

A GRAPHICAL GUIDE TO FINANCING GROWTH
in the
JAPANESE ECONOMY: 1950s - 1990s

by
Barbara J. Heinzen
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"Hey, that's not fair! You're using Japanese money!"

CARTOON BY S. GROSS

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No conclusions have yet been written, but it would be a good place to look at the implications of the overall analysis. Possible things to think about here are: 1) the value of the Classical System for today's developing countries; can this be applied elsewhere? If not, why not? and 2) what are some of the consequences of emerging open system of Japanese financial structures for the long term view? Will the long view still survive? Or will it be modified?

Preface

In 1986 I was asked by a major multinational chemical company to develop alternative scenarios for the future of the Japanese economy. As I studied Japanese business practices, read about the many strengths of the Japanese economy, and interviewed people who had worked in Japan, I heard over and over again that Japanese companies took the long term point of view -- they invested in research, they invested in people, they invested in market share. It was this approach, I was told, that made Japanese companies such formidable competitors and which created an economy that consistently enjoyed very high growth.

But these observations then begged another question: how did Japanese companies pay for this long term point of view? How was the research financed? How did the costs of lifetime employment survive the usual cyclical economic downturns? How could any company afford to keep prices low to secure market share or to provide customer services that Western companies found too expensive to offer?

In answering this question, the company and I began to discover the outlines of what I would now describe as the "Classical" system of Japanese finance. This system had its origins in Japan's post-war ambitions for restoring and advancing its economy. It has probably been more responsible for Japan's remarkable economic growth than any other single factor that can be named. However, even as we came to understand this "Classical" system, we also began to pick up signs that the system itself was changing. Under a variety of domestic and international pressures, the Classical System has been evolving into a different organism, one that may or may not be capable of

sustaining the kind of growth Japan has enjoyed so far.

This book will look at both the Classical System of Japanese finance as well as the emerging Open System. There are several reasons for taking a closer look at the evolution of the Japanese system for financing long term growth. First, it contributes another small insight into the nature of Japanese growth since the end of World War II. Second, it is important for any Western company competing with Japanese business to understand how its competitor is funded -- since the company with the deeper pocket is much more likely to survive. Third, there are a number of interesting lessons to be drawn from the Japanese experience by other countries trying to assemble resources for rapid social and economic development. Finally, Japan is now a leading world economy. As it becomes more and more integrated into the world financial structure a clear understanding of the history and evolution of the Japanese financial system over the past forty years will contribute to our own ability to follow the course of international financial integration.

A note on style: I have chosen in this book to follow the format of a corporate presentation which relies heavily on a visual display of ideas. This has several advantages. First, statistical information is much more accessible when it is presented visually. Second, complex relationships can be sketched out to show how a variety of pieces fit together. Third, the material should be more memorable because of the joint impact of a visual display and written text. This is particularly important for those who must make policy decisions about their business or government, but who may have little time to look up background material and make a logical considered choice from several alternative models. I would hope, therefore, that in this small guide I have made it possible to understand a complex, but successful

system for financing growth and to show how it is evolving in the future.

Acknowledgements ...

B.J. Heinzen
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Chapter One

An Introduction to Finance and Growth in Post-War Japan

Explaining Growth in Japan

The single stunning fact about the history of Japan in the past fifty years is the speed of its economic and technological transformation. From being perceived as a poverty-stricken and defeated nation, it has become one of the economic leaders of the world. (*Figure 1: All MF Index of Output*)

Some of the shock of this achievement reflects the poor understanding of Japan that existed in the West after the Second World War. In particular few people remember that Japan was already a fairly developed nation in 1940 and that the country's growth after the war is better compared to the recovery of West Germany than to the development record of India, for example. In addition, some of Japan's post-war success was purely a matter of good luck and good timing. The United States needed Japan's support during the Korean War, and drew on Japanese manufacturing for much of its supplies just at a time when Japanese businesses needed markets to re-establish themselves. There was also an international climate that favoured the circulation of technology through licences and a trading system that opened the American market to many non-American producers.

But if luck and early development are put to one side, one is still left with a formidable achievement and the desire to understand what in Japan's culture, society, economy and government has helped this achievement be realised. By now, of course, many explanations have been offered. *MITI and the Japanese Miracle* by Chalmers Johnson offered one, emphasising the role of the Ministry of International Trade and Industry in working with business to

generate growth. Japanese "culture" has provided another frequent explanation for success. Japan, we are told, is a consensus society; cooperation is more important than competition and internal corporate harmony determines wider corporate accomplishment.

My own approach has been to look for the rules of the game. I have sought in this fashion to cut through as much of the mythology about Japan as possible, to look underneath this great gloss of accomplishment to discover why individuals in Japan have made the choices they did. To what rules and conditions were people and companies responding? What have been the important carrots and sticks in Japanese society? How have people reacted to them and what has been the effect on economic growth? This approach led me to construct a "pyramid of growth" which put financial structures in a key supporting position.

The Pyramid of Growth

This pyramid, which appears in the diagram *Factors Encouraging Economic Growth*, (Figure 2), shows that three factors were particularly important in encouraging economic growth in the post-war period: 1) financial structures, 2) the speed of technological change, and 3) the flexibility of the labour force. While I could devote several chapters to discussions of both technology and labour, here it is importantly only to note that the technology rules have accelerated the rate of technological change in Japan, while the labour markets have been structured in such a way that the labour force is able to learn new skills and adapt to new positions more quickly than elsewhere.

Neither of these aspects of Japanese growth is cost-free, however. Investment in technology and applied research is expensive, as is the cost of retraining and redeploying staff. For this reason, financial structures lie at the base of the system. Strong financial backing has allowed companies to invest in new technology. It has also made it possible to invest in long-term marketing strategies to sell the products of that technology, and has paid for the cost of retraining and redeploying the flexible labour force of the Japanese system. In this way as technology has evolved, the labour force has taken up new skills producing new products expanding into new markets. This has generated continued economic growth which in turn has supported the financial structures, beginning the whole process all over again.

Other Important Factors

There were of course other important factors in Japan's successful record of growth. Part of the flexibility of labour, for example, has been derived from the presence of numerous small companies acting as suppliers and subcontractors to the larger companies. These small businesses have often acted as buffers surrounding the larger companies, absorbing economic shocks and adapting to changes faster than the larger organisations could have done on their own. There has also been the strength of the *keiretsu* system, which is discussed in more detail below, but which has provided a framework for the working relationships between companies. Nor should the role of government coordination be ignored. While government intervention has not always been wholly successful, there are numerous examples of occasions when an industry, threatened with a need to restructure, has called on government to help negotiate important transitions that needed to be agreed among companies which were otherwise fierce competitors with each other.

However, while many of these factors have helped companies adapt to rapid change and remain competitive, the overriding importance of those rules of the game which have enabled companies to finance the long term point of view must be recognised. These rules have not been obvious nor have they ever been explicitly described outside heavy academic textbooks. However, they have largely determined the ability of Japanese companies to finance the long term point of view.

Financing the Long Term View

From an Anglo-Saxon perspective, writing as an American working with British multinational companies, I have been forced to ask why Japanese companies have been willing and able to bear costs that Western companies have found to be ill-advised? Can it all be laid at the door of some vaguely formulated, cultural commitment to the long view versus an Anglo-American preoccupation with short term goals? Even if there is a cultural base to this difference, what are the rules of the financial game which embody that difference? To what extent have those rules meant that Japanese companies have been better able to afford long term investments and, in addition, have had a better system for managing the risks inherent in such gambles than their Western competitors do? If Japanese financial structures have allowed the long-term view to predominate, to what extent are they now changing? As the Japanese economy becomes more and more integrated with the international economy, how much will the supporting financial structures evolve towards the Anglo-Saxon model? Or is the financially supported competitive pressure of Japanese companies likely to dog the efforts of Western business for many years to come?

In approaching this issue, I will look first at the Classical System of Japanese finance during the post-war period of high growth, with the next two chapters each considering one of the following questions: 1) Where does the money come from for investment? 2) How is long term risk absorbed? To identify the sources of investment money, we need to understand how banking, borrowing and savings have been organised in post-war Japan. By comparison, to answer the second question about absorbing risk requires a more complicated answer. This leads us to consider complex corporate structures, business relationships and the role of both in bankruptcy proceedings.

Once we have addressed these two issues, the final chapter of this guide to Japanese financial structures will look briefly at how the Classical System of financing growth in post-war Japan is changing towards a more open international financial structure. This is likely to be a transition that carries some risk and it is also likely to alter Japan's interaction with the rest of the world and the organisation of business domestically. However, it is also likely that the mark of the Classical System will remain on the organisation of corporate finance in Japan, although how and where that mark will endure remains to be seen.

First, however, we need to understand the Classical System itself, and for that we turn to the next chapter which considers the question: where did the money come from to finance growth in the post-war period?

Chapter Two

Where Did the Money Come From?

Borrowing, Banking and Savings in the Classical System

This chapter addresses our first critical question: where did the money come from to support Japan's long term investment during the period of high growth after World War II? To answer this question we begin with an explanation of the origins of borrowing by Japanese corporations. This in turn leads us into a discussion of the way banking and savings have operated in post-war Japan.

High Gearing

Throughout Japan's high growth period, the major supplier of funding for Japanese companies was the banking system, rather than the equity or bond markets, as shown in *Figure 3: External Sources of Company Funds*. This meant that Japanese firms were very highly geared, with a majority of their investment funds coming from borrowed money rather than equity funding. To Western business people, this seems to put companies at greater risk of failing for the simple reason that interest due on borrowed money must be paid whether a company is in profit or not. In the Anglo-Saxon system such a chronic obligation would force all the risk of hard times onto the borrower, whereas when money is raised through shares in a company, all shareholders "share" the risks and rewards of good and bad times. If there is no profit there is no dividend, and the company is, theoretically, more likely to survive.

So how did it come about that during the period of high growth (and high

risk) in the 1950s and 1960s Japanese companies were very highly geared, borrowing a very large share of their investment costs from Japanese banks? Why did companies not go to the equity markets to raise money for long term investments?

In his book, *Money and Banking in Contemporary Japan* (Yale University Press, 1980), Yoshio Suzuki of the Bank of Japan provided the most cogent explanation for the high gearing of Japanese corporations. His arguments are summarised in the flow chart, *Indirect Finance During High Growth* (Figure 4). They begin with the observation that two government policy goals effectively set the terms for the financial system which followed. First, the post-war Japanese government decided to achieve rapid economic growth through investment-led export policies. Second, the government deficit, until the 1970s, was kept very low, thereby discouraging the development of a bond and securities market comparable to the London or New York Exchanges. (Figure 5 to come: *TIME SERIES OF GOVERNMENT DEFICIT IN JAPAN*)

Another factor, not mentioned by Suzuki, is that at least since the late nineteenth century, the stock exchange in Japan had the reputation of being a highly speculative and risky environment, tainted with corruption and shady dealings. This no doubt encouraged government reluctance to rely on such financial markets, as well as discouraging individual investors from participating. It is also possible that government leaders felt they would be more able to control a limited number of banks than a large number of public investors, thereby maintaining government control over the economy. While that is a hypothetical suggestion there is no doubt that together with the low government deficit and absence of government borrowing, the overall effect of government policy was to delay the development of an open and

sophisticated free financial market in Japan where corporations could raise investment funds in their own name.

In the absence of such a market, the Ministry of Finance (MOF) expected the banks to provide investment money. In part to reduce the risk of this funding the MOF set stable, controlled interest rates on both deposits and on borrowings. This allowed banks in particular to know the terms on which they operated (*Figure 6: Controlled Interest Rate Spreads*). This reduced some of the unpredictability associated with floating interest rates and provided banks with a stable supply of funds, as shown in *Figure 7: Private Banking Sector Funds*.

However, with interest rates -- and the spread between them -- controlled by the government, a bank could not increase its profits by increasing the amount it charged its customers for loans. Instead, profits grew by increasing the volume of loans offered, and by gaining a larger share of the total loan market. This led to arrangements whereby banks asked their corporate customers both to delay their loan repayments and to make compensatory deposits. Delayed loan repayments meant that interest was paid for a longer period of time, while compensatory deposits meant that for every 1000 yen borrowed by a company, 500 would be used for investment, but the balance would be left with the bank which could lend it out again; this effectively allowed interest to be collected at least twice on the same tranche of funds. Both delayed repayments and compensatory deposits acted to raise interest rates, while compensatory deposits also increased the amount of money available for lending, thereby increasing the bank's market share of loans being made.

That companies were willing to go along with these arrangements can probably be explained by several factors already mentioned. First, government pressure and their own ambitions were encouraging companies to adopt high-growth, high-investment policies. This led in turn to a serious corporate deficit which the bond and securities market could not adequately fill. Third, as companies tried to cover their deficits by borrowing from the banks, the banks tried to increase their profits through delayed loan repayments and compensatory deposits. As a whole, therefore, the system created the kind of high gearing so often noticed and criticized by Western business people working in Japan where a company's total investment was largely financed by borrowed money rather than equity funds.

To many Westerners, such a system seems inherently unstable, risking both a high rate of company failures and the inflationary pressures known to attend uncontrolled credit booms. The question of company failures will be discussed later, but since, by all accounts, post-war Japan enjoyed something very like a credit boom as companies "over-borrowed" from their banks (to use Yoshio Suzuki's quaint phrase) why was there so little inflationary pressure in the country at this time? (*Figure 8 to come: TIME SERIES GRAPH OF JAPANESE INFLATION*)

Banking on Negotiated Transactions

The short answer is that this was not a free market system. Most of the transactions between companies and the banks were what Yoshio Suzuki has called "negotiated" transactions. In this system, companies could not simply borrow money from any bank willing to lend it. Rather, most companies got their funds through the thirteen city banks, seven trust banks and three long

term credit banks, with the city banks taking the lead. Moreover, the banks who lent money did so after getting to know the borrowing company and, once the loan was made, bankers kept in touch with that company on a regular basis.

As a result, loans to companies were based on a fairly high level of understanding about both the company and its market. This information was used to decide the access to and use of borrowed funds. Moreover, as companies "overborrowed" from the city banks these banks were forced in turn to go to the Bank of Japan for additional funds. Such additional funds were also negotiated transactions, following the subtle rules of information exchange rather than the simpler (and often idealised) pricing rules of a free market. But as the Bank of Japan in its turn began to "overlend" to the city banks, additional monetary control entered the system from the Ministry of Finance. The MOF's control, however, did not take the form of higher interest rates, but rather was managed through the Bank of Japan and was known as "window control". This was really another negotiated transaction, imposing in this case, a form of credit rationing. As "window control" limited the Bank of Japan's lending to the city banks it limited the flow of funds from the banks to the non-financial corporations, and inflationary pressures based on a credit boom were reduced. It could well be that window control was most tightly exercised in Japan's period of highest growth 1953-62 (*Figure 9 to come: TIME SERIES OF JAPANESE GROWTH RATES v SOURCES OF CORPORATE FUNDS*) when inflationary pressures would have been particularly high. If it had been, that would at least partially explain the greater recourse to equity financing in that period, as shown in *Figure 3: External Sources of Company Funds*.

Overall, however, companies raised investment money through the banks for whom the Japanese government was effectively the lender of last resort in

the post-war Japanese industrial system. This back-up role of government financing is another reason why there should have been higher inflation than seem to have existed during the period. However, it must be remembered that the government deficit stayed low until the mid-1970s. Therefore, investment money, while being in a sense guaranteed by the government, did not actually come from the government. Instead, it came from the private sector. But how did this happen?

