Bank of Japan Working Paper Series

Globalization: Role of Institution Building in the Japanese Financial Sector

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No.03-E-7
December 2003

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G-20 Case Study: Japan

Globalization: Role of Institution Building in the Japanese Financial Sector [1]

1. Core Perspectives

This paper strives to appraise -- in terms of contributions to economic development -- Japan's postwar financial system, a system that has been exposed to a variety of environmental changes over time including globalization.

Having been designed to foster growth, the postwar financial system did contribute to Japan's rapid economic expansion. As such, it served an instrumental role in bringing about what was termed the "Japanese Miracle." However, the 1980s and thereafter witnessed the surge and collapse of a Japanese economic bubble under this same system. With the mounting burdens of non-performing loan that ensued, the financial system has since been remained as an issue of concern in the Japanese economy's "lost decade."

As recent research[2] indicates, an economic system that is successful within one set of environmental conditions could lead to failure if those conditions change. Such environmental changes need not be purely external. The overall institutional arrangements surrounding the system may misfit with the changing environment and ultimately make the original system somewhat incompatible or obsolete. The financial system of postwar Japan has been described as a classic example of this phenomenon.

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[1] This paper was prepared by Wataru Takahashi and Shuji Kobayakawa of the International Department. The authors thank Hirotaka Inoue, Yohei Kawana, Masao Fujiwara, and Yukiko Sakai for their help, comments and suggestions.

[2] See, for example, Masahiko Aoki (2001) *Toward a Comparative Institutional Analysis*, MIT Press, Cambridge.

This paper looks back to the key development of Japan's postwar financial system, and then makes some conclusions about the main features of Japan's system.

2. The Development of the Financial System during the High-Growth Period

The goal for the postwar Japanese economy was clear: achieve high growth and improve national standards of living. To that end, priority was placed on intensive industrialization from light industries such as textiles to heavy industries such as steel, shipbuilding, and chemicals,[3] coupled with steps to foster the advancement of coal mining and other energy industries. This industrialization merited importance as a strategy to help Japan "catch up" with other industrialized countries. Indeed, one key feature of postwar Japan is that instead of relying purely on market forces, the government helped the country reach parity with the rest of the industrialized world by pursuing an active role in market economy through regulations and guidance, amongst others.[4]

In terms of government policy, low interest rates through regulations and principles of balanced budget were valuable pillars of support for the government's growth-oriented policies. On the financial front, the big question was how to promote investment and, in particular, how to concentrate more capital in strategically important industries. The financial sector was expected to encourage efficient investments of the nation's then relatively meager pool of private savings. To that end, efforts were focused on the cultivation of a bank-oriented credit intermediation mechanism.[5] [6]

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[3] Later, the automobiles and electronics evolved as strategic sectors.

[4] Government-led economic activities functioned effectively when the interest of the public was focused on growth rather than the distribution of wealth. Distributing wealth through market forces is important when national standards of living improve and the needs of the public diversify. In addition, "hard-budget constraint" successfully prevented many developing countries from getting into financial trouble.

[5] Franklin Allen and Douglas Gale (2000), in their book titled *Comparing Financial Systems* (MIT Press, Cambridge), focused on the role of financial intermediaries to

The main feature of the Japanese financial system during the high-growth period was its strong orientation to regulate. This was echoed through the use of administrative guidance to encourage the flow of financing into strategic industries as well as to protect and stabilize the banking operations in the interest of facilitating bank-oriented intermediation in national savings. The system of specialized financial institutions was set up and strategic financing was implemented on that basis. Meanwhile, deposit rates were generally controlled, generating rents for the banking sector. Outside the banking sector, restrictions applied to the cultivation of the bond market, thus constraining the flow of funds to and from other countries.

(1) Control over deposit interest rates

Deposit interest rates were controlled to prevent rate competition. These controls were not only effective at stemming unreasonably high lending rates, but also helped reduce the cost of export and investment financing through the implementation of low rates.[7]

(2) Restrictions on the banking business

Controls were also placed on participation in the financial system, thus limiting competition among banks. The banking business was segmented

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alleviate informational asymmetries and drew following conclusions. First, during the era of rapid growth, the profitability of the investment opportunities is relatively easy to assess. Hence, a bank-centered financing saves the cost of monitoring potential borrowers. Second, as economy grows and the profitability diversifies, the merit of delegated monitoring diminishes. In that case, various investment appetite is satisfied more easily under a direct-financing.

During its era of rapid growth, the Japanese economy was driven by the clear-cut policy goal of catching up with the rest of the industrialized world. Under such circumstances, cultivating a bank-oriented financial system was arguably the wise choice.

[6] Contrary to a bank-oriented financial system is a market-oriented financial system.

