JAPANESE FINANCE

A Guide to Banking in JAPAN

ANDREAS R. PRINDL

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The following text, drawing on four years' experience as General Manager of a large foreign bank in Tokyo, is specifically designed for corporate finance managers assigned to Japan and for companies with subsidiaries or joint ventures there or about to create such entities. In trying also to give a deeper explanation for the rigidity of the Japanese banking system, hopefully it will prove of interest to other readers generally interested in having, like Theseus in Crete, a thread through the labyrinth of the Japanese markets. The theme is a broad and a rich one. To describe Japanese banking is to describe Japanese attitudes towards business and ultimately towards the outside world. An attempt has to be made to look at perceptions of the participants in the banking system and its users, skirting the edges of sociology and history. Many Japanese were kind enough to explain their view of the background of Japanese finance, as were several long-term Western residents of Japan. Without their help, this book would not have been possible.

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ANDREAS R. PRINDL

Introduction

This volume is designed to be a guide to the Japanese banking market and how to deal with it. The original impetus was to show the special problems which having subsidiaries in or borrowing from Japan may bring, and to suggest some solutions: ways in which techniques common in the West can be used in or adapted to Japanese conditions. Such an analysis was considered timely, as cash management and financial management practices available in Japan are not always known to Western companies, nor are traditions of bank and government relationships perfectly understood.

A guide to optimizing treasury management in a controlled economy necessarily examines the nature of the controls and the controllers. Rather than concentrating only on how to deal with the financial system, it must also analyse why the system is still rigid and the banking structure still fragmented in the 1980s. The text, therefore, considers the roles of the officials guiding the Japanese economy and its micro-sectors, down, in many cases, to individual loans by each bank. It includes the historical background of Japanese economic development in the Meiji restoration period of the 19th Century and reconstruction after the Second World War and a look at Japanese perceptions of their financial strength.

Depicting the state-controlled development of Japan in historical periods leads to obvious questions: why does the government continue to control tightly a robust economy which has become second largest in the free world only 35 years after World War II, as if it were still rebuilding? Why do government ministries try to guide a huge, chiefly open, maturing economy by minute direction more fitting to a small, closed and developing country? Why are market forces not generally allowed to set interest rates, or more importantly, to allocate credit nationally? Why are the Japanese capital markets not encouraged to become truly international?

Part of the answer to those questions may lie in the conviction of the Japanese of their own economic *fragility*, compared with the rest of the world. The most typical comment heard in Japanese conversations is, "We are a weak country with no natural resources. We have no oil, no coal, no minerals". The perceived need to protect this weak economy from a better-endowed outside world, or to export fiercely to pay for imports of raw materials, is all-pervasive.

A converse implication is that the Japanese may not perfectly assess their own strengths: their intelligence and flexibility, homogeneity, loyalty, respect for authority and obedience to law. These features are very like those of a family, a village, or a tribe and many commentators have remarked on such anthropological similarities. This nation-wide family, by not seeing its strengths, downplays thereby the role it could play in world affairs: in foreign policy, military alliance or financial matters. Japan is often called an economic giant, but a political dwarf. It is not yet a financial giant either, although there are many signs that it could obtain, and sustain, this role.

Other reasons suggest themselves, for example the national concentration on exports as a foundation of economic reconstruction and the need to supply capital-deficient industries with dependable and relatively low-cost sources of credit, aided by a high savings propensity. Institutional lag, i.e. the continuance of a financial structure and monetary control methods suited to the less mature economy of the past, is another plausible factor. A tendency to base the economy on cartels, and the interest in maintaining cartel arrangements by members of distinct banking groups can also be cited. All of these may contribute to the system which monetary authorities have traditionally used to monitor and direct the banking market.

The framework in which controls are exercised is used as a general structure for the following text, designed for the person who may enter into relationships with Japanese banks or negotiate with government officials. It attempts to combine areas of intellectual interest: how money flows, volumes and interest rates are set in a large, open market by government fiat, with practical concerns: how to use that market efficiently and how to tap its increasing availability of capital from abroad. It also calls for a recognition of Japanese strengths and an assumption of its rightful role in world finance.

Section I describes the regulatory environment, dealing with the two primary financial regulators: the Ministry of Finance and the Bank of Japan, the structure of the financial system, and the prospects for internationalising the yen, freeing the domestic financial market and allowing Tokyo to become a major world financial centre. Section II gives guidelines for using the system, whether to raise capital or to improve financial management of subsidiaries in Japan.