High Savings

Japan's high savings rate is legendary and closely matches the rate of capital formation, with both figures being consistently higher in Japan from 1960 to 1990 than in either the European Community or the United States, as shown in *Figure 10: A Higher Savings Rate in Japan* and *Figure 11: Higher Gross Capital Formation*.

Over the years, a number of explanations have been canvassed for the high rate of savings in Japan.¹ Apart from methodological differences which inflate the Japanese numbers slightly, there have been various cultural explanations put forward. One refers to the "earthquake mentality" in Japan, which suggests that a chronic sense of insecurity based on the unpredictable timing and strength of earthquakes leads people to save against a disaster they can anticipate, but not accurately foretell. To this rather vague geological insecurity (never, it should be noted, postulated for people in California who are not known for their high savings) have been added explanations based on the influence of Confucian ethics. These cultural

¹ Largely taken from Koichi Hamada, "The Causes and Consequences of Japan's High Saving Ratio", briefing paper for SOAS conference on the Japanese Financial System, May 3, 1990, London.

explanations take a more sophisticated form in explorations of cross-generational social and family structures which encourage high savings in Asian societies.

In distinction to these cultural motives, economists have also used "life-cycle" analysis to suggest that the high Japanese savings rate has been related to the age structure of society, and that as the population grows older, savings will be spent to support people in their old age. While attractive, this is not supported so far by the data which shows no positive evidence that Japan's savings ratio is declining with the same speed that the population is aging.

However, the link between savings and social security takes another form in the suggestion that savings has been high throughout much of the post-war period because social benefits have been much lower in Japan than elsewhere, forcing families to save against hard times, not otherwise cushioned by the state. A variation on this argues that Japanese families save to pay for housing, education and weddings which cannot be paid for by loans, because there are only very limited consumer credit facilities in Japan. This savings is then further facilitated by the twice-yearly bonus payments most Japanese employees receive, since these can be easily set aside for savings as current daily expenses are met out of basic salaries.

While all these factors may well have contributed to the high savings rate in Japan, they do not take account of the fact that the savings rate between the wars was much lower (*Figure 12 to come: TIME SERIES OF PRE & POST-WAR JAPANESE SAVINGS RATE*) and that therefore some change in post-war terms or conditions has probably been important in encouraging the high savings rate

of the past forty years. Of these, the most significant has probably been the Ministry of Finance rules under which the income on any deposits in private financial institutions or the Post Office savings system has been tax-free. This not only compensated for the low return of the controlled interest rates, it encouraged savers to put their money into private banks and the Post Office savings. Post Office savings were further encouraged by the fact that although in law an individual could only hold a limited number of Post Office savings accounts, this law was frequently got round by a person using several different names to open multiple Post Office accounts, a loophole largely ignored by the government.

The success of this policy can be seen in the *Figure 13: Composition of Personal Assets*, which shows that for the thirty years from 1953 to 1983 slightly more than half of personal assets were held in fixed rate deposit accounts. Furthermore, until the mid- 1970s, the private financial institutions were getting the bulk of these deposits, as shown in *Figure 14: Bank v Post Office Deposits*. Tax policies also influenced the role of equities in personal assets, since individuals did not have to pay capital gains on equity trading unless a fairly high number of transactions had been carried out. The role of equities and the stock exchange will be discussed in greater detail below, but here it is important to note how tax policies were used in Japan to mobilise personal savings for the use of the corporate sector.

These policies on deposit accounts and equity trading allowed individuals to feel that they were getting a fair return on the use of their money, while also providing funds for investment by non-financial corporations. In addition, the Post Office and the banks were effectively

competing for depositors, albeit within a structure of controlled interest rates. This competition to bring depositors into the system may well have helped to raise the overall amount of savings available to the corporate sector, although it is a difficult proposition to quantify.

Linking the Borrowers and Savers: A Funnel for Funds

The final point to be made in this discussion of savings and banking in Japan is to note that the banking system was highly specialised. Not only was it separated by law from the financial companies operating in the securities markets trading bonds and equities, but the banking business itself was also split into different markets managed by different institutions. Therefore, the 31? regional banks handled business in local areas, the 7 trust banks handled business relating to _____, the three long term credit banks were responsible for _____ and the thirteen city banks were most intimately concerned with the day to day financial transactions of the corporations. In addition, the insurance companies, post office savings, and loan trusts all acted to provide a variety of institutions for savings.

The advantages of this segmentation are not obvious, except that in a banking system where the primary products -- loans and deposits -- are governed by fixed interest rates over which the banking institutions themselves have no control, these segmented markets meant that each bank was in effect guaranteed a market niche, a small monopoly position without having to worry about failure by competing on too many fronts simultaneously. It was not, however, a pure monopoly as such, since there were always several regional banks, several insurance companies, several long term credit banks, etc, competing with each other within each market niche. However, the range

of competition was more limited, giving each bank a better opportunity to survive. In this way, segmentation reduced the risks to the banks.

Segmentation also acted to funnel savings from the population at large into the non-financial corporations in need of investment funds (*See Figure 15: Every Bank Has a Place*), those banks which were closer to the grass roots of the population with money to save acted as intermediaries between the population and the city banks which were close to the corporations with a desire to invest. In each relationship the rates of exchange were again controlled by a combination of controlled interest rates and negotiated transactions (CHECK). That this system worked effectively was no doubt in part due to the relatively small number of institutions involved, each operating a clear set of differentiated businesses and responsibilities and relationships to the others. As a system, it seems also to have allowed a fair amount of mutual oversight by the different institutions along the way - - a factor that must have reduced opportunities for corruption in the system and with that reduced the risks of bad loans and bank failures.

Summary: Savings and Banking in the Classic System

In this chapter, we have seen that the companies were urged by the government and their own ambitions to borrow heavily to fund their investments. We have observed that the city banks were willing to lend to them on the strength of back-up from the Bank of Japan, and that the money was available through a high savings rate among the citizenry at large. We have also seen that risks were reduced to all parties by controlling interest rates and by having a high level of negotiated transactions which acted to oversee the use of funds at all levels. Additionally, the Bank of Japan's "window

control" used credit rationing to keep down the level of inflation in the system. Inflation was also controlled by the fact that national savings was used for investment in Japan and that the population was willing to save because of the availability of institutions accepting their money and providing the tax breaks on the interest their money earned.

These factors alone make the Japanese banking system worthy of study when one considers how development growth can be financed. However, it still leaves our second question hanging: How was risk shared? We have seen how the lenders, the banks, reduced their risk through market segmentation, Bank of Japan support, controlled interest rates and negotiated transactions. But how did the borrowers, the investing companies, reduce the risks that they faced in making their investments in long term strategies normally seen as high risk propositions by Western firms? To answer that question, we turn to the next chapter.

Chapter Three

How Was Company Risk Absorbed?

Crossed Shares, Rising Markets and Bankruptcy in the Classical System

This chapter addresses our second critical question: how was risk absorbed by companies during the period of high investment in long term goals? We have already seen in the previous chapter that controlled interest rates, government support and segmented markets reduced risk for the banks, but we have yet to look at what factors reduced risk for the borrowing and investing companies in Japan. Here there are three principal areas of discussion: the evolution of crossed shareholdings and the *keiretsu* structure, the role of the Stock Exchange, and the management of bankruptcy.

Evolution of Crossed Shareholdings and the *Keiretsu* Organisation

In the last chapter we looked at one of the important financial dynamics during the high growth period in Japan: the banking and borrowing system. The main elements of this side of the system are shown on the left in *Figure 16: Two Important Dynamics of High Growth Finance*. A second aspect of the system is shown on the right: the break-up and reassembly of the large pre-war industrial groupings leading to the evolution of crossed shareholdings and the *keiretsu* business organisation. It is that aspect of the Japanese system we discuss here.

Crossed Shareholdings

In 1949 Eleanor Hadley wrote one of the definitive studies of the pre-war industrial groupings in Japan, known as the *zaibatsu*. Before the war

there were 5? important *zaibatsu*: Mitsui, Mitsubishi, Fuyo, Sumitomo, Sanwa and _____, as well as several minor groupings: _____. All of these groups were controlled by very wealthy families whose interest was exercised through shares held in holding companies which in turn held shares in the group's wide variety of financial and industrial corporations. The overall organisation of one such *zaibatsu* is shown in *Figure 17: Mitsubishi Interests 1946*, which reproduces a diagram from Eleanor Hadley's book.

In the pre-war period, the *zaibatsu* had served an important function in mobilising capital, establishing international trading companies to handle overseas business, and setting up industries which contributed to the rapid development of Japan. They were also frequently the chief beneficiaries of government development policies so that, for example, after the government had started an industry under government control using government funds, it would later be sold off to one of the *zaibatsu* interests as a going commercial concern ready for expansion and further development. Furthermore, many of the *zaibatsu* financial houses had descended from businesses which had made their fortunes and reputations by financing government deficits.

These kinds of intimate links between businesses and governments led the leaders of the American Occupation in Japan to conclude that the *zaibatsu* organisations had been one of the chief backers and beneficiaries of Japan's military adventurism in the 1930s and 1940s. While recent research has tended to undercut the strength of this as a blanket conclusion, the U.S. occupation forces concluded that the strength of the *zaibatsu* must be broken if Japanese militarism was to be effectively driven out of the system. To meet this objective, the occupation outlawed all holding companies (a law still in existence today), put a limit on the percentage of shares that could be held

by any bank, and forced the divestiture of shares held by the *zaibatsu* families and their major holding companies. As a result, by 1950, over 75% of corporate shares were held by the public at large. By this measure, the occupation's objective had been achieved, and the strength of the *zaibatsu* had seemingly been broken.

However, over the next ten to twenty years, a new collective form was created: the *keiretsu*. There were at least two forces driving this evolution. First, the major corporations in Japan began to fear they would be subject to hostile takeovers, and were particularly worried about the possibility of American corporations buying up Japanese companies. Second, as companies began to reestablish business ties with each other and with their financial institutions, these working relationships were solemnized by the acquisition of shares in each other, with the dominant partner usually taking a larger holding in his opposite number than the subordinate partner had in him. Banks were particularly keen to acquire shares in those companies to which they lent money, although they were limited by law to 5% or less.

As a result the public proportion of total shareholding had shrunk from 75% in 1950 to 59.1% by 1960, to 46% by 1970 and to about 25% in 1990, with the financial institutions and other, non-financial corporations, holding the balance of shares. (See *Figure 18: Growth of Stable Shareholdings 1950-1990*) These corporate and institutional cross-shareholdings have since become known as "stable shareholdings" and have widely been perceived to be unmoveable, since they have usually remained unsold in a corporate portfolio. Here they have served to solidify the existence of long term working relationships between business entities and have acted as security against bank loans, a subject covered in more detail below.

The 25% of shares held by individuals in Japan in 1990 is actually slightly higher than the comparable 1992 statistic in the UK.¹ However, whereas the UK pension funds and insurance companies who hold over half of the UK company shares, feel free to trade the shares they hold, the Japanese companies have historically held onto their shares, leaving only the individual shareholdings free for trading. While many Japanese companies increased their share trading in the late 1980s, the important crossed shareholdings have largely remained and have been an important aspect of the Classical System and particularly of the *keiretsu* organisation which evolved around them.

Keiretsu Organisation

One of the interesting features of any *keiretsu* organisation is that most of the major corporate shareholders in a company hold less than 5% of the company's shares. However, collectively, the total of these corporate shareholdings from a single *keiretsu* can be considerable and will reflect a degree of group control, even if they do not add up to majority control (51% or more). Most of these *keiretsu* or group shares, are held by the financial and non-financial companies who are members of the group's Presidents' Club.

The Presidents' Club is an informal association in each *keiretsu* which officially has no power and no authority. However, the presidents of the leading companies in a group will meet on a regular basis for lunch and gossip, meetings which, it is claimed, never include any business, but

¹ According to the August 1992 *Economic Trends Bulletin* (No. 466, HMSO, £11.50) from the Central Statistics Office, the percentage of UK quoted company shares held by individuals and unincorporated businesses was just 20% in January 1992 having been as high as 37.5% in 1981.

function as purely social gatherings. For many people, this is a disingenuous claim, since the leading companies have both a financial and operational authority within the group which is widely respected. This is reflected in the club's membership which includes both the financial interests of a *keiretsu* (the insurance companies, banks and trading houses) as well as the major non-financial industries, including the older founding businesses in steel, chemicals and textiles and some of the successful new businesses. (Figure 19: *PRESIDENTS' CLUB MEMBERSHIPS - March 1990*) It can be argued that the lunch clubs have been a substitute for the old *zaibatsu* holding companies, but the analogy is only partially valid. First, the shareholding foundations of the holding company are not really duplicated in the club structures and there is considerable formal scope for autonomous action by the individual club members. Second, as the post-war generation of business leaders with their pre-war *zaibatsu* background dies off, some of this formal (but often unexercised) autonomy may come to be expressed by a younger generation. Nonetheless, throughout the post-war period, the presidents' clubs have been the leading informal institution in any *keiretsu* organisation and their position is reflected in the chain of shareholdings that run from the Presidents' Club members through the associated companies of the larger group.

Some idea of that chain of shareholdings is presented in *Figure 20: Schematic Structure of Keiretsu in the Japanese Chemical Industry*. Unlike many studies of *keiretsu* which have looked at the relationship of diverse companies in a group, this graph is based on looking at one industry and seeing how the *keiretsu* have organised around the industry's requirements. As can be seen, those chemical companies, shown in shaded boxes, which are closely attached to the group count among their main shareholders the

financial members of the Presidents' Club, while their main bank (an important institution discussed further below) is one of the banks associated with the group. In addition, the leading chemical companies in a *keiretsu* are often members in their own right of the Presidents' Club, while others are attached to these big chemical companies in a kind of subsidiary relationship which provides both an operational and a financial link to the larger group. Still others (shown here as "Other Ranks") appear to be attached formally to the group only through the shareholdings of financial members and the appointment of the group bank as their main bank, while more distant connections are held by the subsidiaries of the "Other Ranks". There are finally those companies where a foreign partner or a single family holds a large percentage of shares, but which are still strongly linked to the group through the shareholdings held by financial members of the Presidents' Club and their use of the group bank for their main banker. All these categories of chemical companies, as defined by their shareholdings and their main bank relationship, constitute the core chemicals business of a *keiretsu*.

More widely, both the financial and non-financial group companies at all levels are likely to hold shares in chemical companies outside the group. This has often reflected some business relationship; in the case of Mitsubishi in 1989/90, for example, the financial members of the Presidents' Club held "minority" or "placeholder" shares in a large number of companies which were more closely linked to other groups. This may have reflected the fact that, for example, non-Mitsubishi companies were located on large "combinat" chemical sites which were managed by Mitsubishi who organised a number of downstream industries around Mitsubishi's own basic chemical plants.

This shareholding analysis of *keiretsu* in the chemicals industry,

completed in the spring of 1990, does not give any weight to the value of loans in defining a company's relationship to the larger group. As already noted, companies during the post-war period of high growth were very dependent on loans and it can be argued that such loans acted as a kind of equity investment. Research by Nishiyama assumed that this was at least partially the case and he analyzed the nature of the relationship between members of a *keiretsu* by calculating the strength of both shareholdings and loans members held in each other. To do this, Nishiyama created a "power index" based on the percentage of shares any company held in another and calculated the value of loans as equal to 1/10 the value of shares. This led to the ranking of five Mitsubishi companies in order of their relative dependence on each other, as shown in *Figure 21: Interfirm Dependence and Power*. In this analysis, Meiji Life Insurance has the highest "Net Power Index" largely because it is a mutual fund and therefore no company holds any shares in Meiji Life. However, the relative weight of other shareholdings and loans placed some companies in a stronger position than others, despite the mutuality implied by the term "crossed-shareholdings".