[7] It has been pointed out that lending rates were not held at low levels if examined on an effective basis by taking deposit yields into account. In the past, firms were required to hold compensating balance with main banks (demand deposit accounts that had been required to hold under a low interest rate in compensation for borrowing at higher rates). Nonetheless, lending rates were arguably held down to some extent in practice through the stabilization of bank operations. A more important point is that bank rents contributed to an expansion in bank lending.

into various specialties. That is to say, city banks provided short-term funding to the nation's strategically important industries while long-term credit banks supplied financing for long-term capital investments, thus functioning as an alternative to financing through the bond market. In the interim, as a fundraising measure, the long-term credit banks issued bank debentures in denominations smaller than those for corporate bonds, thus contributing significantly to the absorption of savings. The regional banks and credit unions provided loans to small and medium-scale businesses and also extended funding to larger banks through the short-term money market using the excess capital remaining from their lending activities. This system of specialized financial institutions effectively prevented any competition between the regional and large banks.[8]

(3) The coordination of bond issues and the partitioning of the domestic and foreign markets

In keeping with its policy of fiscal balance, Japan did not begin issuing government bonds on a serious scale until after the 1970s. Most companies obtained their long-term funding from the long-term credit banks, and controls were in effect on coupon rates and bond volume. Under these conditions, the bond market lagged in its development. Foreign capital transactions were also subject to constraints. In particular, tight curbs were placed on inflows of foreign capital to protect domestic regulatory frameworks from outside influence.[9]

To summarize the main points made so far, Japan can be credited for establishing a rather controlled, bank-centered financial system and achieving high economic growth with intensive capital injections into strategic industries driven by the allocation of bank deposits and lending.[10]

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8 Monitoring was effectively done by specialized financial institutions.

9 Among the more-recent cases of economic development, some countries have relied on foreign capital, that is, foreign direct investment, to offset domestic shortfalls of investment funding. In this respect, they followed significantly different paths than did Japan during its high-growth era.

10 Bank-centered financial systems are able to support strategic investments with the preferential extension of certain forms of credit. The government was capable of monitoring the supply of capital to strategically important industries through the

In the process, the generation of bank rents through regulated low-interest-rate policies, together with the stabilization of business operations with the aid of assorted regulations, allowed Japanese banks to orient themselves more toward quantitative expansion. With their net yields protected by regulations, the banks enjoyed a structure that ensured higher returns as they accumulate more deposits and extended more loans.[11] Such banking behavior promoted tendency for the public to save more. As branch network of banks expanded, financial services rendered to the public contributed importantly to the absorption of deposit, thus enabling businesses to raise funds during the high-growth period.

3. The End of High Growth and the Beginning of a Transformation in the Financial System

In the 1970s, a number of significant environmental changes brought the Japanese economy to a crucial turning point. First, the phase of rapid economic ascension had come to an end, and the growth rate began tracing a downtrend (see Figure 1). Although several factors may be cited to explain the decline of the growth rate, the most noteworthy and fundamental factor was the virtual end to the migration of labor from the agricultural to the industrial sectors. The shift of the labor force from rural areas to the cities had increased overall labor supply through the expansion of the available pool of labor, and also fostered growth in aggregate demand through a corresponding increase in the total number of urban households. However, the 1970s heralded the end of this pattern and ushered the Japanese economy into a phase of stable growth, as natural rate of growth declines.

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lending activities of banks. Additionally, the Bank of Japan used window guidance to encourage private banks to keep aggregate increases in loan volume within limits deemed appropriate. Note, however, that window guidance sought to limit aggregate lending by individual banks, and not the amount of lending to individual companies.

[11] On the surface, this may appear to be a contradiction. However, while competition was limited among Japanese banks in different fields of specialization, it was intense among those operating in the same fields. On top of that, banks were eager to absorb deposits and actively competed for good customers. These factors in turn contributed to improved business efficiency.

Second, the Japanese public had begun to express a desire for a shift in the government's growth-oriented policy goals. For example, public opinion favored revisions to growth policy because the era of rapid growth had been accompanied by increased levels of environmental pollution and other problems. Furthermore, the people had demonstrated a strengthened interest in the creation of a welfare state. On the financial side, households had amassed significant pools of financial assets (see Figure 2). As a result, the risk appetite associated therewith had risen, and everyone began seeking financial assets that generated a higher rate of return.

Third, Japan had come under growing foreign pressure to deregulate and open up its markets. A heightened presence in the trade arena demanded that Japan in turn open its markets wider to foreign trade. Likewise it came under pressure to liberalize its capital markets.

