other hand, most are under the regulatory supervision of their respective prefectures, and that supervision is particularly weak and inadequate.

– Moreover, there is little disclosure. While we know now the dimensions, more or less, of the bad loan problems for larger banks, we have very little information about the actual condition of these small institutions – until they collapse!

While the private banking system dominated in terms of total loans, several government institutions were also important, especially the Japan Export-Import Bank which promoted exports of ships and machinery with long-term loans, and the Japan Development Bank, which made loans to key strategic industries, typically in syndication with the private long-term credit banks and the major city banks.

In terms of international comparison with the experience of other countries the government-owned Japan Development Bank is virtually uniquely successful. First, it always makes a profit, not losses.

– It has to charge a positive real interest rate since its funds come from postal savings, and those depositors have to be paid.

– This, its credit subsidy was perhaps 2-3% age points below the market rate, always positive in real terms.

– Moreover, while it extended the longest term portion of a syndicated loan, it had first claim on the collateral in the event of a loan default.

Second, Japan Development Bank loans were made essentially by market principles of banking creditworthiness and project feasibility, with virtually no interference by politicians or government bureaucrats. There was virtually no corruption in its lending process. The government decided which industries, rather broadly, but the Japan Development Bank loan officers chose the company and project.

Financial intermediation – by bank and by other financial institutions – inherently involves risks since the commitments made are inter-temporal. There are many kinds of risk, including

– credit risk as borrowers cannot repay

– inflation risk which erodes the real value of financial assets

– interest rate risk from mismatching of assets and liabilities

– foreign exchange risk

Banks and other financial institutions reduce risk by pooling and diversification of portfolios.

From the viewpoint of the monetary authorities, and indeed from everyone, the two major criteria for a successful financial system are safety and efficiency. There are several dimensions to safety.

– the fundamental one is the protection of depositors to offer them a very safe and convenient financial asset

– safety of the system, systemic safety, requires mechanisms to prevent a single bank bankruptcy or a run on a bank from becoming a financial panic, with widespread deposit withdrawals

– similarly, systemic safety requires mechanisms to protect the payments system and the settlement system

Given its prewar experience, the Japanese government attached extremely high priority to the safety not just of deposits, but of banks. A regulated system was established so that no banks were allowed to fail, while competition was constrained, first of all by interest rate policy.

– ceiling interest rates on deposit were established, at quite low rates in real terms

– ceiling interest rates were also set on loans, though some evasion was tolerated, and demand was high

– the spread was sufficiently wide that even the most marginal bank made profits

Second, entry conditions were severe

– no new banks were allowed to be established

– creation of new branch offices was limited, and licenses allocated carefully, since branches collected deposits and deposits were profitable. All banks were supposed to grow at about the same speed

Third, if a bank – typically a small one – was so poorly managed that it got into trouble, then it was merged into a larger bank. Even if it had losses, it nonetheless had the franchise value of its branch offices since interest rates were low and demand for loans high.

From the saver's perspective, this system was completely safe – and Japanese are risk-averse – but the interest rate on deposits was inefficiently low and alternative financial instruments were not available. However, in the high growth era savers were willing to put up with this because they could see their deposits becoming highly productive loans to business, and business spawned the rapid growth which generated not only high profits but substantial increases in real wages.

It is on the lending side – the use of savings – that the efficiency story is so important. While of course there were mistakes, on the whole Japan's banking system allocated funds to highly productive business investment projects. In retrospect that seems obvious – and the period of sustained rapid growth meant mistakes were not serious. But at the time – in the 1950s – the investment environment was very uncertain. Information on companies was limited, often of poor quality, and there was great information asymmetry: banks initially knew far less about the company's actual conditions and intentions than did the company and its manager. Moreover, companies were building new plants based on foreign technologies which were being imported under license. How were projects to be evaluated, and accepted or rejected for financing? Which technologies would prevail?

Japan's vaunted main bank system of very close relationships between large banks and their large industrial clients is the way in which these problems were overcome. It evolved out of the need to assess credit risk and to attract and keep excellent customers. It is a system of ongoing, repeated loans and other financial business, a system of mutual interdependence of bank and customer, not subjection of one to the other.

The main bank relationship is multidimensional. Typically, the bank was

– the single largest lender to the company (15-25% of its borrowings), but not the sole lender
– the organizer of a de facto syndicate of other banks and lending institutions to the customer
– the main clearing bank for the customer, and provider of trustee, foreign exchange and other services, at good fees
– it held close to 10% of the company's shares (a maximum reduced to 5% in the 1980s), and the company held some of the bank's shares – not to exercise control but as a symbol of the relationship
– the bank had special access to very detailed information about the company's plans and prospects, and monitored its performance, in effect providing management consulting services
– the main bank had a special responsibility to help out its client in times of distress – to refinance, to restructure it, even if costly to the main bank. Usually this involved replacing top management.

This system was efficient in two respects. First, by investing staff and time into monitoring, the main banks were able to increase information and improve credit evaluation, thereby reducing loan risk premia; and probably this oversight provided incentives for borrower company management to perform well, and not to shirk. Second, the main bank system reduced the costs of reorganizing and restructuring firms in distress. Of course, if they were beyond hope the company was closed. Otherwise, management was changed, financing was restructured, new strategic business alliances found – all of this more quickly and more cheaply than in the highly legalistic U.S. system.