This work by Nishiyama, together with the *Schematic Structure of Keiretsu in the Japanese Chemical Industry (Figure 20)*, suggests that the *keiretsu* organisation functions with a strong sense of hierarchy based on both formal and informal sources of power and authority. In this hierarchy, every company understands its precise relationship to the others and does not, normally, attempt to go outside the understood boundaries of its position. This means that a company operates within a relatively secure organisational framework and has access to the group's banks, insurance companies and trading houses. However, the same framework can also be seen as a constraint on individual company decisions. This notion of the *keiretsu* acting as a

constraint on a company was supported in my own 1990 study of the Japanese chemical industry, which sought to identify which companies belonged to which *keiretsu*. When the information was finally compiled, it became clear that a sizeable minority of chemical companies functioned on a relatively independent footing. However, these companies may have paid a price for their independence; the average sales per company of the independents were lower than most of the *keiretsu* companies, and they may have had less access to borrowed funds, as shown below.

As shown in *Figures 23 and 24: Keiretsu v Others 1989/90 and Keiretsu Group Sales v Others*, of the 212 chemicals companies² listed on the Tokyo Stock Exchange in 1989/90, 66% were strongly linked to one or another of the dominant *keiretsu* which together accounted for 72% of the sales. Another 11% were large companies (such as Hitachi) which were members of several Presidents' Club or the chemicals subsidiaries of such companies. These companies were defined in my work as those with "multiple loyalties" and accounted for 12% of sales. The remaining companies (23% of the total) were classified as 'independent' of all groups and had 16% of sales.

When the financial information for these three kinds of companies was analyzed, as shown in *Figure 25*, the independent companies raised slightly more of their investment from equities (39%) than did those with *keiretsu* links; *keiretsu* companies had equity ratios of 32% and the multiple loyalty companies' equity ratios were even lower at 28%. The greater dependence on borrowing of the linked companies could indicate that those companies with

² The data for this analysis was taken from the Tokyo Stock Exchange Handbooks of 1989 and 1990. Any company which listed some kind of chemicals as part of its main business, or which was a major shareholder in a chemical company, was included in the data base; hence, for example, Hitachi was included, even though it is not known primarily for its chemical business.

good *keiretsu* relationships enjoyed greater security against the risk of borrowing than did the independent companies who were, albeit marginally, more reliant on equity financing. Such a conclusion is supported in *Figure 25* which also shows that the independent companies were much more likely to have a "positive net interest/dividend flow". This figure, which appears in the Tokyo Stock Exchange Handbook for all companies, results from adding up all the interest and dividend payments made by a company and then subtracting the total from all the interest and dividend payments received by a companies. Those with a "positive flow" (i.e. more money coming in than going out) are considered to be in better financial health than those with a negative flow. The stronger financial position of the independents has no doubt grown up in part because the independent companies knew they were less able to fall back on the support of a wider group and needed to be more self-reliant. From a Western point of view, the relatively greater financial strength of the independents would appear to be an advantage. However, during the post-war period more investment was available from borrowing than from equity, and it appears that those with strong *keiretsu* links were able to borrow more money than those without such links.

In addition to access to borrowing, there was another advantage to group membership which enabled companies to take a long-term point of view; namely, that the tight crossed-shareholding structure, provided security against hostile takeovers. Initially, in the early post-war years this structure, as already stated, evolved in response to the threat of foreign takeovers. However, the Japanese system is still famous for avoiding unfriendly mergers between companies and it is obviously extremely difficult to launch a stock market raid when a large percentage of a company's shares are held in friendly hands. This shareholding defence has been further reinforced by the

cultivation of company loyalties which have frequently meant that when mergers do occur they are unhappy alliances, with legendary tales circulating regularly to show how mergers subsequently suffer from cultural clashes between the companies. More acceptably, mergers have taken place between group companies, reflecting a process whereby a new venture is spun off independently during its early loss-making years and only reincorporated when it begins to succeed, as shown in the cartoon *Mergers and Acquisitions in Japan (Figure 26)*. There is also the well-documented fact that in times of crisis Japanese industries have frequently restructured, as shown below in the discussion of bankruptcy. Overall, however, such restructuring and the mergers and acquisitions that allow it to take place appear to be less common than in an Anglo-Saxon system.

Summary: Crossed Shares and Keiretsu Organisation

Overall, in considering how long term risk is managed by Japanese companies during the post-war period, it is clear that the *keiretsu* organisation has acted to provide security against hostile takeovers may have increased an individual company's access to borrowed funds. It has also provided a secure framework for companies which contained within it banking, insurance and trading services as well as links to other companies in its industry. It must therefore be considered a key part of the Classical System of financing growth in post-war Japan.

Two other features of the Classical System can now be explored: the role of the Stock Exchange and the management of bankruptcy in Japan.

Role of the Stock Exchange

Figure 27: Shareholders and Loans in a Presidents' Club Member, looks at the 1987 ownership and financial stakes in a major company in Japan, called here, "KR Basic Industries", a member of the "KR" *keiretsu*. This diagram shows that about half of the principal loans to KR Basic Industries were held either by the KR Trust Bank or the KR City Bank, with the balance held by non-group long term banks. The company's main bank, KR City Bank, held the largest share of loans, 33%. Of the shares in KR Basic Industries, 38% were held by other group companies, with the affiliates of a foreign partner, "ABC International", holding another 28%. This gave the KR group and its foreign partner majority control of KR Basic Industries. Of the remaining shares, 13% were held by other banks and insurance companies, with the public at large holding 21%. It is this 21% that in 1987 would have been traded freely on the Tokyo and Osaka Stock Exchanges, with the other shareholding considered to be "stable" investments.

Apart from the foreign participation, this shareholding structure of "KR Basic Industries" is not greatly different from other companies in the 1980s, as shown in *Figure 28: Shareholder Composition and Shareholder Activity, 1981*. This table, which was published by M. Aoki in 1984, compares the percentage of market holdings with the percentage of market transactions. It shows that in 1981 individuals held about 28% of the shares, but accounted for 42% of the transactions. Japanese securities brokers and foreign shareholders accounted for another 38% of the transactions, while the financial institutions and intercorporate holdings were barely traded at all. Not surprisingly, the steady fall in the percentage of any company's shares available for trading, and the growth in the Japanese economy generally after the Second World War,

has contributed to a steady increase in Japanese share values over the past 40 years as seen in *Figure 29: Share Prices Index: 1950-1985*.

However, the effect of the rising value of company shares did not lead to more companies entering the equity markets for investment funds. On the contrary, so long as the government continued its policy of controlled interest rates, and so long as companies were committed to holding shares in their business partners (the value of which would have been diluted by any new rights issues), and so long as growth in the economy continued, the equity markets were ignored as sources of new investment. Instead, as shown in the cartoon *Growth = High Gearing (Figure 30)*, crossed-shareholdings which were held on a company's books at their historical value (i.e. their value when acquired) became "hidden assets" against which banks were content to increase their loans to a company. A company's property, which was also rising in value throughout the post-war period, was another hidden asset and likewise seen as backing up greater borrowing.

These hidden assets thus acted as collateral to further loans. Such loans were also encouraged by the government's continued emphasis on growth and investment, and the bank's own knowledge of a company's affairs, including its market share, reputation and good will. Given that there was surplus saving needing a home, a company in the Classical System could be comfortably cradled between the rising value of its assets and the availability of savings looking for investment opportunities. The investment in turn, of course, continued to create growth, which further raised the value of shares, which acted as new collateral and so the process continued. Not unreasonably, the Japanese system has been compared to a bicycle: so long as it keeps moving, it remains upright.

This system benefited the majority of participants, as seen in the cartoon, *Shareholding: Growth = Capital Appreciation (Figure 31)*. The friendly shareholders who held the stable shareholdings found that they benefited from increased borrowing secured against the rising value of their hidden assets. They also had the benefit of the *keiretsu's* mutual support and, customarily, they received (and paid out) dividends which averaged an insignificant 10% of the par value of the shares. This low dividend payment meant that profits made by a company could be reinvested. The public shareholders, who were actually trading in the market, also benefitted, particularly private individuals who did not pay any tax on capital gains until they they made a great number of transactions. They were, therefore, happy to continue trading for the untaxed profits they made. They too received dividends averaging no more than 10% of the par value of their holdings, but were content with their untaxed capital appreciation and continued to support the market by reinvesting in it. The biggest losers in this system were Western shareholders who were seeking to establish businesses in Japan. Many did not finance their businesses with borrowings or hold crossed shares; they therefore did not benefit from the rising value of hidden assets. Nor were they as a rule closely linked to any of the *keiretsu*, which were seen as primarily Japanese associations. Finally, many Western investors with businesses in Japan were obliged to pay out to their shareholders in the West larger dividends than their Japanese competitors were paying in Japan. Moreover, the cost of competing with companies not obliged to make such dividend payments was high, since the Japanese companies could spend more on R&D, customer service and employee training. As a result, the Japanese subsidiaries of Western companies were often not seen as good investments by the home office, who found 10% of par value a paltry return indeed.

There is finally, one other aspect of the stock exchange which should be mentioned, the role of the securities houses. As was seen in *Figure 28: Shareholder Composition and Shareholder Activity*, the nearly 28% of the total transactions on the Tokyo Stock Exchange in 1981 were "self-dealings" by the four securities houses: Nomura, Daiwa, Nikko and Yamaichi. The importance of their weight in the market is best illustrated by the chapter hyperbolically titled "The Day Normura Helped Save the World" in Al Alletzhauser's book *The House of Nomura*, published in 1990. This chapter describes the Japanese response to the October 1987 crash in stock markets around the world, which began on Friday, the 16th of October 1987, when the London market was shut because of a unusual hurricane, and the New York Stock Exchange (for reasons unrelated to the storm in Britain) closed down 107 points, a fall of 40%.³ In response the following Monday, the Japanese stock market fell 2.5%, with both Hong Kong and Singapore falling much further (11% and 12% respectively) and London following suit and dropping by 10%. The combined effect was to throw the New York Stock Exchange (the last to open each day) into a panic so that by the end of dealing on Monday, the Down Jones had fallen 508 points and all markets were in a state of chaos.

The next morning, Tuesday the 20th of October, The Tokyo Stock Exchange continued to fall, but broke for its customary two-hour lunch at 11am. During the lunch hour, the four largest brokerage firms met for their regular Tuesday lunch at the Ministry of Finance where Takashi Matsukata of the Ministry gathered the views of the equity trading managers. Alletzhauser quotes Matsukata as later saying, "It was an emergency. In order to normalize the markets we listened to the opinions of the leaders of the securities industry

³ By comparison, Alletzhauser notes, on Black Tuesday, 29 October 1929, the Dow Jones industrials fell thirty points, or 11%.

and asked them to co-operate." Alletzhauser further reports that when asked whether the government wanted the four firms to support the market, "Matsukata leans forward and, almost imperceptibly, nods." (p.16) That afternoon, the securities firms began issuing orders to buy. The degree of control of the equity markets in Japan that this collaboration exercised is reflected in the graphs comparing stock market performances around the world in October 1987. (Figure 32 to come: *FEER GRAPHS OF REPRESENTATIVE STOCK EXCHANGES: October/Nov 1987*)

Summary: Role of the Stock Exchange

The 1987 story is an extreme example of the links between the government, the securities houses and the stock exchange. Moreover, the relationship between these three, as will be shown later. However, it is clear that the role of the stock exchange in creating capital appreciation which supported company financing has been well-understood by the Ministry of Finance and manipulated accordingly. Thus, even though by comparison with other leading stock exchanges in the world, the Japanese market has lacked many of the sophisticated instruments and mechanisms of New York or London, it has therefore been a crucial feature of the Classical System of Japanese finance and has been manipulated to support that system as and when required.

Managing Bankruptcy in Japan

This brings us to the last element in how risk has been absorbed in the Classical System: safer and cheaper bankruptcies. Most of this discussion is based on research by Jenny Corbett, which was published in the November 1987 *Oxford Review of Economic Policy*, under the title, "International Perspectives

on Financing: Evidence from Japan". While part of her paper confirms that Japanese industry does have higher gearing ratios than elsewhere, Corbett also looks at various aspects of Japanese banking practice and concludes that most of these are not significantly different from other banking systems. Thus screening, terms of loans and monitoring may differ in degree, but not substantially in their nature from elsewhere. However, Corbett goes on to examine typical bank responses to problem loans and bankruptcy and argues that "it is this that distinguishes Japanese banking more than anything else from counterparts elsewhere." (p. 33)

The diagram *Banks' Monitoring and Problem Loans (Figure 32)* summarises Corbett's description of a bank's response to problem loans. While she sets out to describe bankruptcy procedures, in fact most of the activity around a company in difficulties begins long before any bankruptcy (*tosan*) is declared. This activity is the natural outgrowth of routine monitoring by the bank's branch officers or head office. This monitoring, which may occur more frequently than in the West, relies on regular contact and a high exchange of information, something that is consistent with the style of negotiated transactions we have described earlier.

It is this monitoring which first uncovers any problem loans, which are then referred to the bank's Loan Committee, consisting of the senior managers of the bank's main divisions. This committee in turn appoints a "Project Team" to decide what should be done about the problem loan and the company which has borrowed the money. The Project Team will include people from the Credit Administration Division of the bank as well as someone with experience of the particular industry, and it will use the resources of the bank's Industrial Research Department. The establishment of this team shifts

responsibility away from the officer with the original responsibility for the loan. His career is unaffected by the difficulties of his client, but he will be seen as having built up personal relationships with the clients that could cause difficulty in resolving things. The Project Team will then recommend whether to call a meeting of the firm's creditors, send in a team of advisory managers to help the company, or negotiate changes in the terms and conditions of the problem loans.

Various factors will affect their recommendation. If the lending bank is not the main bank of the company, it may simply attempt to increase the security against the loan or may try to reduce the amount outstanding. In deciding when to call a meeting of creditors, the Project Team may consult them early, or the management advisors may first try to sort things out and either propose a solution to the creditors or demonstrate that reform has already taken place. The decision to send in advisory managers depends on whether the company is listed (since listed companies will be helped, if possible), whether there are any special social responsibilities of the company (e.g. it is in a depressed area or other companies are dependent on its survival), and finally on the size of the bank's possible losses. Obviously, the more the bank stands to lose, the more likely it is to send in advisors to mitigate the loss. According to Corbett, at the end of 1984 25% of top management in listed companies came from outside of the firm and of these 21% were from the banks, constituting roughly 5% of top management. Finally, any financial help to a problem company will be contingent on the production of a recovery plan, which may have been drafted with the help of the company's main bank, but which in any case will require the main bank's approval.

It may happen, of course, that none of these measures succeeds and the company continues to experience difficulties. In that case, an early stage of bankruptcy, called *Tosan*, will be declared. Corbett points out, however, that even at this stage *tosan* "does not refer to a legal status, but to a situation". The situation is one in which the company is operating at a loss, and its bank has suspended its checking and bill discounting services. However, the company may still function on a cash basis and may not yet have defaulted on any commitments. In 1975, there were 12,606 companies declared bankrupt in this fashion. More recent numbers for 1983 and 1984 can be seen in the table *Bankruptcies by Size of Firm (Figure 33)*. This table also shows that the Japanese rate of bankruptcy for all firms was higher than that in the USA, supporting one of Corbett's conclusions, that bankruptcy is a less expensive option in Japan than elsewhere.