(1) Pressure for financial deregulation

The falloff in economic growth, coupled with the accumulation of financial assets, brought about a change in capital flows (see Figure 3). Funding shortfalls in the corporate sector dwindled. Although a savings surplus continued to accumulate in the household sector, that surplus was absorbed by the public finance and foreign sectors (current account surplus).

This correspondingly undermined the simple lending function of financial intermediaries to corporate sector and generated increased demand for the role of asset allocation services. The increase in private and corporate savings sparked demand for higher returns on bank deposits, which in turn created pressure to liberalize Japan's financial sector. In the arena of public finance, slower GDP growth translated into slower growth or a decline in tax revenue. As a consequence, increased spending on welfare and economic stimulus led to fiscal deficits. To offset these deficits, the government expanded its reliance on the issuance of bonds. JGBs had been purchased by banks when their volume was still small in scale. However, the expanding volume of issues outstanding necessitated that bonds be floated in the financial markets. Interest rates were accordingly deregulated to improve the appeal of JGBs as investment vehicles. This in turn had the effect of expanding the open market[12] and encouraging the deregulation of rates on bank deposits and other financial assets. Pressure to deregulate Japan's financial sector also came from capital markets overseas. Heightened business abroad encouraged many Japanese corporations to invest their asset holdings in foreign capital markets despite a variety of controls and regulations. Japanese banks also became active overseas and accordingly began to express a desire for globalized forms of asset management. These trends of globalization accelerated with the abandonment of restrictions against the conversion of foreign currencies into yen. Efforts in domestic financial deregulation were also encouraged as a means of curbing the "hollowing" of Japan's domestic financial markets.

(2) The pursuit of gradual approach in financial liberalization

Faced with the critical environmental changes described above, Japan opted for a strategy of gradual adjustments to its financial system while maintaining a degree of order.

The financial liberalization process was a phased and gradual approach. For example, the liberalization of deposit interest rates took 15 years (see Table 1), beginning in 1979 with the lifting of a ban on the issuance of CDs. In addition, capital and foreign exchange transactions were fully liberalized in 1998, 34 years after the liberalization of current transactions in 1964 (see Table 2).

Liberalization steps in the form of a lowering or removal of barriers separating the banking, securities, and insurance, as well as the relaxation of the specialty banking framework, were also gradual. Although the government began studying financial reforms in the 1970s, opposition from vested interests somewhat delayed progress. Fundamental reforms in this area had to wait until 1996, the year of Japan's financial Big Bang (see Table 3, 4).

Given that progress in the arena of financial reform could also be expected to bring about a decline in rent resulting from the remaining regulations,

[12] Open market, as opposed to interbank market, first appeared in *Gensaki* transactions. As a result, disintermediation in the banking sector became acute.

banks faced pressure to improve their profit margins within the new financial market setting. However, the banks continued to earn rents because of the gradual nature of steps in financial liberalization. This let them maintain an expansionary lending stance and increase their lending volume even during periods of slow growth. Consequently, bank lending expanded at a pace exceeding macroeconomic growth through the 1970s and 1980s (see Figure 4, 5). Although most Japanese banks at that time were not able to rid themselves of weak profit margins, they did make an effort to improve their margins in the first half of the 1980s. In the process, they increased their lending to customers in the real estate sector (see Figure 6, 7).

This strategy, however, fueled Japan's speculative bubble. Real estate prices in Japan had risen without pause throughout the postwar era. Japanese banks for this reason proved relatively poor in managing the risk associated with real estate-related loans. Arguably, expanded bank lending without adequate risk management in a climate of gradual rate liberalization bred the seeds of the speculative bubble, the collapse of which left Japan's banking sector saddled with a growing burden of nonperforming loans.

4. Provisional Appraisal

Taken together, the forgoing points lead to the following conclusions.

The choice of a bank-centered financial system afforded several advantages to the Japanese economy during its developing stages. First, from a financing standpoint, banks were skilled in the absorption of small-scale savings.[13] In terms of fund allocation, they intensively channeled funding to strategically important industrial sectors, in line with the government's policies on industrial development. Eventually, though, the economic

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[13] By contrast, direct financing was not suited to the absorption of small-scale savings because (i) the small denominations for many financial products are still relatively large, and (ii) investors are directly exposed to corporate credit risk.

transition into a phase of stable growth, coupled with the accumulation of financial assets and globalization, prompted sweeping changes in the flow of funds. This in turn sparked growing pressure for steps in financial liberalization, preventing the banks from maintaining their frameworks for a financial system marked by limited competition. The Japanese government, in response, implemented a progressive, staged schedule of financial liberalization. Under the circumstances, many banks proved too slow in improving their earnings structure under new principles of self-accountability, or in establishing frameworks for risk management. These conditions arguably bred the seeds for the eventual creation and collapse of the speculative bubble and the non-performing loan problems that emerged thereafter.