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JAPANESE BANKING AT A TURNING POINT

A Present Framework

CHAPTER 1

Historical Perspective

A book about Japanese banking is necessarily one which will describe a system of strict control by its regulatory authorities. Banking technology is roughly the same in industrialised countries; it concerns channelling the flow of funds from savers to investors, while promoting the other functions of money: use as a medium of exchange and as a store of value.(1) The monetary/banking system lies at the heart of any advanced economy, and its operations are too important to be left totally to market forces. Business investment and government financial needs influence official policy in this sector; if savings flows are too meagre or incorrectly allocated, monetary authorities will take action to augment or redirect them. Growth in money supply will affect the level of inflation, which government will also try to control.

The nature of those actions—the choice of which part of the technology to use—categorises monetary systems. In most Western economies, control over monetary developments is *indirect*, using market forces and mechanisms to regulate the growth of credit and money supply. An opposite method, not necessarily less efficient, is for government to allocate *directly* the flow of funds in an economy, the extension of credit by sector and the level of interest rates. This is often found in developing countries or those characterised by state socialism.

Japan has traditionally controlled its monetary system by direct state guidance and does so now, despite its advanced status as one of the world's richest economies. The tools used to channel savings flows, to regulate monetary volumes and to set interest rates are still direct ones. To explain why involves a look at Japan's pattern of economic development.

Many reasons have been given to explain Japan's remarkable economic success since it was forcibly opened to trade with the West in 1853. The reaction to that jolt, i.e. state direction of the economy, coupled with the homogeneity and intelligence of the Japanese, a high savings and investment rate, rapid infusions of Western ideas and technology have all been cited singly or together as factors behind Japan's rapid economic growth in the Meiji period and after World War II. Three of these diverse elements are useful as well in an analysis of the development of Japan's financial system: the Japanese perception of themselves as economically vulnerable, the role played by authority in Japanese society, and the success of state direction of other economic sectors.

A belief in vulnerability has pervaded Japanese thinking, both in the past and in the present. Japan has no substantial energy resources; it lacks essential raw materials and fertile land is limited. For most of Japanese history, harsh conditions have kept living standards of the bulk of the population at low levels, although by the same token, strong, self-supporting community ties were developed in the characteristic rice-growing and fishing villages. These ties, like those of a family, have often been identified in Japanese national society as well. The feeling of fragility can lead directly to a sense of needing barriers or controls to withstand uncertain future events, whether political or economic.(2)

Perceived vulnerability and identification with a close-knit unit have permitted and, indeed, encouraged the development of authoritarian figures in Japanese political history. Central authority also has directed the use of limited natural assets and the energies of the Japanese towards maximum output, whether at national levels (historically through a medieval system of fiefdoms and tribute) or at the village level. At the lower level, that role was played in traditional Japan by the *cho-ro*, or village elders. In the Japanese rice-growing village, the allocation of water to individual paddies is the critical factor in the success of each farmer. Water distribution is decided by the village elders on the basis of benefit to the whole community, a community which is interlinked by the physical joining of the irrigation system to all fields in the village. Commenting on the social ties this system develops, Chie Nakane suggests: "This system certainly makes a village one distinct social and economic unit; without being a member of the village it is difficult to carry on wet rice cultivation. The fact that individual farming is directly linked with the village organisation, as appears in the network of the water flow, and the way in which households are inevitably bound to each other by water, determine the form of the village organisation: internally it involves severe economic and political competition among the households, and externally it presents the village as a tightly-knit organisation. The situation has been enhanced by the shortage of water".(3)

The role of the village elders in allocating a scarce resource in a tightly-knit society is exactly parallel to that of the monetary authorities in modern Japan and is used in this study to characterise their role of directing the financial system. Capital, like water, is a scarce resource and its allocation to specific uses shapes the economy of any country. In Japan, state allocation of flows in the financial system often interferes with uses which supply and demand factors might otherwise have determined. Competition between financial sectors is limited by government fiat. Flexibility can be reduced, as government direction is more blunt than subtle. Sophisticated financial instruments and fully competitive markets are typically not encouraged in such a structure; Chapter Four questions whether this system is flexible or efficient enough for modern Japan.

The analogy of water has external parallels as well. The Japanese capital markets represent a growing reservoir which increasingly can be tapped by borrowers in the rest of the world. A reservoir, of course, connotes a filling up and replenishing function as well as tapping. And it is the state of Japan's capital reservoir which will be taken into account by the guardians of the reservoir—Ministry of Finance and Bank of Japan officials in their roles as *cho-ro*. If use of that resource by local interests has lessened, owing to maturity of the Japanese economy, then more liquidity will be available to outside borrowers. If the reservoir—the Japanese money supply—is growing too rapidly, particularly from Balance of Payments surpluses, strenuous efforts will be made to recycle flows abroad. If Japanese capital markets are strained to meet domestic needs, the tap to outside borrowers will be lessened or turned off completely. Access to the reservoir, represented by credit extension through Japanese financial institutions, is directly controlled by Ministry of Finance instructions/guidance to those institutions.