One of the reasons bankruptcy in Japan is less expensive, is that most of the *tosan* bankruptcies do not proceed to legal remedies. Of the 12,606 companies that were declared bankrupt in 1975, only 21% (2699 companies) went through the legal procedures, which can take years to settle and are very expensive. Even amongst these a small number (less than 700 of the total) were able to experience some form of company rehabilitation, as shown in *Figure 34: The Process of Bankruptcy in Japan*, which is taken from Corbett's article. The remainder, 79% of the *tosan* bankruptcies in 1975, were handled by informal procedures.

In the informal procedures at this stage, the company's main bank appears to take the lead. Under the Japanese system, its main bank is seen as having a particular responsibility for a company, which is why in defining the strength of any company's links to a *keiretsu* the affiliation of its main

bank is important. This responsibility does not seem to have any legal status, but it becomes extremely important when a company experiences difficulties. Like the original project team appointed to help a company with a problem loan, the main bank has three courses of action: it can call a creditors' meeting, or it can send in advisory managers, or it can arrange for financial assistance. Corbett quotes examples of the kind of direct financial assistance which has been arranged by main banks, as described in 1986 research by Sheard. These include reducing interest rates to below prime and/or reducing the size of the compensatory deposits held by the bank. A moratorium on interest payments can also be agreed, but requires cooperation of the Ministry of Finance and the Tax Authorities since otherwise the bank would be liable for tax on its 'gift' to the troubled company. The main bank may also seek to share the burden with smaller lenders and eventually with shareholders. In some cases the main bank will replace the loans held by smaller lenders, but it does not usually provide guarantees for them. Finally, the main bank may arrange for the sale of some company assets to paper companies in order to create an accounting profit, or it may reorganise the firm through mergers, genuine sales of assets, or reductions of the labour force.

In considering these efforts by the main bank for a troubled company, it is natural to ask: why does the bank take on these responsibilities and risks? Corbett argues that it is one half of an 'implicit contract' between a company and its bank, as sketched in *Figure 35: Implicit Contracts Create Long Term Relationships*. As we have seen in the chapter on banking and savings, the Japanese banks have operated in a controlled and fairly protected environment. This has given them "a degree of oligopoly", in Corbett's words, which has meant that when companies are doing well and times are good, the

banks earn higher than 'normal' margins because firms pay higher than 'normal' interest rates. She illustrates this with *Figure 36: Bank Margins and Discount Rate Changes*. In return, the companies are able to rely on the banks to help them when times are hard. Corbett sees this implicit contract as acting to 'smooth' the interest rates paid by companies according to the ups and downs of a company's business. She also argues that, given the reliance of the banks on a high level of knowledge and information about their client companies, new customers are an expensive proposition for a bank so that maintaining long term relationships is actually cheaper than repeatedly establishing new ones. Furthermore, the bank's own reputation is enhanced by its loyalty to its customers in bad times. Conversely, a firm's reputation would suffer if the firm defected to another bank when times were good, thereby leading to doubts about the firm's reliability among its own commercial network of suppliers, distributors, etc.

Summary: Bankruptcy and the Long Term View

The bank's willingness to lend money to companies has been based on many factors, including the availability of savings, the collateral of hidden assets and the ultimate backup of government through the Bank of Japan. However, it has also been based on greater access to company information, which supported the "negotiated" transactions of the system. Jenny Corbett goes further in stressing that the bank's access to information functions hand in hand with "the *ex ante* knowledge that intervention is possible when bad management is the cause of poor performance." Furthermore, the bank's knowledge about a company enables it to intervene long before legal bankruptcy is declared, which lowers the cost of bankruptcy considerably. From the company's point of view, the system is beneficial since it can rely on its

bank when times are hard. However, the very nature of this implicit contract means that both firms and banks only reap the benefits of the relationship over a long period of time that includes both periods of hardship and periods of well-being. Given that both parties find the benefits of this long-term relationship greater than any temporary advantages, the implicit contract that underlies the Japanese approach to bankruptcy has not only helped to manage and reduce risk, but has also served to sustain the long term point of view.

Summary: How Was Company Risk Absorbed?

There are, in summary, three critical aspects to the absorption of risk among Japanese companies. First, there is the strength of the cross-holding system of the *keiretsu* organisations, which has provide a high degree of mutual support. Second, this system itself has been strengthened by the rising value of shares in the stock exchange. Third, the process of bankruptcy is less costly than it is elsewhere. These three elements are further summarised in a brief concluding chapter which follows and shows how the various pieces of the Classical System of Japanese Finance have fit together, both from the banking side and the corporate borrowing side.

Chapter Four

A Short Summary of the Classical System: 1950s - 1980s

This short chapter presents *in Figure 37: The Classical System* a visual summary of Japanese financial structures from the 1950s to the 1980s. It shows that the Ministry of Finance and the Bank of Japan have provided both supervision and back up to the banking and securities sides of the financial system. The diagram also puts the high saving rate in Japan in a central position, pooling the money that then went through the long term credit banks and regional banks to the City banks which negotiated transactions with the corporations. Some of this savings pool also went into the rising equity market, usually through the big four securities houses. As the economy grew, the value of the equity market and was partly supported by a corollary rise in land values.

As the equity markets grew, more and more publically-held shares were transferred into stable cross shareholdings, creating the *keiretsu* groups. This structure reduced the risk of hostile takeovers, helped to share long term risks among a wider group of companies, and tolerated low dividend payments in return for a shared opportunity to reinvest earnings in greater growth. This growth, in turn, increased the value of shares on the stock exchange and the 'hidden' value of shares held in the stable holdings of the companies. These shares, together with the rising value of land held by companies, was then used to secure more loans from the city and regional banks. These banks were willing to lend the money because they benefited from a high level of information about a company and knew that they were implicitly given the right to intervene when bad management was causing trouble in a company. This arrangement has also meant that 'bankruptcy' in Japan has been

relatively inexpensive and part of a wider early warning system which has been able to identify troubled loans at a stage when informal, non-legal remedies could be applied.

Overall, therefore, the banking system and the shareholding system, operating under the supervision of the Ministry of Finance and the Bank of Japan, has enabled high growth corporations to take the long term point of view from the end of the Second World War until the beginning of the 1990s. More recently, however, a number of gradual changes in Japan, the wider world and the corporations and banks themselves have led to the evolution of new conditions and institutions governing Japanese financial structures. What some of those changes are, and what they might mean for the ability of Japanese companies to take the long view in the future is the subject of the final chapter of this book.

Figure 1

ALL MF INDEX OF OUTPUT

Four countries compared: 1960 - 1987

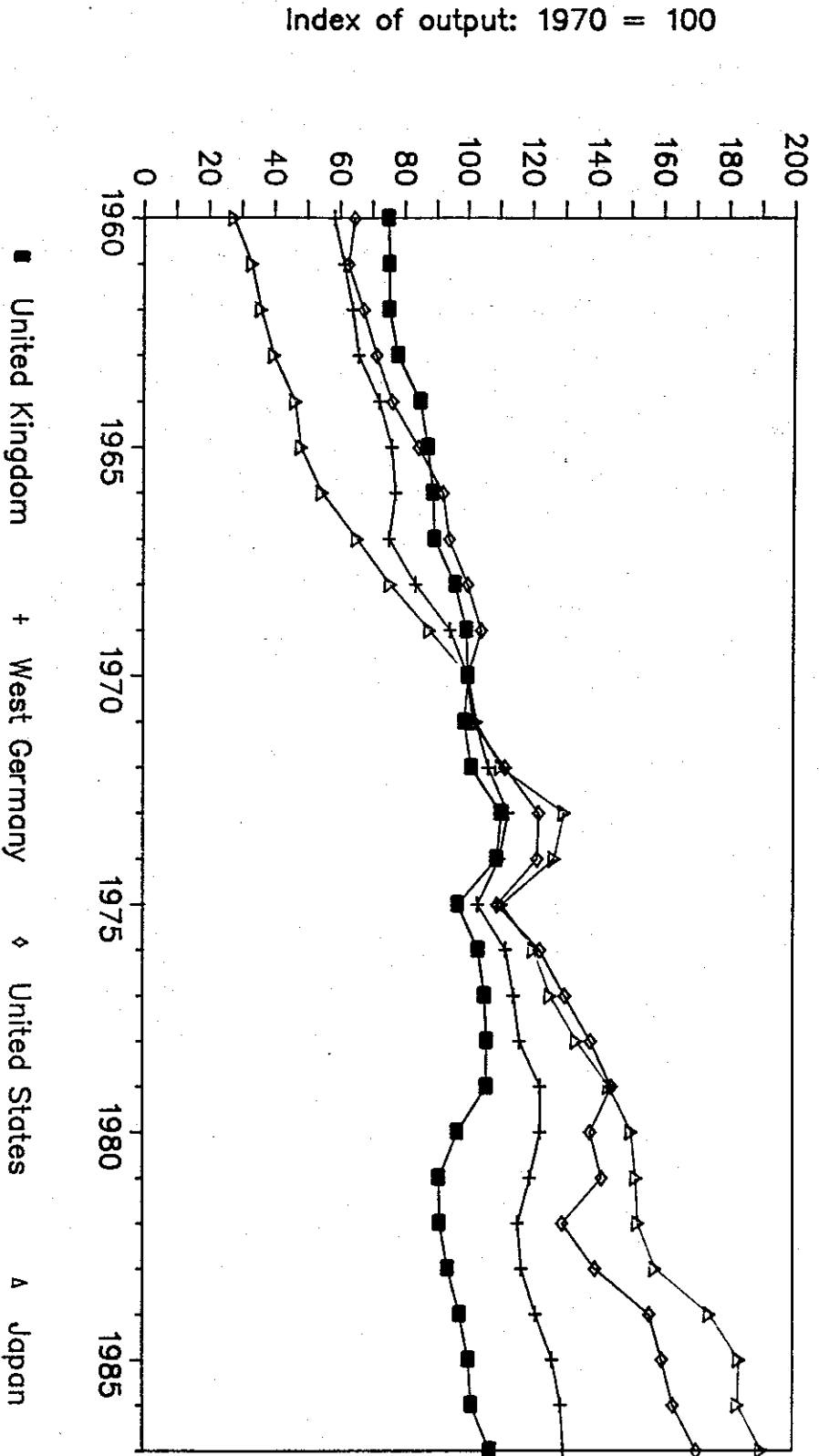


Figure 2

FACTORS ENCOURAGING GROWTH

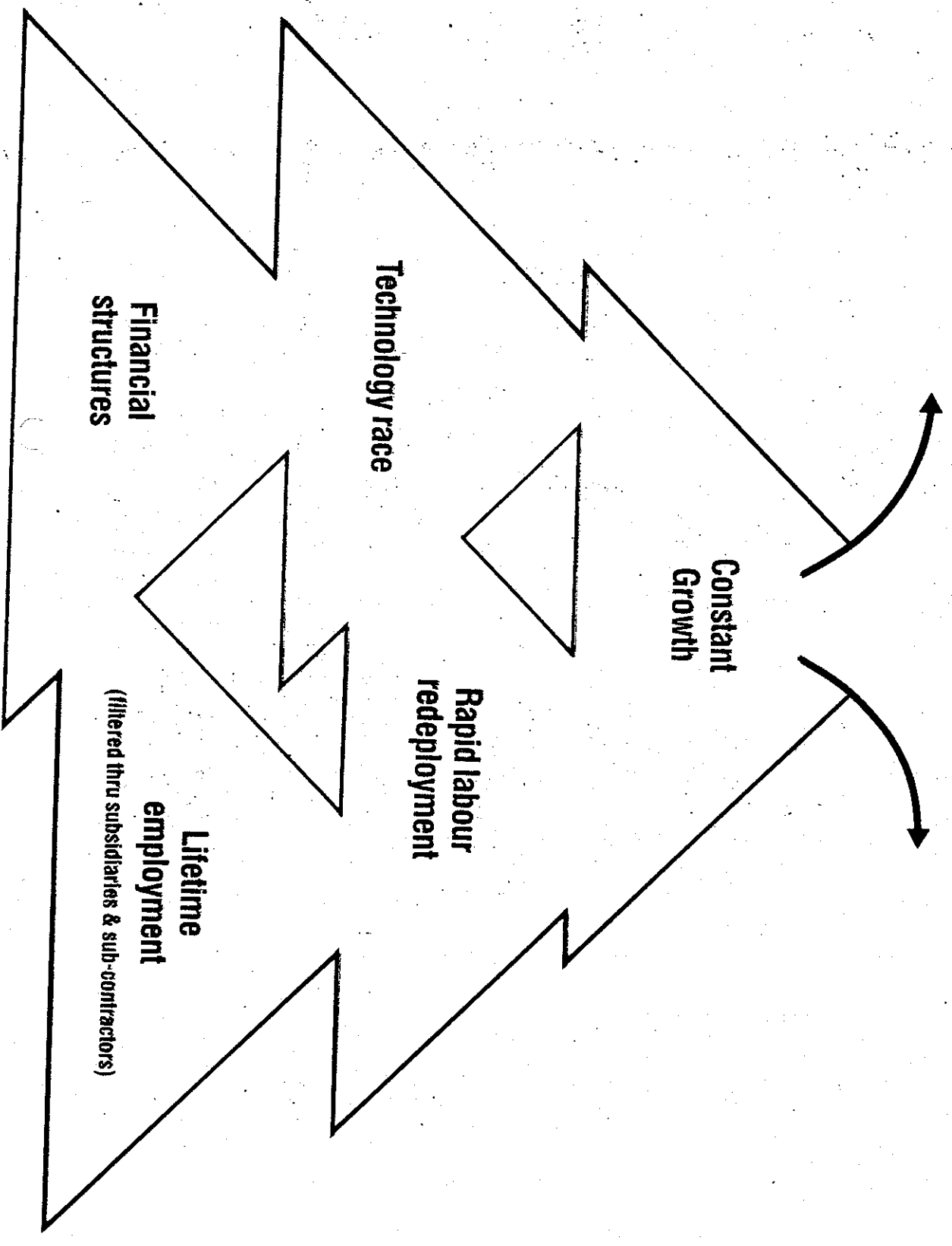
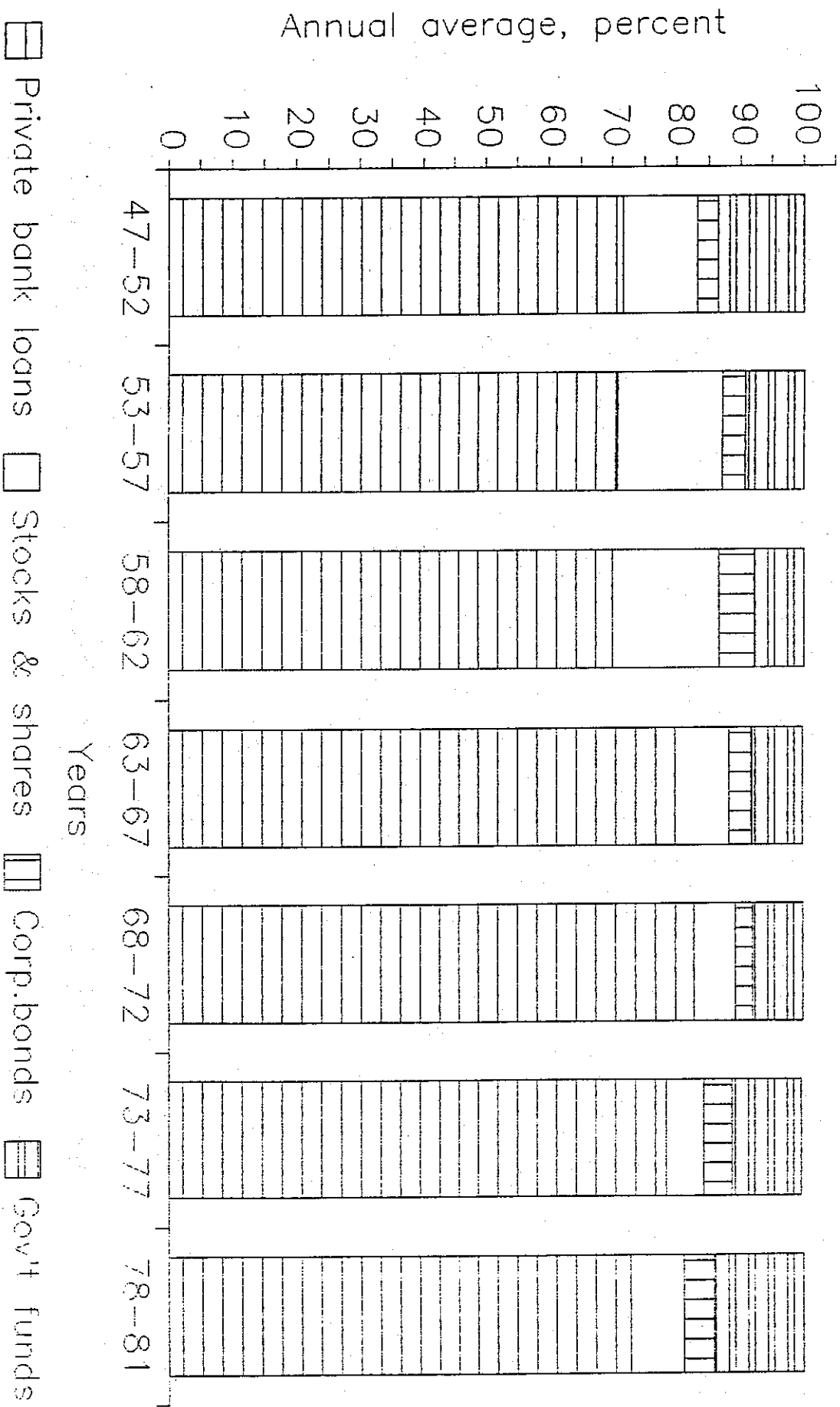


