Japan's Financial System and the Evolving Role of Main Banks

Hugh Patrick

Working Paper No. 50

Hugh Patrick is R.D. Calkins Professor of International Business and Director of the Center on Japanese Economy and Business at the Graduate School of Business, Columbia University. This paper was prepared for the MITI/RI Advisory Board Meeting, June 3-5, 1991. Not for quotation or citation without permission.
The Japanese case of financial system development is important in a comparative context for theoretical and analytical reasons, and has policy implications for the developing market economies and transforming/reforming centrally planned economies as well as the advanced industrial market economies. The Japanese main bank system of long-term bank-borrower relationships is at the core, analytically and empirically, of Japan's loan-based finance system. At the same time, the rise in importance of securities markets in the latter half of the 1980s has been profound.

An analysis of Japan's main banking system has five interrelated dimensions: the theory of main banks in the context of imperfect, asymmetric information; empirical analysis of the role, behavior and performance of Japanese main banks; the historical context under which Japan's bank system emerged, thrived, and more recently became subject to competition from direct finance (securities markets); the institutional framework of Japan's financial system into which the banking system fits; and, importantly, the nature and role of government (Ministry of Finance and Bank of Japan) regulatory and allocative policies in shaping the main bank system, and more broadly, in affecting the allocation of credit and real economic performance.

Following a general discussion of the evolution of Japan's financial system and its broader relevance, this paper briefly discusses three issues. First, which is a better financial system: one based on banking (and main banks); or one based on competitive, efficient markets for the issuance of securities, notably bonds, shares, and commercial paper? Second, what is the requisite institutional infrastructure and what are the most
appropriate and efficient institutional arrangements to finance the priority activities and sectors as defined by a country’s development strategy? Third, from a political economy perspective, how are the rents generated in regulated systems characterized by below-market interest rate ceilings (e.g., financial repression and hence reliance upon bank loans) allocated among different potential claimants? Are the banks no more than handmaidens of authoritarian and/or corrupt regimes?

The Japanese Financial System

The development of the Japanese financial system has been an important factor contributing to Japan’s modern economic development and growth since the Meiji Restoration in 1868. The Japanese case provides a useful analytical and empirical basis for evaluating key institutional issues in development finance. The Japanese experience provides important insight for developing countries: how savings have been mobilized and then allocated to finance productive investment; how the financial system and its panoply of institutions were created and developed; how problems of imperfect and asymmetric information have been dealt with through the development of the main bank system; how priority activities and sectors have been funded. Institutions matter -- financial structure does affect economic performance.

And history matters. Japan’s present banking and financial system is a direct consequence of its long-run development, which can be divided into five quite distinctive phases in terms of institutions, policies, patterns, and performance.
The first phase -- from the 1870s to the first decade of the twentieth century -- was devoted to the initial creation of a modern, market-based financial system through the importation, assimilation, and spread of the institutions of banks and other modern financial intermediaries. Japan, like continental Europe, was an early follower in the institutional development of its financial system. The second phase, ending in 1936 or so, evolved from the first; it was devoted to the growth, development, and increasing diversification of the financial system in a quite free, competitive, and rather unregulated market environment in which considerable bank consolidation took place (from 1,697 commercial banks in 1905 to 424 in 1936) as a consequence of endemic bank runs and financial panics.

The third phase was brief, from 1937 to 1952, but traumatic. In the wartime and Occupation environment, market forces were replaced by direct government controls, the number of banks was sharply reduced, and finance was repressed as credit was allocated by bureaucratic decision-making rather than market-based interest rates.

The fourth phase -- from restoration of independence in 1952 to the beginning of financial liberalization in the mid-1970s -- was characterized by a very stable, inherited system of banks and other financial institutions mobilizing and allocating savings in a high-growth economy still regulated by controls over loan, deposit, and bond issue interest rates. Finance was mildly repressed in that demand for funds were in excess of supply as markets did not clear, but real interest rates were positive; and new entry was prohibited, creation of new financial instruments restricted, and markets
and financial institution activities segmented. Funds were in practice rather competitively allocated among large business borrowers, but at the expense of small business, housing, consumers, and particularly depositors (savers).

The fifth phase, from the mid-1970s to the present, has been one of transition to a free market-based system of finance characterized by a gradual, piecemeal process of financial deregulation and liberalization. Private (ex ante and ex post) saving for the first time in the postwar period exceeded private domestic investment; and securities issues -- equity as well as bonds -- became an increasingly important source of external finance for large corporations, replacing bank loans to some extent, though not for the non-financial corporate sector as a whole.