That detailed state direction of an otherwise modern capitalist economy and its financial markets is not seriously contested, even when private financial institutions are negatively affected, relates in part to Japanese cohesion and sense of fragility. If an economic unit sees itself threatened by lack of resources or external competition, it will accept the direction of superior authority, whether coming from the village elders or from their national and societal counterparts. Although perhaps not sharing proportionately in allocation, the unit's continuing role in a more prosperous whole is implicitly guaranteed.

The tendency to accept authority is augmented by the visible success of state economic and financial direction in the two most dynamic periods of recent Japanese history: Meiji and post-World War II. Less motivation to contest state authority appears if past state guidance has demonstrably paralleled fast growth, in which all the population has shared. Western organisations in Japan have also not questioned Japanese ways of guiding or developing the financial system.

Origins of Japanese Banking

In the 17th century, Osaka was a large trading and commercial centre, equal in size and power to many European cities. A diverse merchant class arose, which was later to play a major role in the Meiji Restoration period. The Kansai area of southern Honshu, Japan's main island, became partly urbanised and appreciable economic growth appeared in the second half of the 1600s.

Credit institutions developed in parallel. Different types of credit were needed to go along with economic growth: to merchants to build inventory, to traders for settlement of inter-regional trade between Osaka and Tokyo and to farmers to anticipate rice harvest receipts.[(4)] Different types of lenders arose: money changers, merchant financiers and lenders to the nobility. The merchant financiers developed exchange and remittance services and even a foreign exchange market (trading currency between holders in gold-based Tokyo and silver-based Osaka); these houses became financial agents of the shogunate. A forward market for gold-silver deals paralleled financing of trade and commodity flows.

In the middle part of the 17th century, a number of merchant financiers had grown large enough to become characterised as banks, and in 1662, an official bank credit system in Osaka was authorised. Notes issued by its designated members began to circulate widely and to be accepted as money; the first of these, based on silver backing, had appeared as early as 1617. The biggest ten banks in Osaka grew into a "Bankers Association", which later acted as a central bank in its control over the new note issue. It is characteristic that the Osaka Bankers' Association was developed with government encouragement "to create channels for official control" of the money supply, a significant stage towards today's financial system.(5) State/bank co-operation, and state influence over the financial system, can be dated back three hundred years.

Meiji Restoration

Shortly after the West forced Japan's doors open, the tottering shogunate gave way to the Meiji Restoration (1868/1912). After being compelled to look at their own economic weakness compared to the West, Japanese leaders set national policy to catch up, in a campaign of emulation, adaptation, education and investment.

State planners instituted a wide range of manufacturing industry. If private capital was insufficient to found an iron foundry or a railway, state funds were made available and state employees seconded to run the new venture. Entrepreneurial talent was tapped from the former aristocratic and samurai class, many of whom became excellent industrial managers. By the end of the 19th century, Japan possessed—if sometimes in rudimentary form—heavy industry in almost all sectors. Although it is debatable whether economic growth in the Meiji period was stimulated from above, i.e. by nascent industry and trading groups, or from below, by agricultural and small industry, the role of state guidance and investment cannot be understated.

A major thrust of the Meiji planners was also to create a range of new banks for specific purposes. The architect of today's Japanese banking system and its specific divisions between specialised sorts of institutions was Prince Masayoshi Matsukata, Finance Minister during the late 19th century. He was responsible for the Banking Act of 1882, creating the Bank of Japan, and the formation of the Yokohama Specie Bank (now the Bank of Tokyo) in 1880 to be the foreign financial arm of the Japanese Government. The Industrial Bank of Japan (IBJ), designed to finance new industrial companies, was created in 1900. In the same period appeared the Long Term Credit Bank and various semi-governmental institutions such as the Agricultural Co-operative

Banks. These banks still exist and are among the dominant institutions in Japanese finance, along with the city banks; they continue their specialisations. While the new types of banks complemented commercial banks, such as Mitsui, which had long offered banking credit and services, they also formed specific partitions in Japanese financial markets. Specific banks were created for distinct purposes to help a fledgling economy, "supply leading" before credit demand developed.[6]

Other banks developed from entrepreneurial motives, some within industrial groups, serving financial needs of group members, then customers of the group. Their activity expanded into unrelated third party trade domestically and into international trade financing. Mitsubishi, Fuji, Sumitomo and Mitsui Banks became the core of the industrial groups known as *Zaibatsu:* "financial combines". Common to all banks, however, was a sense of helping the national purpose by financing industry and infrastructure.