Figure 3

EXTERNAL SOURCES OF COMPANY FUNDS

Japan: 1947-1981

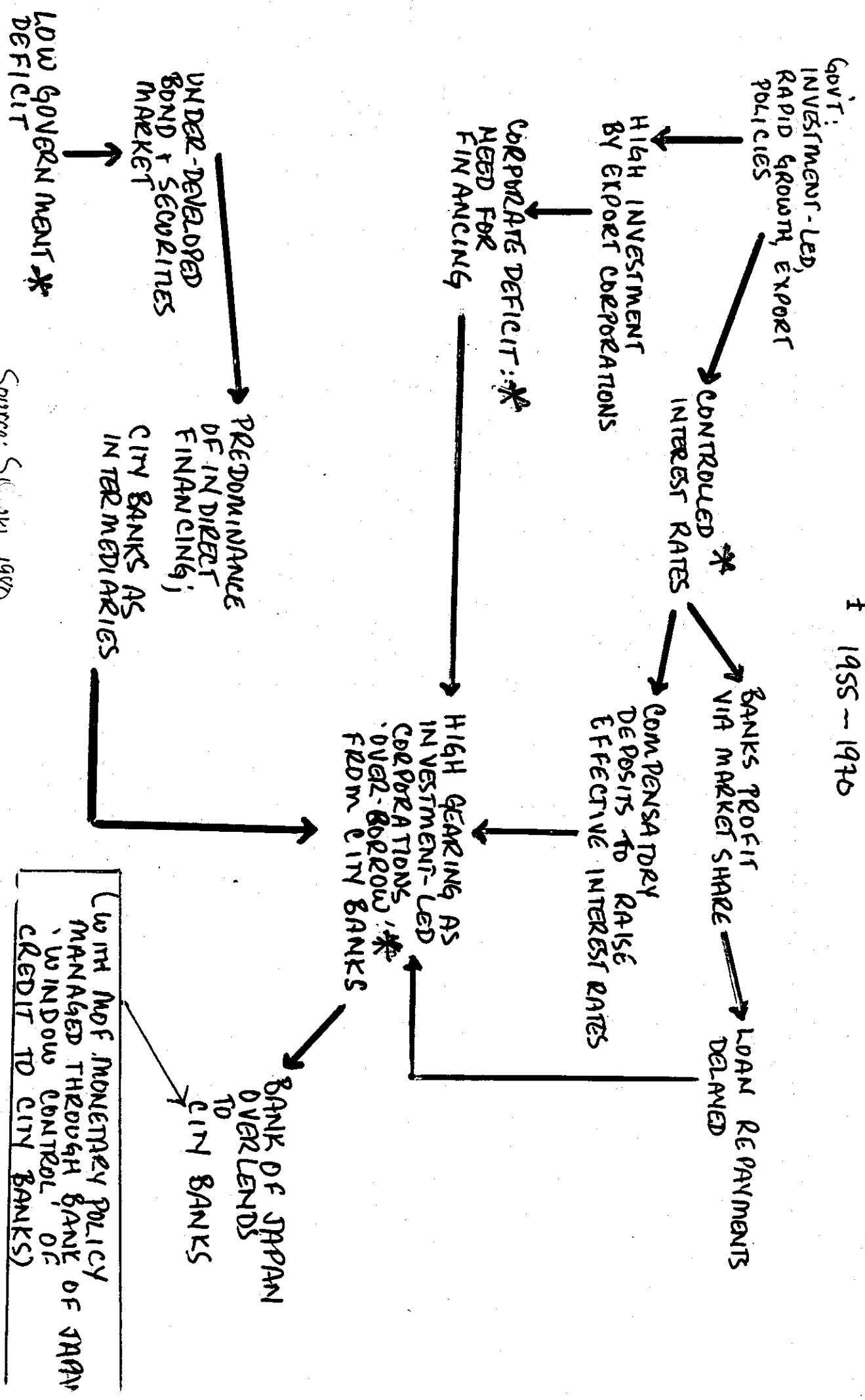


Source: Hamada and Horuchi, undated
SAVES

Figure 4

ORIGINS OF HIGH GEARING

1955 - 1970



Source: Scott, 1980

ORIGINS OF HIGH GEARING

Figure 5

JAPANESE GOVERNMENT DEFICIT

1950 - 1990

to come, if statistics are available

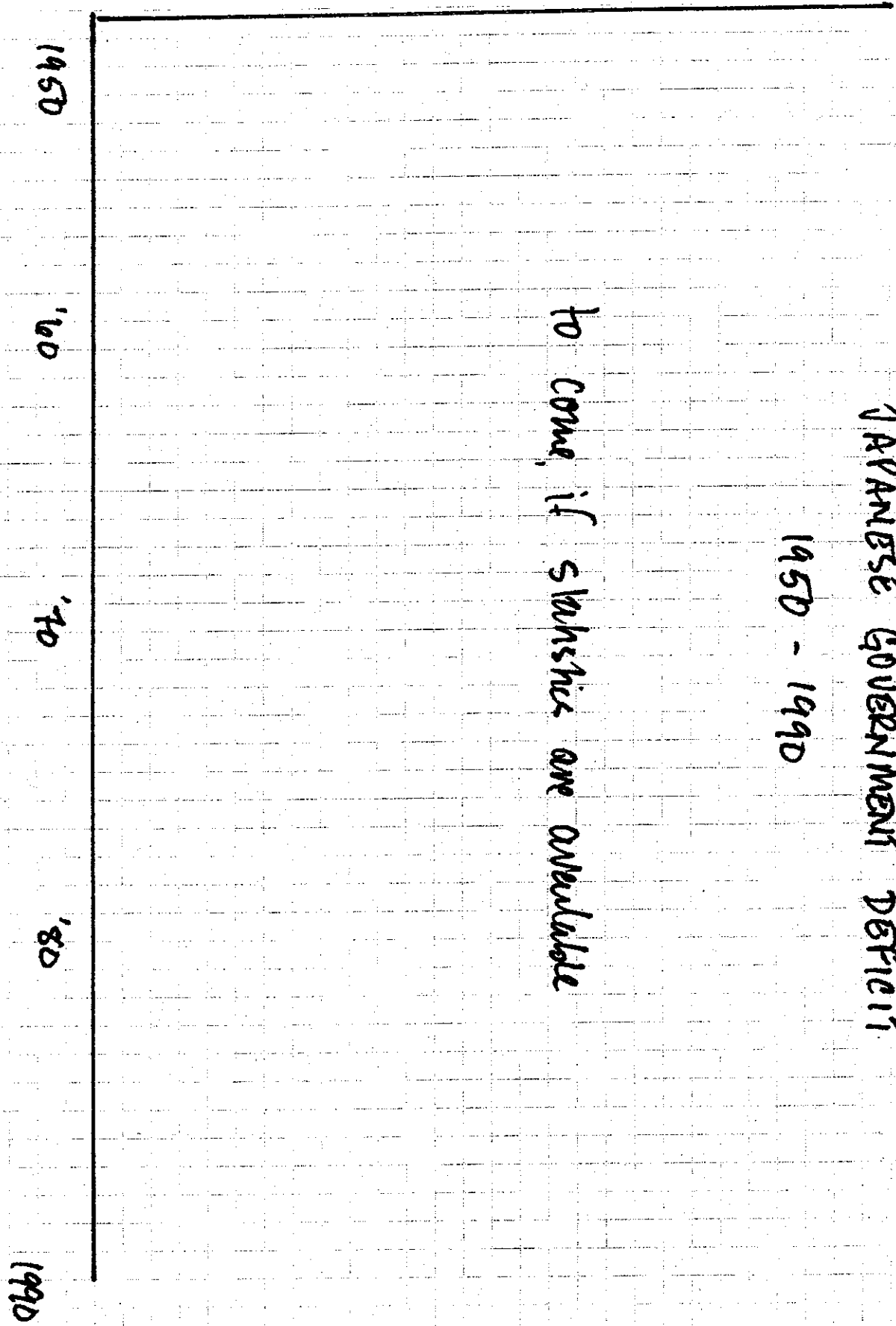
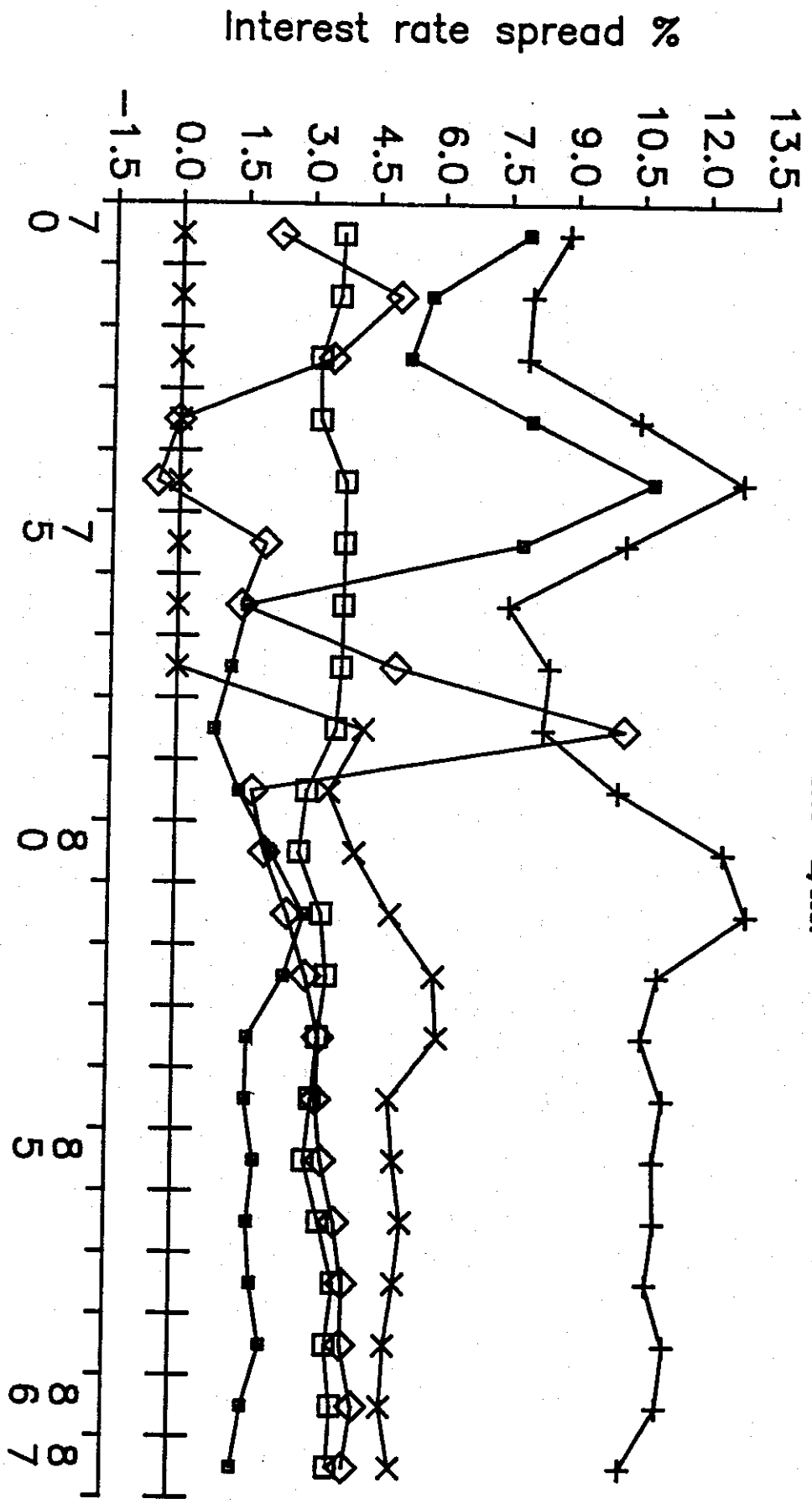