It should be said that the main bank system was very much a product of its times and the needs they generated. Main banks play a role today, but in much less pronounced a form, and for a different set of clients – mid-sized companies preparing for an initial issue in the stock market have found a main bank relationship very useful.

Several factors have reduced the intensity of the main bank relationship over the past two decades. First, with the ending of super-rapid growth in the mid-1970s, the financial system shifted from one of financial tightness to ease, as the domestic saving rate became higher than the domestic investment rate; accordingly interest rates declined and competition increased. Second, deregulation brought other competitors into the loan market. Perhaps more importantly, the development of a corporate bond market – especially the Euro-bond market – with lower borrowing costs, made it possible for top quality companies to finance through bond issue. Third, the very success of the Japanese economy and its companies meant that the business environment was much more stable; information was much better, more widely available, and transparent; and international credit rating companies could and did rate Japanese companies and their debt issues. Fourth, companies, while continuing to value a main bank relationship but always fearful of an unequal bargaining position, substituted a system of 2 or 3 core banks for the single main bank.

Given a system of intense relationship banking, there are possibilities of its misuse – by the stockholders, by the managers themselves, by the government. On the whole, that did not happen a great deal. Except for some very small banks, the stockholders do not control the banks. Stock ownership is highly dispersed, is a system of cross-shareholding in which companies hold the majority of shares in each other, in banks, and banks in them. This was a mechanism developed by management to entrench itself, to protect itself for the threat of hostile take-over. All Japanese companies behave this way. Accordingly, management stays in power under normal circumstances.

How then, does corporate governance work?
– for industrial corporations, in substantial part through its main bank, as well as an informal council of retired chairmen
– for banks, management is subject to the broad regulatory authority of the government, whose basic objectives are safety
– – and strong banks helping out weaker ones in a crisis

There is a symbiotic relationship between the bankers and the regulators; retired Ministry of Finance and Bank of Japan officials become members of the senior management of banks.

Given the lack of information and the opaqueness of transactions, and some degree of credit rationing, there has been remarkably little corruption in the Japanese banking system, compared to many other countries. My interpretation is not that Japanese are fundamentally more honest, but that the penalties for being caught are huge. Japanese place great emphasis on status and pride in a job well done. To be caught in a bribery situation means both great shame – on self, family, and employing institution; and a loss of job in a managerial labor market in which there would be no other opportunities. So while the financing of politics and politicians is dubious, most government officials – a true career elite – and bankers are not corrupt.

Finally, let me address two broader issues.

First, I have focused mainly on the financing of big business by the large banks, and their reduction of costs through information gathering and monitoring. But how were other sectors financed: small business, infrastructure, exports? The structure of small business finance was similar to that for big business: small banks and specialized lending institutions, though requiring collateral and lending at higher interest rates. Infrastructure – the regional electric power companies, the national railroad, the telephone company – were financed by bond issues and loans on preferential terms: buyers were the large private financial institutions subscribing in proportion to their size. Important also was government institution lending. The central bank accepted these bonds as collateral for low interest rate loans to city banks, in effect indirectly financing these infrastructure projects through the normal (desired) growth in the money supply.

While infrastructure needs were great, and were met, the rest of the government sector was kept small. During the 1950s and 1960s, there was little in the way of social safety nets. The government did not provide jobs, nor did it provide unemployment insurance. The labor market was flexible, and everyone worked. And families took care of their family members. The rapid growth that ensued was a virtuous circle: creating new jobs, raising productivity, wages, incomes, and saving, and making attractive more new productive investment.

Export credit was readily available, and relatively cheap; export bills were rediscounted by the central bank, and the Japan Export-Import Bank provided longer-term export credits. Industries generating exports had little difficulty in borrowing.

Second, I have alluded to relatively low interest rates and some degree of credit rationing. Such policies of <u>financial</u> <u>repression</u> are also an avenue for corruption and for misallocation of resources. Why didn't this become a serious problem in Japan? The main reason is that financial repression was <u>very</u> <u>mild</u>. First, A market-clearing interest rate was quite high, perhaps 7-9% in real terms, because of the high productivity of investment.

The credit subsidies provided by the Japan Development Bank and by interest rate ceilings on loans, though they were often evaded in practice, were low – 2 to 3 percentage points below the market rate. So even subsidized credit was provided at a positive real interest rate.

Second, credit rationing was by broad categories, not narrow. Banks could choose among priority sectors, and did reject some the government targeted for support, such as ocean shipping. There were no national champion companies which obtained preferential credit. The state did not own manufacturing enterprises. Basically, the credit allocation system, in cost and availability, discriminated against consumer credit, housing loans, and small business, and in favor of big business in the period we are considering.

Two cliches have been Japan Inc. and MITI industrial policy. Both are simplistic misrepresentations of the market realities. Two of Japan's most successful industries, automobiles and consumer electronics, were built by Japanese companies <u>despite</u> the government rather than because of special targeting.

In simply summary, Japan's banking system contributed so much in the postwar rapid growth era because

– families saved a large share of their incomes, and put their savings into bank saving deposits
– banks lent to firms based on their credit-worthiness and growth potential
– firms had to borrow a great deal to finance their market growth opportunities, and loans were the only external source of funds
– the main banks carefully monitored their client companies to ensure that management performed well, and good projects were chosen
– and the regulatory authorities monitored the banks to ensure that they maintained their safety and thereby the safety of the entire financial system.