Post-war Japan

This motivation was re-emphasised in the aftermath of World War II. Again, Japan had to build industry from nothing; again, it was government which shaped the direction of rebuilding and the channeling of finance. The motto used to stimulate a defeated population to rebuild was "export or die", a thought still likely to exist in the Japanese subconscious. Although Japanese banks lost their branches abroad and much of their substance, they were the beneficiaries of the currency reform imposed by the Occupation forces. The long-standing pattern of emphasis on capital investment rather than consumption reappeared; the growth of Japan's economy allowed a large percentage of savings to personal disposable income and ballooned the deposit base of commercial banks. Those connected with *Zaibatsu* groups were strengthened by and in return aided their array of related companies. Those used as semi-official arms of the government: Bank of Tokyo and the long-term banks continued their historic role and, through their bond-issuing ability, had sufficient resources to sustain that role.

Today's Structure

Japanese banking is still characterised by historical patterns: state guidance, delineation of separate banking groups to fulfill different functions and less than modern markets. The first two features can be described as *fiat* and *fragmentation;* the third is a consequence of a system dominated by monetary authorities' direct guidance of rates and credit volumes. A system based on past divisions is using past tools; but the Japanese banking section no longer has as its primary function the financing of a developing industrial base. The authorities in that country have shown little interest in moving away from historical patterns of structure and control. This is usual of bureaucracies: change comes slowly and financial change, possibly affecting the levels of national reserves, the financing of government debt or Balance of Payments flows, even more slowly. But deeper reasons must exist, among them Japan's appreciation of itself as a vulnerable nation. If its financial system is fully freed, and left open to possibly malevolent forces from abroad, so goes the argument, the fragile Japanese economy could be hurt. The impact—economic and financial—of the 1974 and 1979 oil shocks has done nothing to dispel such thinking. (Indeed, certain recent financial changes have been retrograde: the imposition of reserve requirements on funds taken from abroad or the reintroduction of direct credit controls per bank on yen lending in 1979.) Whether these perceptions are true and valid is of little importance. If the Japanese feel themselves weak and endangered, no amount of statistical proof of their strength will quickly change their approach to economic life.

A second reason may be the lagging behind of the institutional framework. Japan has demonstrably moved into advanced industrial status. But this can be characterised as "catch-up" growth, and perception of Japan's economic strength is recent.(7) Success has come quickly; appreciation of it is short-lived enough that many Japanese temper their belief in success by reflecting on the Depression years, or the bleak post-war period. Importantly, the gentlemen who as young officials were guiding the Japanese economy through its post-war reconstruction are now its senior financial officials. Their own experience and training tend towards using the same monetary tools successfully implemented in a rebuilding economy, even if those tools appear to the outside observer as outdated.

NOTES

1. Henry C. and Mabel I. Wallich stress the point in "Banking and Finance in Japan", Chapter 4 of Hugh Patrick and Henry Rosovsky (eds.). *Asia's New Giant: How the Japanese Economy Works*, Washington: Brookings Institution, 1976.
2. The idea is echoed by a number of foreign observers, even being used in the titles of their studies, e.g. Z. Brezinski, *The Fragile Blossom*, or Frank Gibney, *Japan: the Fragile Superpower.*
3. Chie Nakane. *Kinship and Economic Organization in Rural Japan*, London: Athlone Press, 1967, p. 79.
4. See Sydney Crawcour. "The Development of a Credit System in 17th Century Japan", *Journal of Economic History*, XXI, No. 3, 1961, and Kozo Yamamura. "Towards a Re-examination of the Economic History of Tokugawa Japan, 1600–1867, *Journal of Economic History*, XXXIII, No. 3, 1973, for a fuller account.
5. Crawcour, op. cit., p. 3.
6. This observation is developed at more length in Hugh Patrick. "Japan, 1868–1914", in Rondo Cameron (ed.). *Banking in the Early Stages of Industrialization*, Oxford: OUP, 1967.
7. Thomas Pepper, Asia Pacific Director of the Hudson Institute sees the change from "catch-up" growth to "keep-up" growth in Japan as more important than societal factors. See: Herman Kahn and Thomas Pepper. *The Japanese Challenge: The Success and Failure of Economic Success*, Sydney: Harper and Row, 1979.