Figure 6

INTEREST RATE SPREADS*

France, Germany, Japan, UK & USA
1970 - 11/1987



Years or quarters

+ France x Germany □ Japan ◇ UK ■ USA

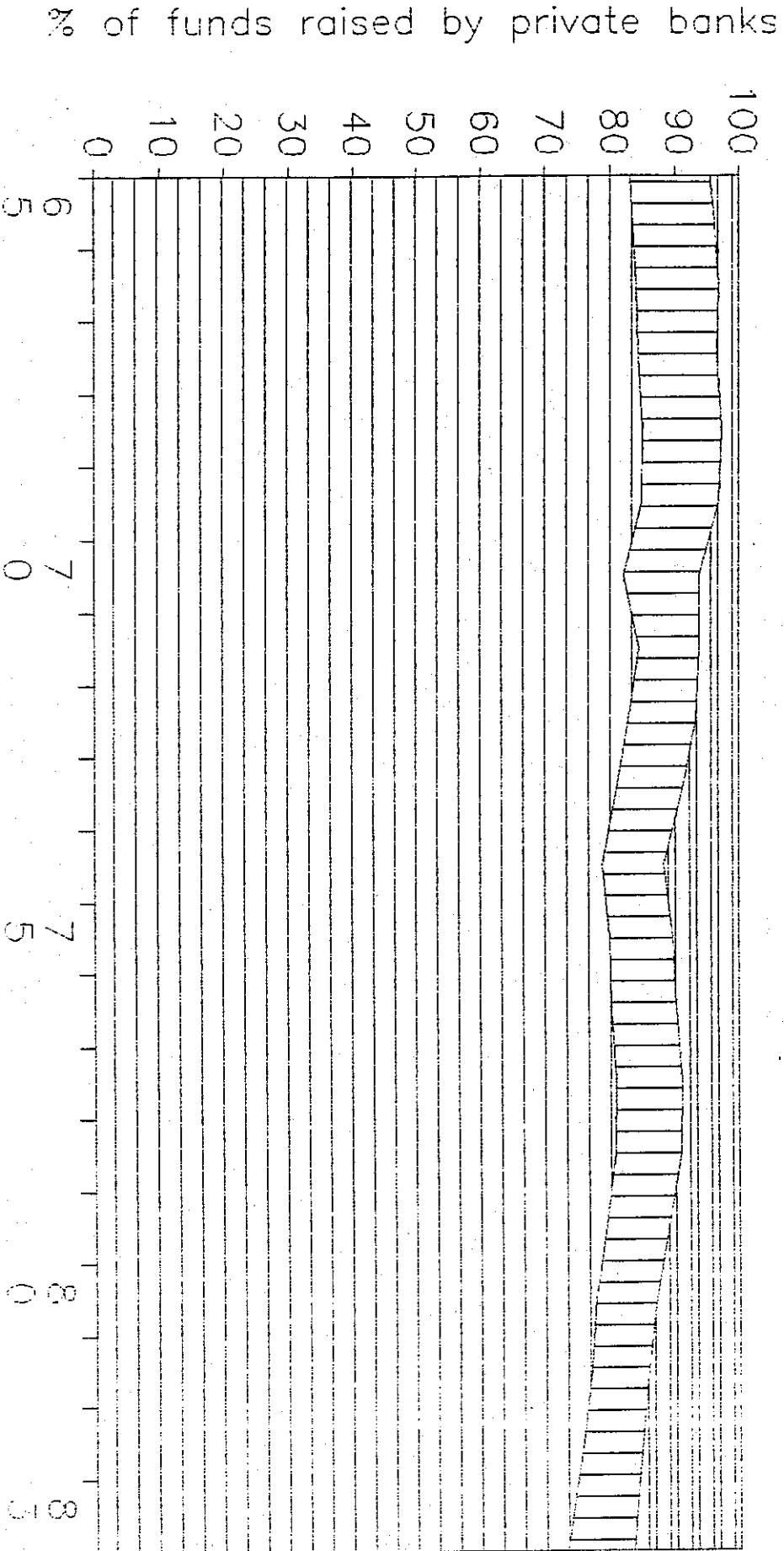
Source: F3 Yearbook 1986 & August 1987
*Lending rate minus deposit rate
Note: USA = prime rate - CD rate

(all data 1950-1970, if available)

Figure 1

PRIVATE BANKING SECTOR FUNDS

Regulated v unregulated rates
1965 - 1983

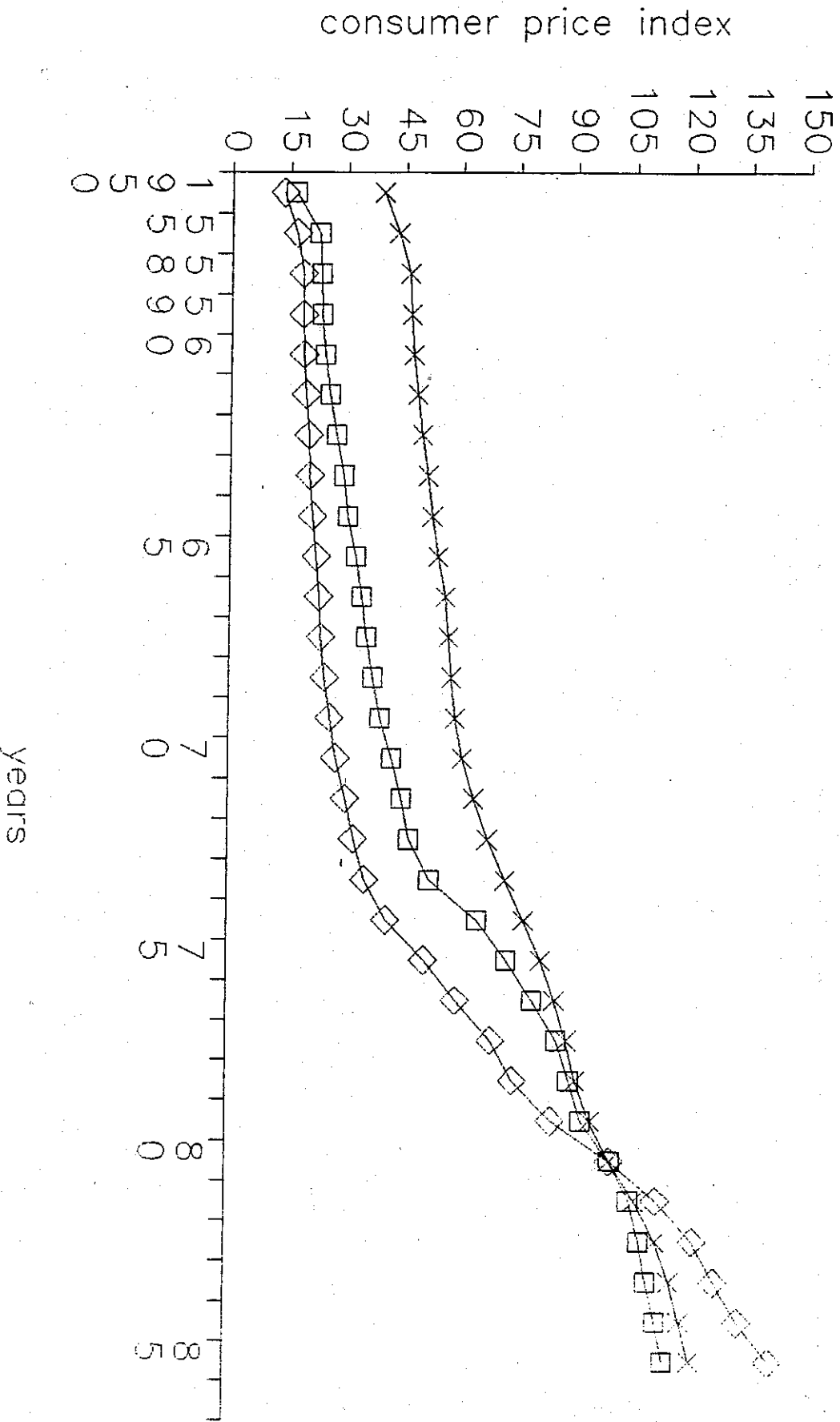


Source: Suzuki, 1986, Table 3.1
SAVE4

Figure 8

CONSUMER PRICES INDEX: 1950-87

three countries - 1980 = 100



a. (continued)

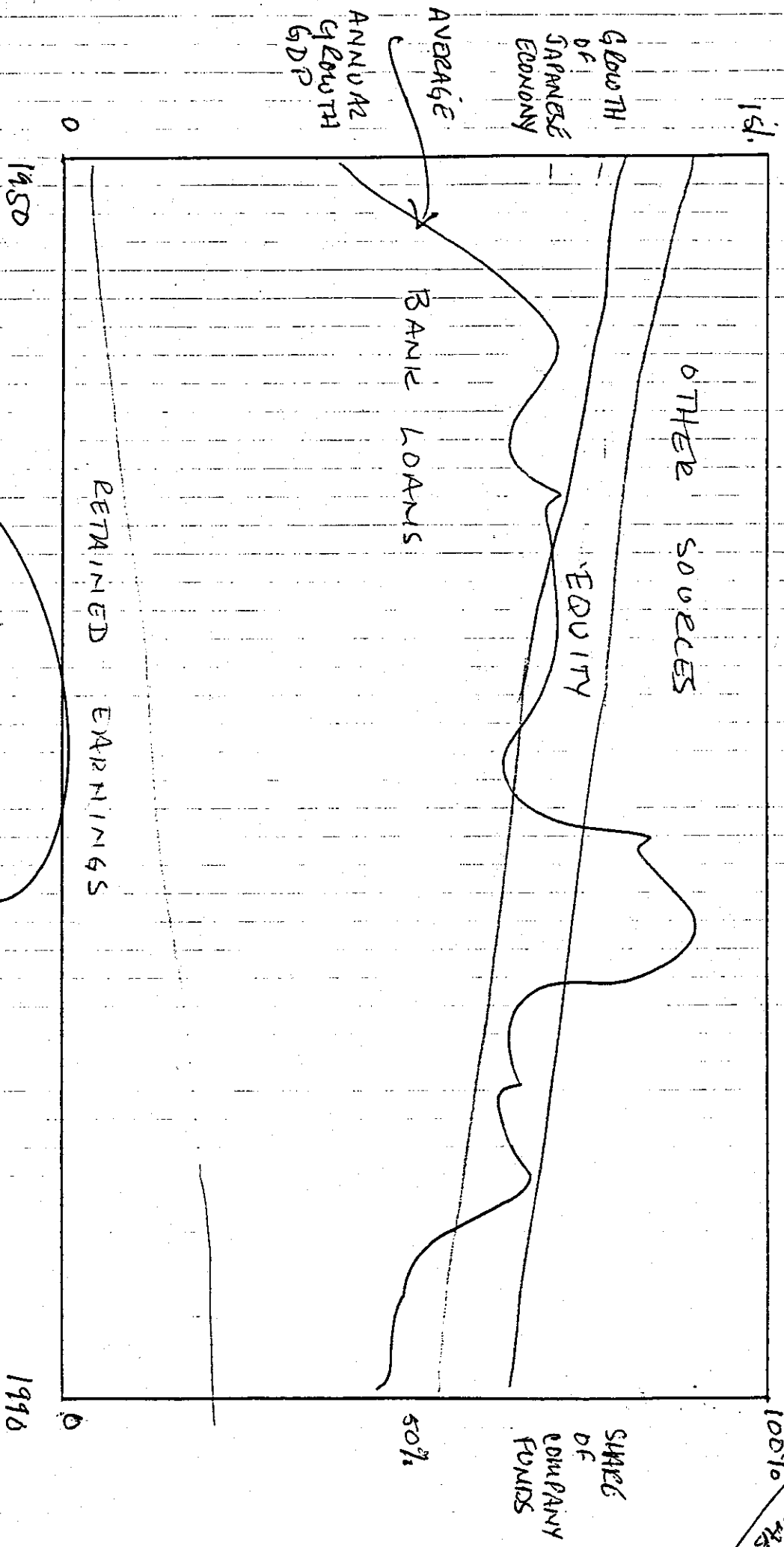
X Germany □ Japan ◇ UK

(use other statistics for inflation?)