The Japanese system of main banks began to emerge in the prewar period, though initially most banks were owned and controlled by industrial entrepreneurs who used them to finance their own business activities. During World War II the main bank system was strengthened as firms and banks were assigned to each other by governmental regulation. Postwar reforms brought on the separation of ownership and control, and Japan's main banking system grew up in the high-growth era which persisted until the mid-1970s. In the past fifteen years, the main banking system has matured and been transformed by the rise in securities markets finance (and explosive increases in share prices), opportunities for expansion into international markets, and now new and unexpected problems of decrease in the amount of unrealized capital gains and of serious potential real estate loan problems.
Why should one study the Japanese case of banking and finance in particular? The answers are straightforward. Japan has the world’s second largest national financial system. But that is less important than the fact that the system has grown and evolved from virtually nothing 125 years ago, and continues to evolve in a dynamic pattern of growth and institutional development. And that is less important than the fact that Japan is the pre-eminent case of the institutional system of main banks and relationship banking, through by no means the only case. There are other reasons as well. In the past fifteen years the government, pressured by inexorable market forces, has engaged in gradual but major, comprehensive liberalizing reform to free up financial markets and make them more competitive. Moreover, the financial system in 1991 faces its greatest challenge since Japan’s financial crisis of 1927. The empirical data and studies available on the Japanese experience are sufficient to make analysis possible and worthwhile. Importantly, while every country like every person has its unique features and own history, the Japanese financial system is not unique; it is not fundamentally based on unique Japanese values, patterns of behavior, or institutional arrangements. Insights can be gleaned from the Japanese experience of financial development and applied to the analysis and policy prescription for other countries. There are lessons, direct and indirect, for the developing world -- both market economies and centrally planned economies in the process of fundamental reform and transformation toward market systems.
Banking versus Security Markets

Perhaps the most important current issue in the theory of finance relevant to advanced industrial market economies is which institutional arrangement is more efficient: banking or securities markets. In some respects this is a relatively new issue -- of the last decade or so -- in the literature. For all too long the prevailing view was that finance does not matter: the structure and nature of financing has no effect on investment or other real economic activity. This view was derived from the quite restrictive assumptions of the neo-classical perfect competition paradigm. It was reinforced by the 1958 seminal Modigliani-Miller theorem that, tax considerations assumed away, corporate financial structure is both indeterminate and irrelevant -- whether internal finance or external, and for the latter whether debt or equity. If finance does not matter, then neither do its institutional arrangements.

Economic historians and development finance specialists, and certainly policy makers, have known that in the real world finance does matter, and so too do its institutions. In the literature the Modigliani-Miller theorem has now come to be recognized as a special case, not consistent with the empirical evidence. Taxes do matter, as has been amply demonstrated. Transaction costs are significant and reflect substantial economies of scale. More important theoretically, it is now accepted that markets are incomplete and imperfect, particularly for information; and information asymmetries between borrowers and lenders do make it more difficult and costly to raise funds to finance investment. A quite different criticism of the Modigliani-Miller
theorem is that ownership and control are separate in large firms and that the management in control does not work solely to maximize owner (stockholder) benefit. While many see this as essentially a principal-agent problem, Aoki has extended the analysis in his model of the Japanese firm in which management is the arbiter of the competing interests of (widely distributed) stockholders, employees with (implicit) lifetime employment contracts, and (main bank) creditors.

The main thrust of the recent developments in the theory of finance has been founded on the recognition that information about the creditworthiness of borrowers and their investment projects is far from perfect; costly to produce; and unequally distributed between insiders (typically borrowers) and outsiders (typically creditors), both lenders and their ultimate sources of funds. From this has arisen analysis of problems of incentive structures, management of risk, moral hazard, adverse selection, insurance mechanisms against default losses, costs of information production, design of financial contracts, delegated monitoring, syndication of loans and underwriting, and mechanisms for corporate control. A main bank, engaging in repeated, negotiated lending transactions with a borrower, invests in and develops a relationship which provides it superior access to information about the client. The main bank’s functions vis-a-vis its borrower are threefold: to collect and analyze information; to monitor the borrower’s behavior and performance; and to exercise control when adversity arises. Control is absolute only in extreme cases; it is typically more nuanced, subtle, and partial, intertwined with both the information-gathering and monitoring functions.
Analysis of the relative merits of bank-based versus market-based finance must be placed in empirical context. At an aggregate level, both historically and in the postwar period the gross real investment of the non-financial corporate sector in every advanced industrial market economy has been financed primarily from internal sources (retained earnings and depreciation allowances) rather than through the financial system, whether bank loans or new securities issue. In other words, the financial system certainly plays an important role as the marginal supplier of funds but most investment is financed within the corporate sector. Moreover, bank loans have been the predominant form of external finance -- some two-thirds in the United States (between 1970-85), more in the U.K., and 85-90 percent in Japan and Germany. At this aggregate level, equity was a significant external source (one-sixth) only in the U.K., and bond issue (28 percent) only in the U.S.