Certain features come into better focus if one makes some conclusions based on a comparative institutional analysis[14] of the changes that have reshaped Japan's financial system.

First, state involvement in market mechanisms was one of the principal features of Japan's high-growth era. The Japanese financial system was not left to market forces, but rather, was actively cultivated with an array of financial regulations that governed deposit interest rates and different financial market segments and erected partitions between the domestic and foreign markets. These forms of government involvement facilitated the intensive allocation of funds to strategically crucial industries, which set the stage for the era of high economic growth in turn. This approach differs from the neoclassical paradigm of minimizing state involvement and fully harnessing market forces.

Second, financial liberalization from the 1970s forward progressed only

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[14] Comparative institutional analysis is an approach advocated by Professor Aoki of Stanford University. Its main feature, in brief, is the assumption that resource distribution within a given economic system depends on a variety of socially supportive structures and institutions, including resource holdings, public expectations and preferences, corporate technologies, social customs and norms, and the way corporations are organized. Applying the same logic to financial systems leads to the conclusion that resources will be allocated differently under different financial systems in countries with different institutions and structures. It thus follows that not all financial systems will conform to the Anglo-Saxon model within a market economy.

through gradual stages because of forces (the holdings of vested interests) that sought to maintain the system's traditional structures and customs. An inertia prevailed despite the trend toward globalization, the progress of the IT revolution, and other sweeping changes under way in the setting for Japan's financial system. Japan made gradual progress toward liberalization. Some studies and recommendations suggested that Japan should have moved earlier, more boldly and swiftly to remove its regulatory barriers and transition to policies that limited the government role to the extension of market mechanisms. In hindsight, within the political and economic climate of the time, this would have been an extremely difficult task.[15]

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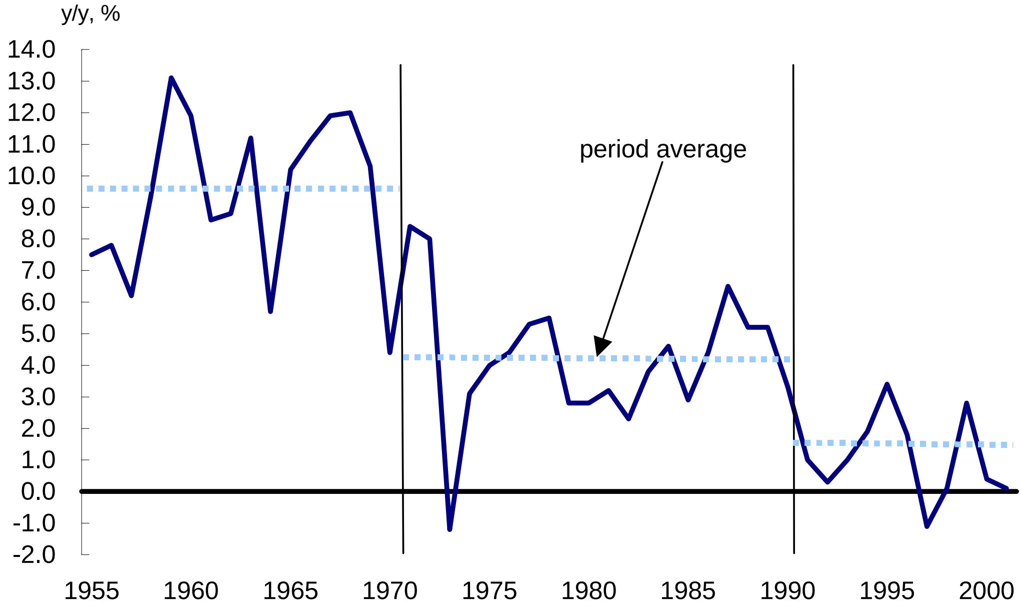
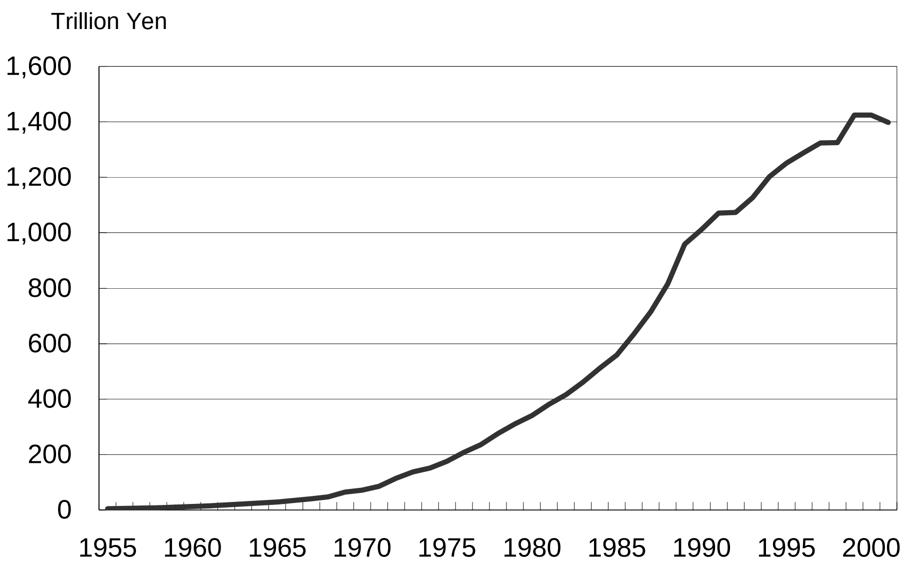
[15] In reality, the task of weaning itself from a bank-centered financial system has proven painful for Japan. Nonetheless, attention has focused on the promotion of market-based indirect financing through methods of securitization while maintaining the traditional bank-centered system. A classic example would be the arrangement and sale of a mutual fund by a bank. Despite the current difficulty associated with the transition from a bank-centered to market-centered system, effectively utilizing financial products such as mutual funds while harnessing the existing financial system should have value as a means of fostering the development of market-driven forms of indirect financing. Encouraging the development of capital markets through securitization will be an important step for Japanese banks that plan to participate in the securities business.