Figure 9

RATES OF GROWTH v. SOURCES OF COMPANY FUNDS

1950 - 1990

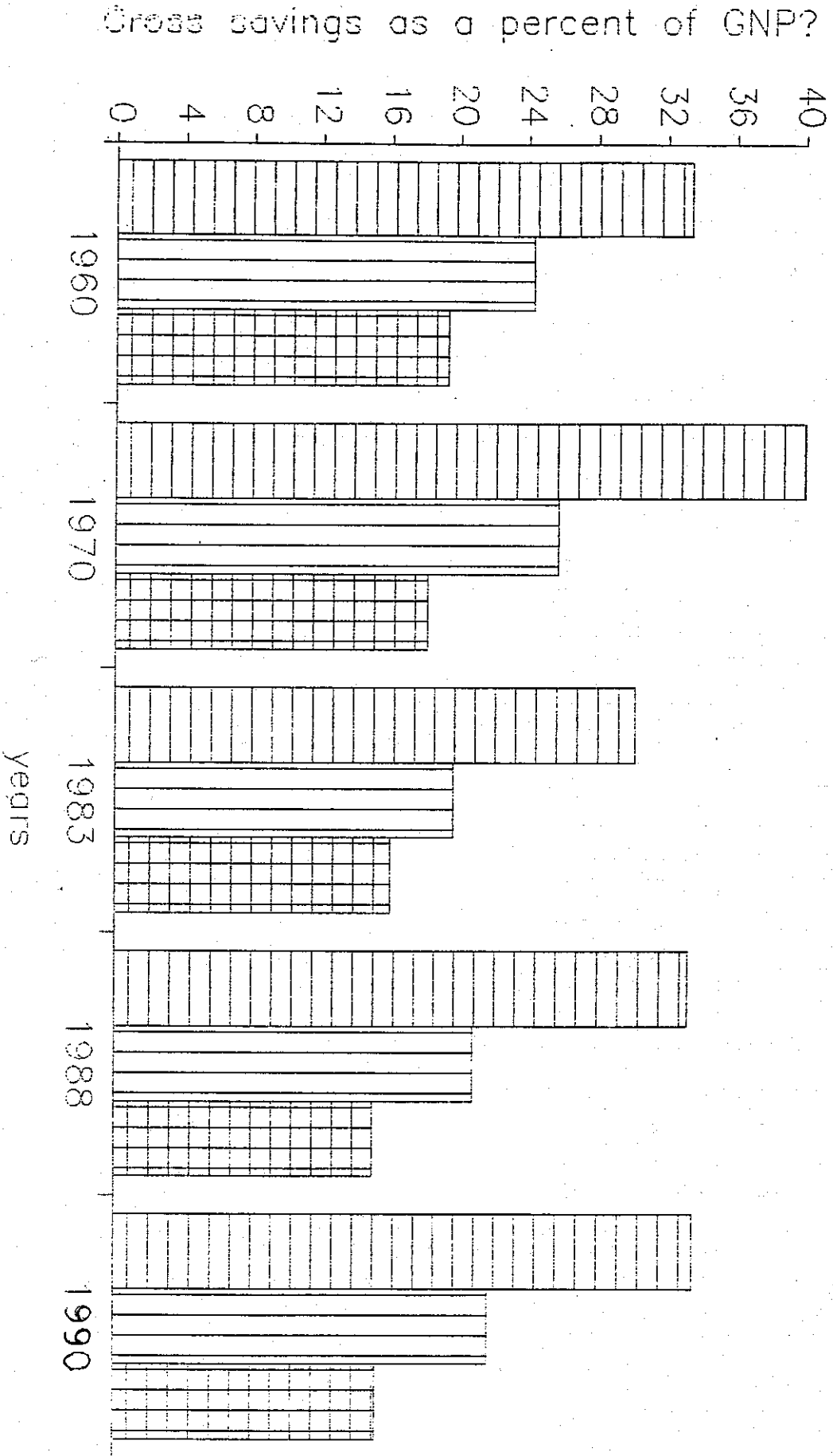


to come

Figure 10

A HIGHER SAVINGS RATE IN JAPAN

1960 - 1990



Source: EUROPEAN ECONOMY, No. 42, November 1989, p. 199 via Research 1990
EAGE2

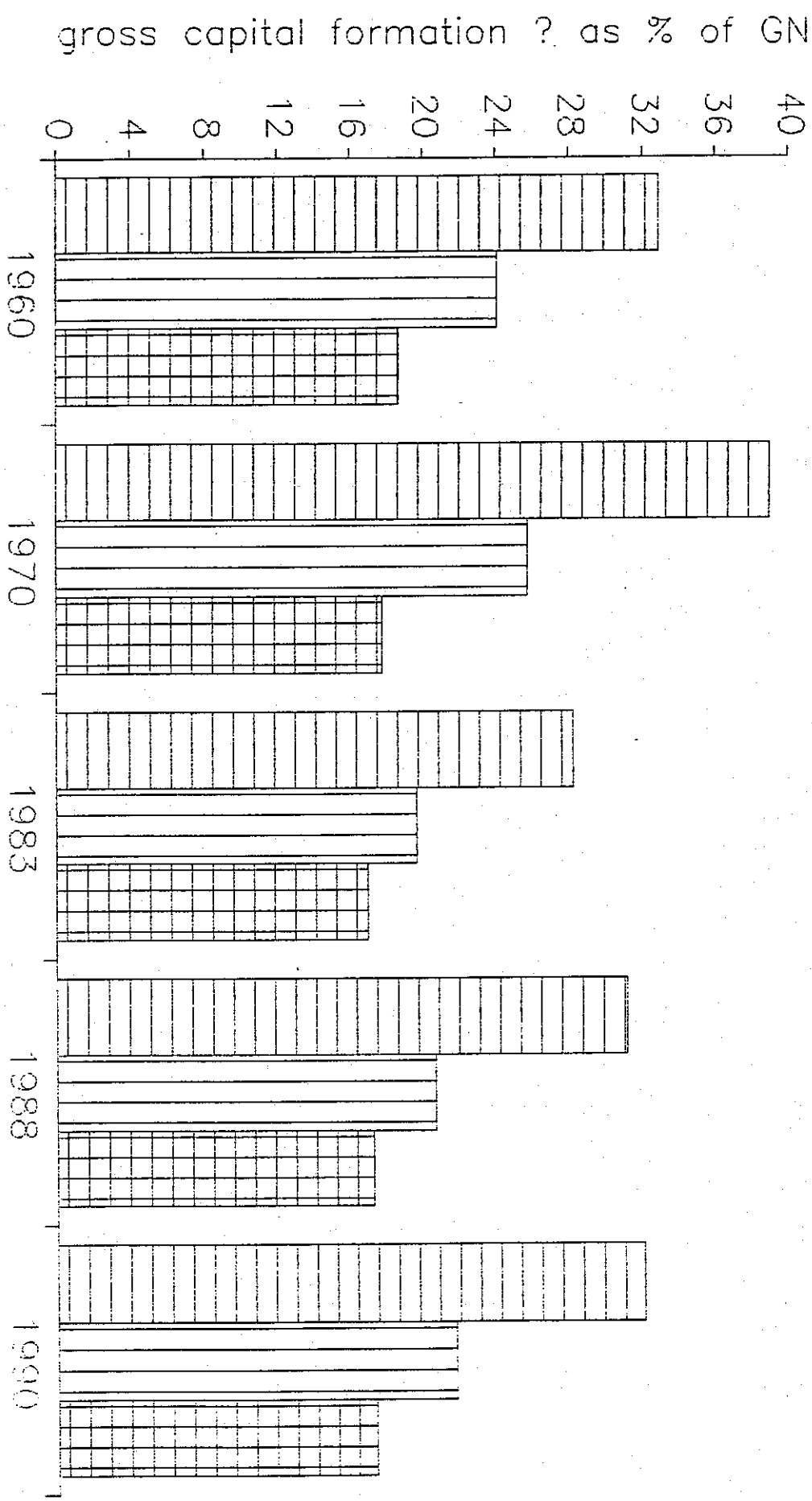
Japan
European Community
United States

Figure 11

HIGHER GROSS CAPITAL FORMATION

Japan v EC v USA 1960-1990

** 1990 estimated figures only



Source: EUROPEAN ECONOMY, no 42
November 1989, p. 199 via Rayanna 1990
SAVES

Figure 12

40%

0%

JAPANESE SAVINGS RATE

1925 - 1990

to come, if statistics are available

1925

1950

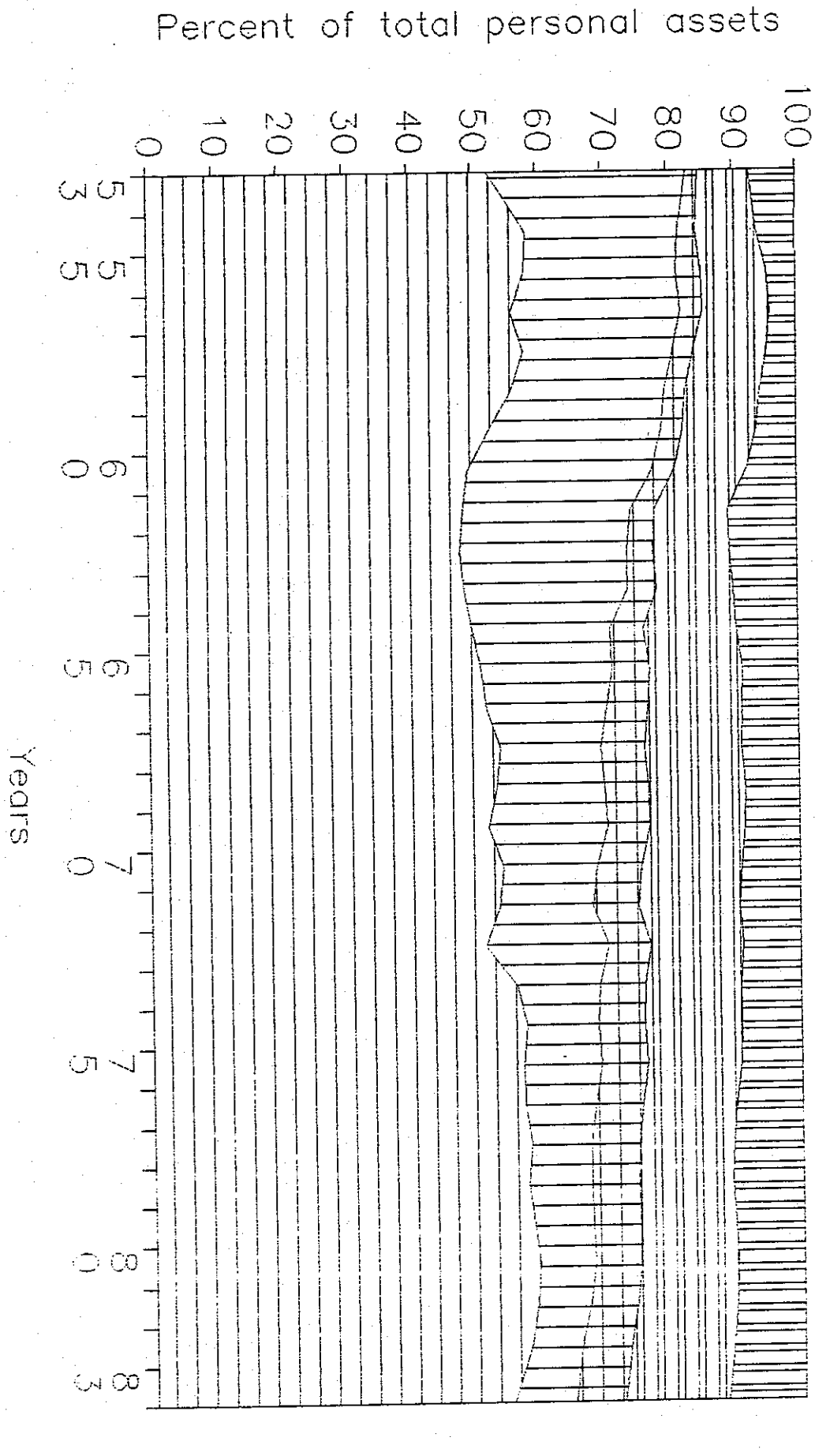
1975

1990

Figure 13

COMPOSITION OF PERSONAL ASSETS

JAPAN: 1953-1983

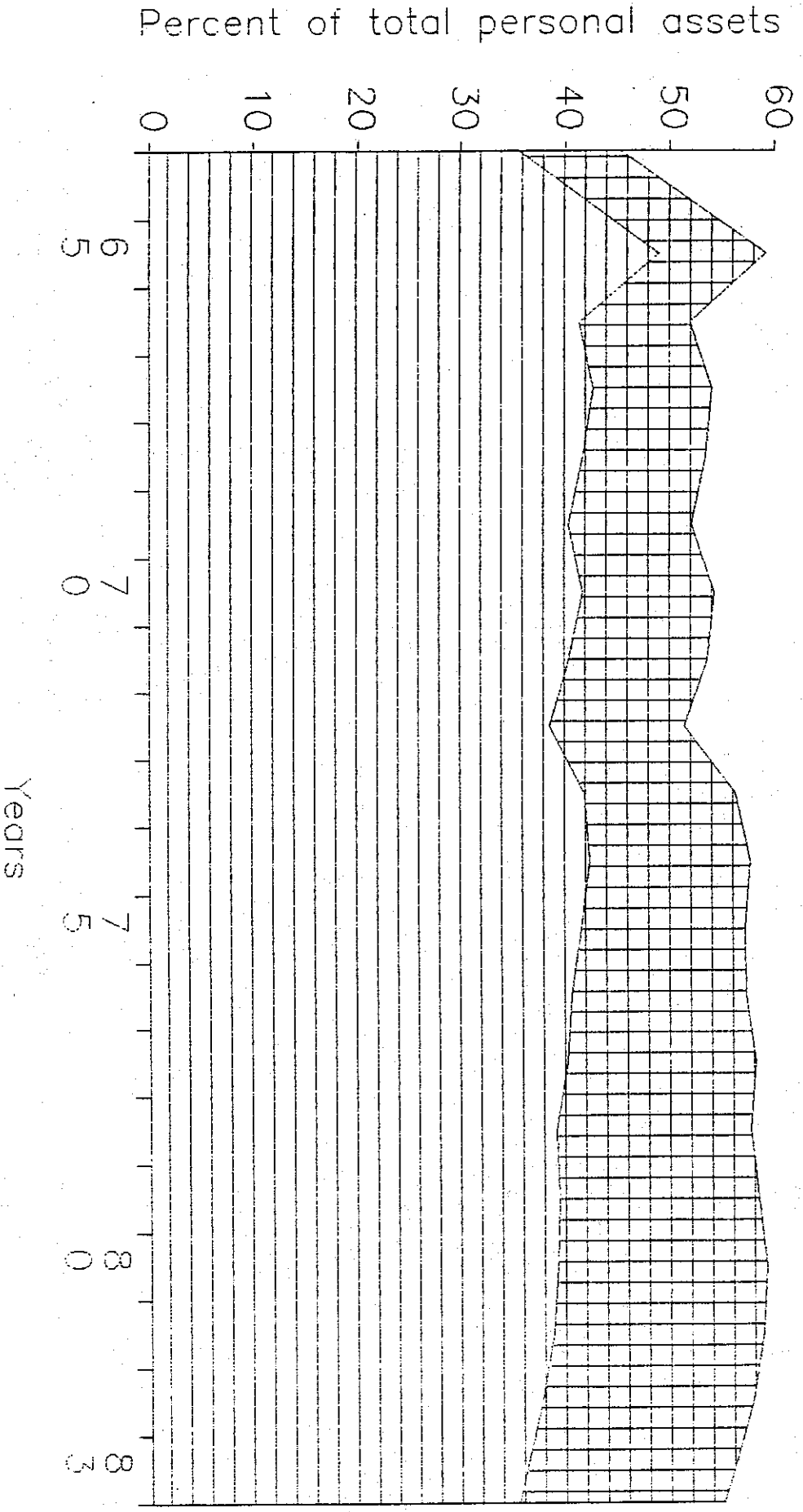


Source: Suzuki, 1986, Table 2.1
 Fixed deposits includes both private banks & Postal Office savings
 CAWF/1

Figure 14

Bank & Post Office Deposits

as share of personal assets
1953-1983

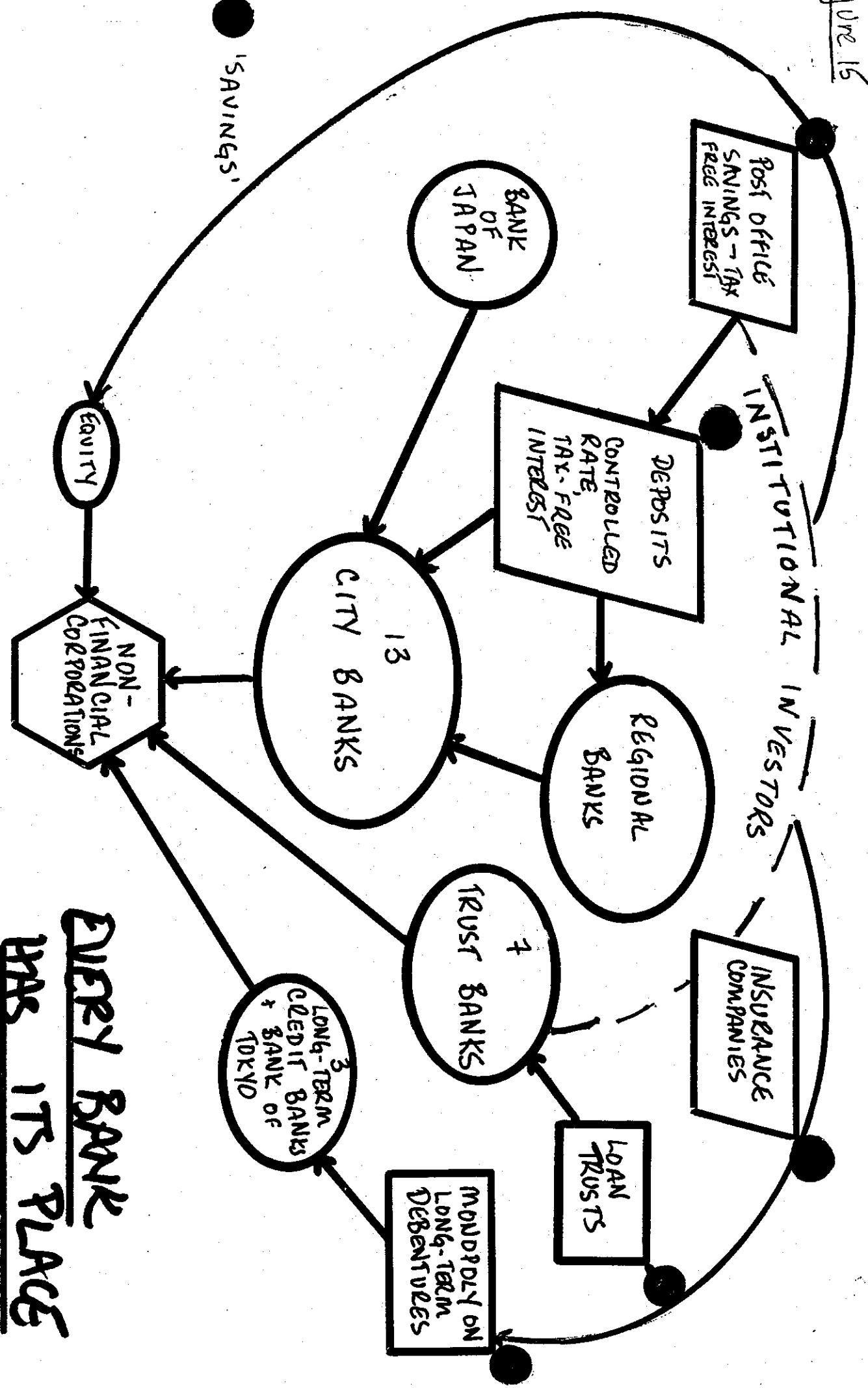


Source: Suzuki, 1996, Table 2.1
Bank deposits = fixed term time deposits
in private financial institutions SAVES