What is going on? The aggregate data disguise two sets of important external financing patterns. First, at the micro level some firms are paying off debt and repurchasing equity, while others are obtaining funds; and some firms are purchasing other firms. All this presumably improves allocative efficiency within the corporate sector, but the macro data net out these effects. Second, small-medium firms, unlike large, typically cannot issue securities in markets; they must rely on bank loans and trade credit for external finance. The debate over bank versus market finance is relevant only for large corporations.
Nonetheless, new issue markets for corporate stocks and bonds thrive, which tell us that in some financial systems and for some (large) scale of issue markets compete effectively against bank finance. It is here that the Anglo-North American system of securities finance through open competitive markets is contraposed against the Japanese and German systems of negotiated bank loan finance. U.K. and U.S. securities issue markets are broader, deeper, and less bound by policy and institutional restraints; not surprisingly, direct costs of bond issue in these markets are significantly lower than in Japan or Germany. Large creditworthy corporations prepared to meet the informational requirements of these securities markets -- whether they be British, American, Japanese, German, or other firms -- can indeed raise funds by securities issue more cheaply than bank loans.

Thus, securities markets can efficiently serve the large, elite corporations of the world -- but they do not comprise the majority of corporate business investment in any country. Moreover, the matter for them is simply one of cost, not access; elite corporations can readily borrow from banks. The important issue for them now is whether or not they benefit from establishing and maintaining main banking relationships. In funding large corporations, securities markets indirectly enable smaller firms to borrow more from banks (depending on changes in flows of savings to securities markets and to deposits.)

The resurgence of interest in banks as more efficient financial intermediaries than securities markets for even quite large firms has been generated in substantial part
by the remarkable economic successes of Japan and Germany and their respective banking systems. Germany practices universal banking whereby banks hold substantial equity positions in major corporate clients, and apparently have and exercise substantial powers not only to monitor but to shape and even control management decisions. In Japan commercial banking and investment banking have been separated under Article 65 of the Securities and Exchange Law (analogous to and based on the Glass-Steagall Act), but Japanese banks are allowed to invest in up to 5 percent of the shares of an industrial corporation. Japan’s main bank institutional arrangement has been analyzed in some detail. That analysis frequently has been intertwined with, and at times confused by, analysis of Japan’s business groups (keiretsu), particularly the six major horizontal groups. The main bank phenomenon may be seen in its purest form in the member bank of these groups, though that is by no means clear; the main bank system probably characterizes most banks and most borrowers in Japan, large and small.

In the development finance context, the debate as to whether banking or securities markets is the better institutional arrangement is, in fact, a much less important issue. Securities markets, unless they are heavily subsidized, are unlikely to play a major role in the efficient allocation of new saving to business investment activities. There are simply too few large firms capable of and willing to issue new securities in the open market, quite aside from the demand for them. Even more than in the economically advanced countries banks are and will be the dominant source of external finance in developing economies.
Institutional Arrangements and Sectoral Credit Allocations

Almost all of the recent theoretical developments in finance have been framed, usually implicitly rather than explicitly, in the context of advanced industrial market economies with generally competitive markets. Sophisticated variants of the neoclassical paradigm or of oligopoly models are employed, embodying a host of implicit assumptions about institutional arrangements. These include, for example, the existence and effective operation of a legal system under which contracts, while incomplete, can be inexpensively written and enforced; a developed accounting profession and auditing system which generates substantial amounts of reliable information about corporations and their financial positions; and financial markets and institutions which, while regulated, are highly competitive and in which prices for financial products and services are determined in the marketplace rather than by regulatory fiat.