Figure 1　Real GDP Growth



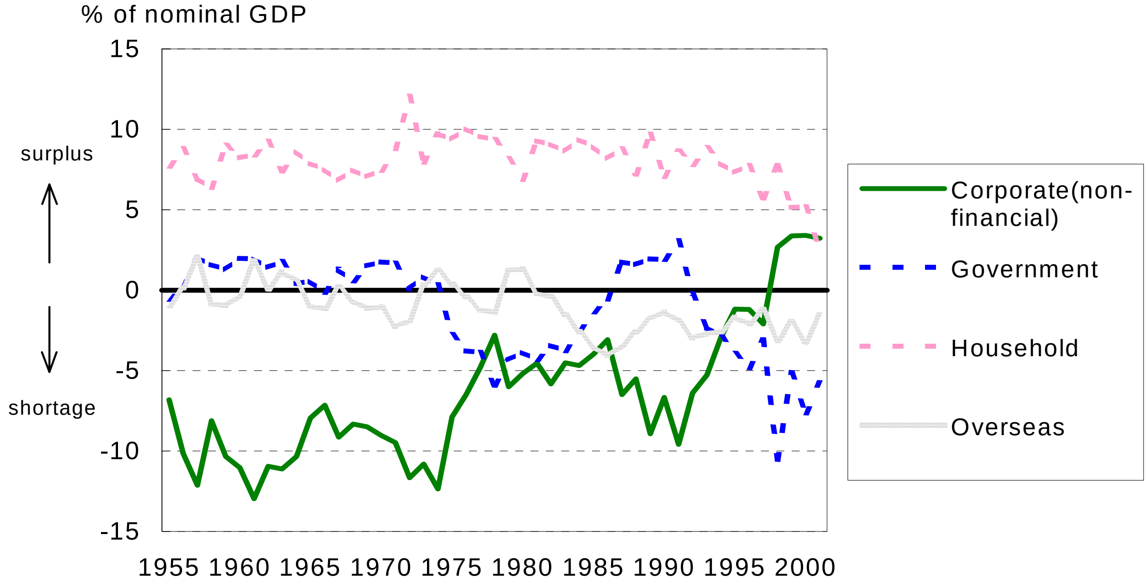
Source: Cabinet Office.

Figure 2　Financial Asset of Households



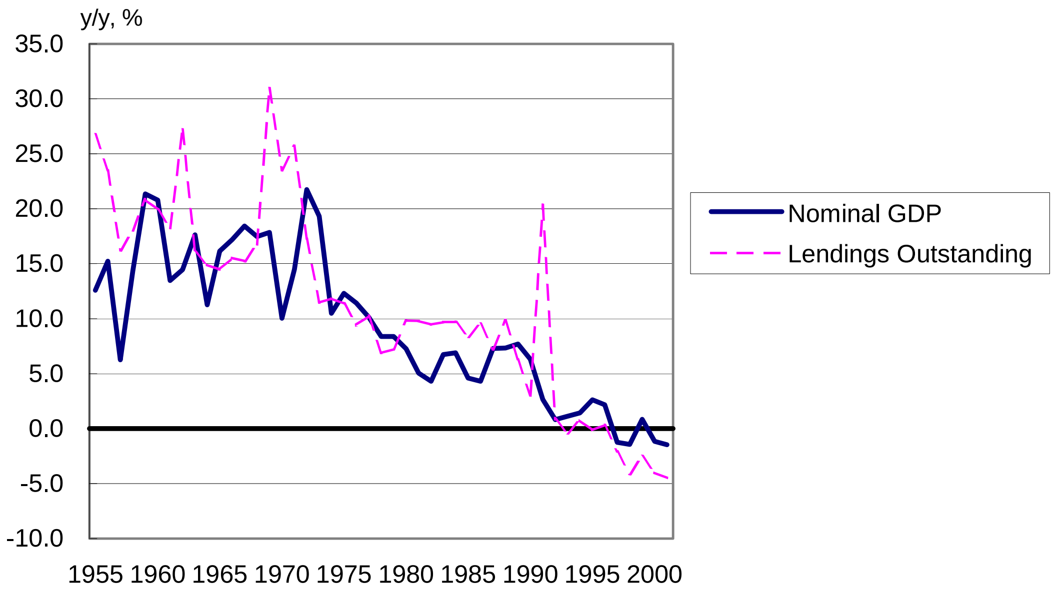
Source: Cabinet Office.

Figure 3 Flow of Funds



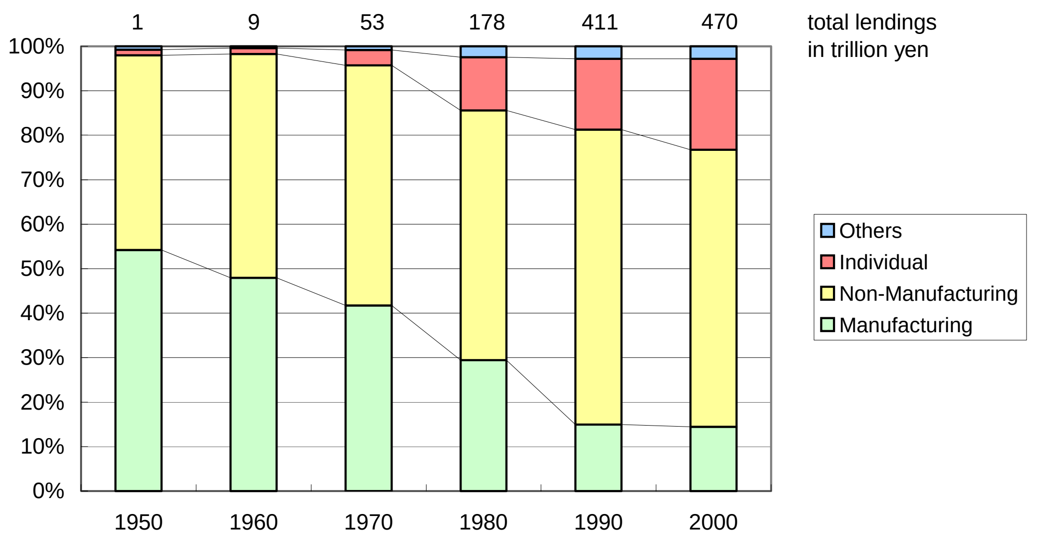
Source: Cabinet Office.

Figure 4 Growth in Nominal GDP and Lendings Outstanding



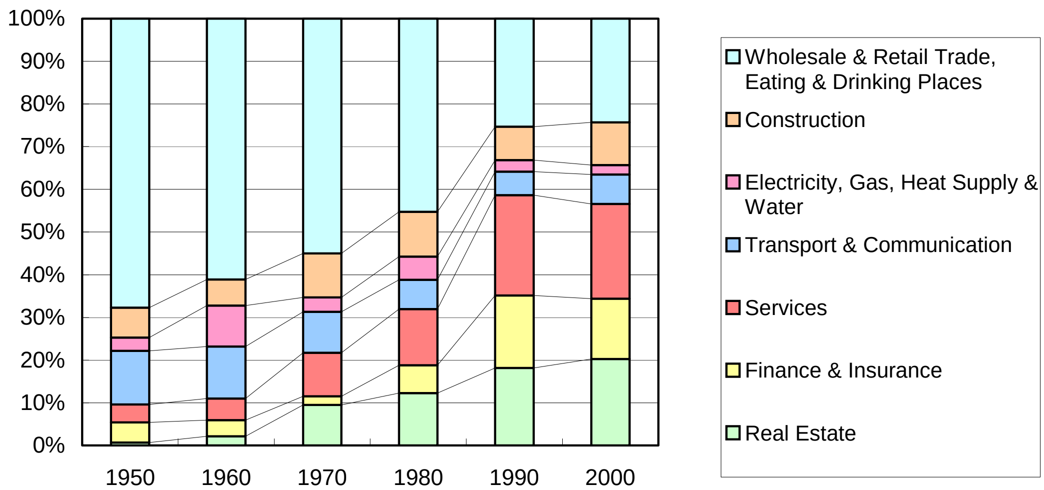
Source: Cabinet office and Bank of Japan.