Finance in developing market economies is a quite different world. The institutions are less well developed. Banks and their loans are the main instruments of financial intermediation; primary and securities markets are fledgling (and typically appropriately so). The institutional infrastructure is weaker. A far wider range of contingencies cannot be covered by contract, or as readily enforced through an effectively operating system of civil law. Information is difficult to come by, and frequently of dubious quality or reliability. The rules for accounting, auditing, and disclosure are far less developed, weaker, and often used to protect corporations and
their owner-operators against outside creditors and the tax authorities. The financial system may be highly regulated and more or less repressed. Promotion of competition typically is given far lower priority than the maintenance of system stability. Financial repression means, first of all, that ceiling interest rates on loans, deposits, bonds and other financial instruments are set below market-clearing rates. Some developing economies are unwilling or unable to prevent inflation; the greater the rate of inflation the more severe the financial repression, with negative real interest rates and a sharply diminished role for the organized financial system. This institutional infrastructure -- law, auditing, regulation, supervision, government macroeconomic policy -- is an essential ingredient for an effective financial system; it is assumed as a given (taken for granted) in most finance theory. It cannot be assumed away in the development finance context.

In Japan as elsewhere these institutional issues have been of concern, and over time have been increasingly addressed. Over time, auditing and reporting standards and requirements have become more comprehensive and thorough. However, it was only in the 1980s that consolidated balance sheets were required for large firms listed on the stock exchanges. On the other hand, unlike the United States, company managements make annual forecasts of profits. The legal system is much less relied upon to settle disputes; most are handled by private negotiation. The supervisory system of the Ministry of Finance and Bank of Japan has been assumed to be strong, anticipatory, and effective -- but the system has not yet really been tested by serious adversity.
Banks in trouble have been merged into bigger banks; there have been no depositor losses. Under the regulated system, popularly termed a convoy system, all banks made profits; deregulation will expose the differences in portfolio quality and management efficiency and moral hazard problems may surface.

A second set of institutional issues arise from the utilization of finance as a major policy instrument to implement a country's development strategy. Virtually no government adopts a complete laissez-faire, purely market economy development strategy. Appropriate criteria and rationales for government intervention is one set of issues. How the policies are implemented is another. Are policies and policy instruments pro-market (market conforming), or do they attempt to replace the market with direct methods of resource allocation?

Japanese experience is relevant in addressing these issues of development finance. There have been five types of economic activity which the government designated as of developmental priority, and for which specific policies and institutions have been devised: transport, power, and communications infrastructure; the financing of long-term, fixed investment; export credit; small business financing; and sector-specific industrial policy ("picking winners and phasing out losers"). Japan is by no means unique in its policies and in its creation of institutions to provide preferential funding for these purposes. A careful, comprehensive evaluation of the sources and uses of funds, and the effectiveness of these institutions in the Japanese case has yet to be made.
Government intervention in financial markets -- through the creation of government financial institutions and/or the provision of incentives (market-oriented or directly regulatory) to private financial institutions -- is justified on other grounds in addition to economic growth and development. Japan and all the economically advanced countries, the U.S. and U.K. included, use finance to achieve social policy goals, usually income redistributive and/or political in intent. These include Japanese financing institutions and programs for housing, agriculture, and, some would argue, small business.

The Financial System and the State

Finally, the relationships between the financial system, the state, and the political system are very important in any society. Access to, and the cost of, credit are powerful instruments, particularly in systems where competition does not reign supreme. Financial regulation and repression can create large rents due, for example, to the gap between loan and deposit rates or other forms of anti-competitive institutional and policy arrangements. Subsidized, low interest rates on priority sector credit also generate rents. Someone gets these rents. They are somehow shared among bank owners and managers, borrowers, government officials, and political leaders and parties. This is the central political economy issue of finance. The seamy side of finance has not been subject to much empirical analysis, for obvious reasons: these relationships and arrangements are opaque, far from transparent; information is particularly difficult to
obtain; and research on these topics is not encouraged. Thus, while theoretically and conceptually rent-seeking (sometimes termed corruption) is well understood, quantitative analysis is very difficult. It may not go too far to say this is a taboo topic for research.

By noting this issue I do not mean to imply that Japanese institutions or behavior are particularly conducive to rent creation and rent seeking through the financial system. Indeed, Japan seems to have avoided a major source of trouble: low effective interest rates to borrowers. The nominal ceilings on loan interest rates were evaded by the use of compensating balances and other loopholes; the prevailing view is that loan markets cleared, certainly those for large corporations, so rents were not created. The Japanese government bureaucracy is notably honest; its rewards come in post-retirement positions, and then for merit, not pay-offs for direct policy decisions. The dilemma for Japan is that of every democratic society: how to finance the costs of elections, politicians, the political process. In Japan as elsewhere the financial system apparently plays a not unimportant role.
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