Figure 5 Breakdown of Bank Lending by Sector



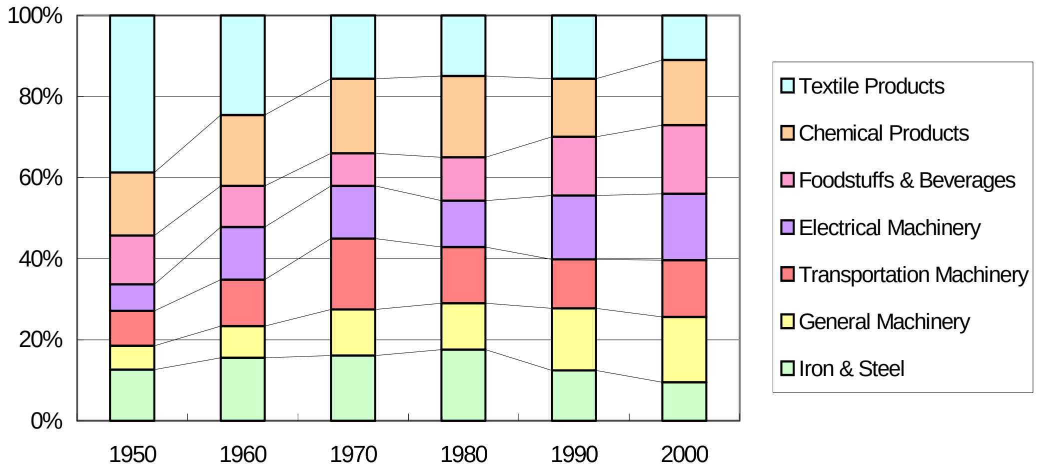
Source: Bank of Japan.

Figure 6 Breakdown of Bank Lending in the Non-Manufacturing Sector



Source: Bank of Japan.

Figure 7　Breakdown of Bank Lending in the Manufacturing Sector



Source: Bank of Japan.

Table 1 History of Interest Rate Liberalization in Japan

1947	Dec,	Temporary Interest Rates Adjustment Law enforced.
1949	Dec,	Foreign Exchange and Foreign Trade Control Law enforced.
1979	Apr,	Call rate liberalized.
	May	Negotiable certificates of deposit introduced.
	Oct,	Trade bill rate liberalized.
1980	Jan,	Medium-term government bond funds introduced.
	Dec,	Foreign Exchange and Foreign Trade Control Law amended.
1982	Apr,	New Banking Law enforced.
1984	Apr,	Sales of foreign CDs and CP permitted.
	Dec,	Interest rates on short-term euroyen CDs liberalized.
1985	Mar,	Money market certificates introduced.
	July	Interest rates on medium- and long-term euroyen CDs liberalized.
	Aug,	Large-lot open-end bond investment trusts introduced.
	Oct,	Interest rates on large time deposits over 1 billion yen liberalized.
1986	Mar,	Long-term government bond funds introduced.
1989	June	Small-lot money market certificates over 3 million yen introduced.
1991	Nov,	Interest rates on time deposits over 3 million yen liberalized.
1992	Mar,	Money management funds introduced.
1993	June	Interest rates on time deposits fully liberalized.
1994	Oct,	Interest rates on demand deposits (excluding current accounts) liberalized.
1998	June	CD issue terms fully liberalized.

Table 2 History of Capital Account Liberalization in Japan

1964	Apr,	Japan accepts IMF Article VIII obligations. Japan becomes an OECD member.
1968	Feb,	Yen conversion controls introduced to restrict conversion of foreign currencies into yen and domestic investment in yen.
1971	July	Upper limit on foreign securities purchased by investment trusts and insurance companies abolished.
	Aug,	US suspends dollar conversion to gold (the so-called 'Nixon Shock').
	Dec,	IMF parity changed to ¥308/US$ (Smithsonian rate) and band widened by +/-2.5%.
1972	Feb,	Purchase of foreign securities by trust banks liberalized.
	Mar,	Purchase of foreign securities by commercial banks liberalized.
	June	Outward foreign direct investment liberalized.
1973	Feb,	Floating exchange rate regime introduced.
	May	Inward direct investment liberalized with exception of five categories of business.
	Dec,	Yen conversion controls on banks partially eased (non-residents permitted to hold yen accounts <except inter-office accounts>).
1974	Jan,	'Voluntary restraint', to balance net foreign securities investments by banks, securities companies, investment trusts, and insurance companies introduced.
1976	Nov.	Conditions attaching to outward long-term bank loans are eased.
1977	Mar,	'Voluntary restraint' on foreign securities investments by banks abolished.
	June	Acquisition of foreign equities and bonds by residents belonging to foreign companies permitted.
		Regulations on net open positions of residents abolished.

1979	Jan,	Regulations on acquisition of yen-denominated bonds excluding those with remaining maturity of more than one year by non-residents relaxed.
	May	Repo transactions by non-residents liberalized (*gensaki* market).
		CD issuance commenced.
	June	Short-term impact loans introduced and regulations on long-term impact loans lifted.
1980	Dec,	New Foreign Exchange and Foreign Trade Control Law implemented; in-and-out transactions free in principle.
1984	Apr,	Regulations based on the principle of real demand related to forward foreign exchange transactions abolished.
	June	Regulations regarding the conversion of foreign currency-denominated funds into yen abolished. Yen-denominated loans to residents contracted in overseas markets liberalized.
1985	Oct,	Interest rates on large time deposits liberalized.
1986	Dec,	Japan Offshore Market (JOM) established.
1993	June	Interest rates on time deposit fully liberalized.
1994	Oct,	Interest rates on demand deposits (excluding current accounts) liberalized.
1995	June	Restriction on number of new branches a bank can establish removed.
	Aug,	Recycling restrictions on yen-denominated bonds issued by non-residents in overseas markets abolished.
1996	Nov,	'Big-Bang' reform of capital market announced.
1997	Dec,	Ban on financial holding companies lifted.
1998	Apr,	Revised Foreign Exchange and Foreign Trade Law enforced.

Table 3 Japan's Financial 'Big Bang'

1. Diversification of investment and financing choices		
1998	Apr,	Cross-border capital transaction liberalized.
	Sept,	Securitization of loan assets permitted.
	Dec,	Securities derivatives fully liberalized.
		Sale of investment trusts by banks permitted.
		Definition of 'securities' expanded and enhanced.
2001	Apr,	Over-the-counter sale of insurance products by banks partly permitted.

2. Improvement of intermediary agent service quality and fostering competition		
1998	Mar,	Establishment of financial holding companies permitted.
	Dec,	Licensing of securities activities shifted to register system.
1999	May	Range of fund-raising for financial companies diversified.
	Oct,	Scope of business widened for subsidiaries of financial institutions.
		Equity brokerage commissions fully liberalized.

3. Development of user-friendly financial market		
1997	July	Sale of unlisted and unregistered equities by securities companies permitted.
1998	Dec,	Stock exchange features improved, and off-exchange equities transactions permitted.
		Over-the-counter market for equities improved (introduction of market maker and new register system).
		Features of financial futures contract improved.

4. Development of credible, fair and transparent business system		
1998	Dec,	Disclosure practices enhanced.
1999	Apr,	Prompt corrective action introduced.
2001	Apr,	Law on Sales of Financial Products enacted.

Table 4 Development of Bond Markets in Japan

1948	May	Securities and Exchange Law enacted.
1952	Aug,	Publicly-offered local bonds first issued.
1953	Aug,	Government-guaranteed bonds issued for the first time after the war.
1956	Apr,	Secondary market for public and corporate bonds commenced.
1961	Jan,	Bond mutual funds introduced.
1966	Jan,	Government bonds first issued.
1970	Dec,	*Samurai* bonds first issued.
1979	Apr,	Uncollateralized convertible bonds first issued.
1981	Dec,	Non-detachable warrant bonds first issued.
1984	June	Dealing in public bonds by financial institutions commenced.
1985	Jan,	Uncollateralized straight corporate bonds first issued.
	Apr,	Domestic credit rating agency first established.
		Euroyen bonds first issued by residents.
	Oct,	Tokyo bond futures market opened.
	Dec,	Detachable warrant bonds first issued.
1986	Feb,	Short-term government bonds (TBs) introduced.
1993	Oct,	Restriction on volume of corporate bond issuance abolished.
1994	Mar,	Dual currency corporate straight bonds first issued.
	Apr,	Floating rate corporate bonds first issued.
	June	Delivery-versus-payment (DVP) for settlement introduced for government bonds.
1995	Sept,	Corporate bonds without fiscal agent first issued.
1996	Jan,	Restriction on bond issuance depending on credit standing abolished.
1997	Dec.	Online network system for settlements of corporate bonds commenced.
1998	Apr,	Delivery-versus-payment (DVP) for settlement introduced for corporate bonds.

2001	Jan,	Method of settling government bonds changed from designated-time net settlement to real-time gross settlement (RTGS).
2003	Jan,	STRIPS (Separate Trading of Registered Interest and Principal of Securities) introduced for government bonds.