Bank Deposits Post Office Savings

Years

Figure 16



'SAVINGS'

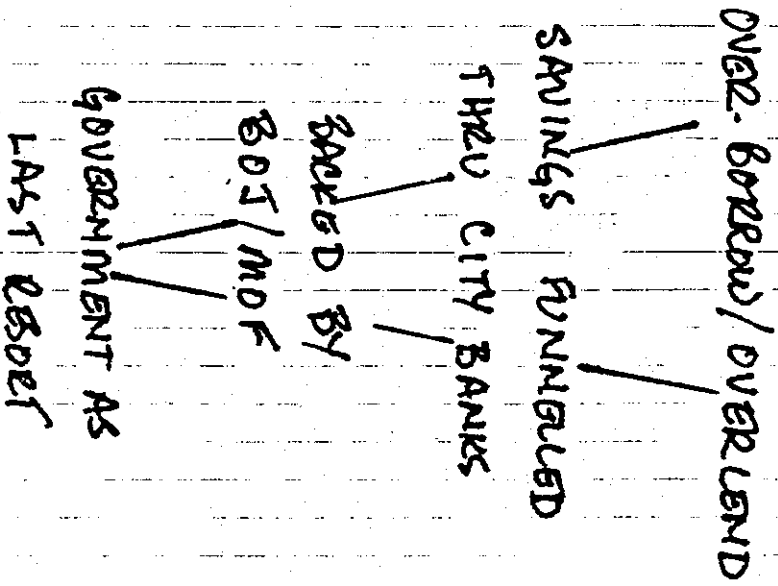
EVERY BANK HAS ITS PLACE

Source: Russell Johnson, *Manufacturers' Hammer Bank*

Figure 16

TWO IMPORTANT DYNAMICS OF HIGH-GROWTH FINANCE

BORROWED FUNDS



CROSSED SHAREHOLDINGS

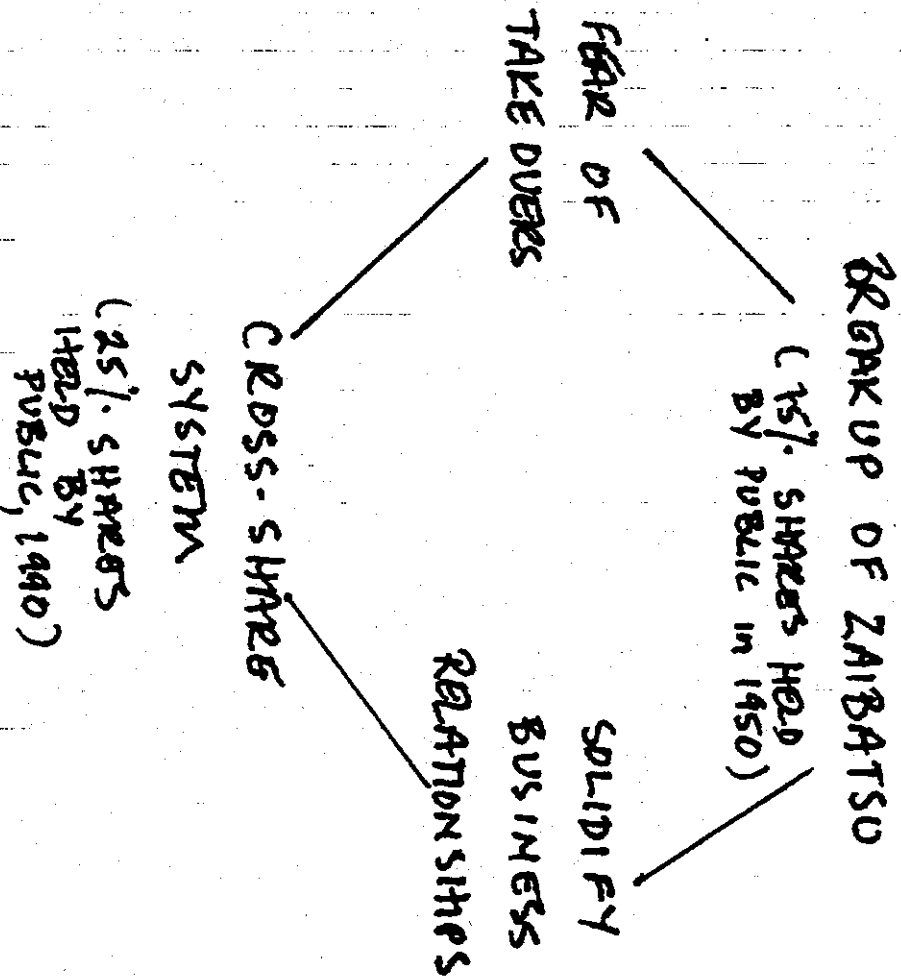
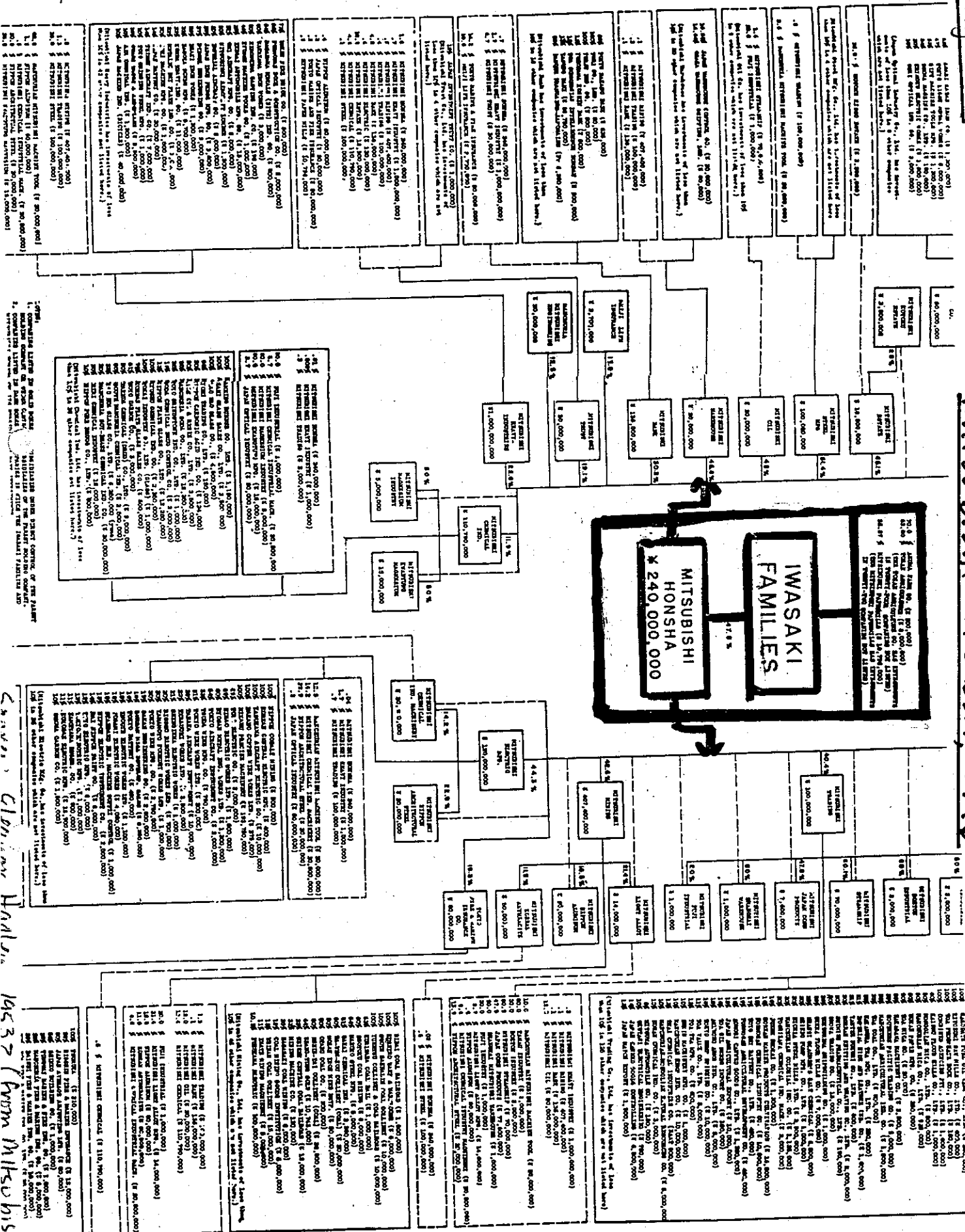


Figure 7

MITSUBISHI INTERESTS 1946



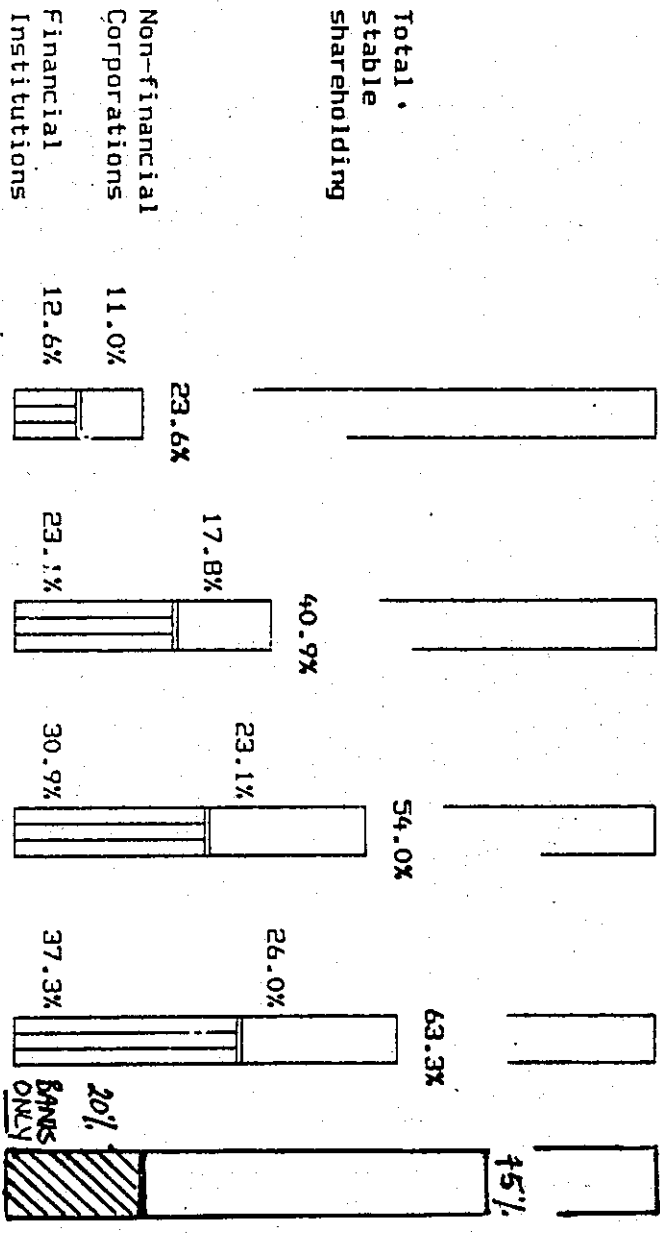
1. COMPANY NAME
 2. PERCENTAGE OWNERSHIP
 3. SHAREHOLDERS AND SHARES HELD

19537 (From Mitsubishi) Honda

GROWTH OF STABLE SHAREHOLDING

IN JAPANESE COMPANIES

1950 - 1990



Note: "Financial institutions" exclude investment trusts.
 Source: Okumura Hiroshi, *Nihon no Kaishiki Kaisha*, Toyo Keizai, 1986, p18

* Financial Times 11 April 1991 - Tokyo Stock Exchange only.

Via
 Dr. Rodney Clark
 briefing paper
 prepared for
 Reform Club
 Meeting
 April 1988

SUMITOMO GROUP - MARUICHI-KAI - 21 MEMBERS
Established 1951

Financial Institutions
Sumitomo Bank
Sumitomo Life
Sumitomo Trust & Banking
Sumitomo Trust & Banking

Non-Financial Corporations

Nippon Denki (NEC Corp)
Nippon Sheet Glass
Sumitomo Aluminum Reduction Co (1940's name)
Sumitomo Bakelite
Sumitomo Cement
Sumitomo Chemicals
Sumitomo Coal Mining (Saijima Kogyo)
Sumitomo Construction
Sumitomo Electric Industries (Sumitomo Denki Kogyo)
Sumitomo Forestry
Sumitomo Heavy Industries
Sumitomo Light Metal Industries
Sumitomo Metal Industries (Sumitomo Kinzoku Kogyo)
Sumitomo Metal Mining Co (Sumitomo Kinzoku Kozan)
Sumitomo Realty & Development (Sumitomo Fudosan)
Sumitomo Trading House (Shoji)
Sumitomo Waterworks

MITSUBISHI GROUP - MIKIKAI - 21 MEMBERS
Established 1961

Financial Institutions
Mitsui Bank
Mitsui Life
Mitsui Trust Bank
Taisei Fire & Marine

Non-Financial Corporations

Hokkaido Coal Mining & Shipbuilding Service Co (UMI)
Mitsui Bussan
Mitsui Construction
Mitsui Engineering & Shipbuilding (Mitsui Zosen)
Mitsui Mining (Mitsui Kozan)
Mitsui Mining & Smelting Co Ltd.
Mitsui OSK Lines (Shippin)
Mitsui Petrochemical
Mitsui Real Estate Development (Fudosan)
Mitsui Toatsu
Mitsui Warehouse Co (Soko)
Mitsubishi Department Stores
Nippon Flour Mills - (Mitsui Seitun)
Nippon Seiko KK - (Beiering)
Oji Paper Co Ltd
Sanki Engineering (Sanki Kogyo)
Toshy Industries
Toyoda
Toyota

MITSUBISHI - MINOKAI - 28 MEMBERS
Established 1965

Financial Institutions
Meiji Life
Mitsubishi Bank
Mitsubishi Trust Bank
Tokai Marine & Fire

Non-Financial Corporations

Aashi Glass
Mitsui Beer
Mitsubishi Aluminum
Mitsubishi Construction
Mitsubishi Corp. (Shoji)
Mitsubishi Electric
Mitsubishi Estate Co Ltd (Mitsubishi Jisho)
Mitsubishi Gas Chemical
Mitsubishi Heavy Industry
Mitsubishi Kasei
Mitsubishi Kasei Corp.
Mitsubishi Metal Corp.
Mitsubishi Motor Corp.
Mitsubishi Oil
Mitsubishi Paper Mills (Mitsubishi Seisan)
Mitsubishi Petrochemical (Yokka)
Mitsubishi Plastic Industries (Mitsubishi Jushi)
Mitsubishi Rayon
Mitsubishi Steel Manufacturing (Mitsubishi Seiko)
Mitsubishi Warehouse & Transportation (Mitsubishi Soko)
Mitsui Corp (Camera Co.)
Mitsui Yuzen KK (Shippin)

DAI-ICHI KANITO BANK GROUP - 17 MEMBERS
Established 1976

Financial Institutions
Dai-ichi Kangyo Bank
Asahi Life
Fukoku Life
Nissan Life
Nissan Fire & Marine
Taisei Fire & Marine

Non-Financial Corporations

Aashi Chemical (member of Sumitomo)
Aashi Denka Kogyo KK (electric chemicals)
Asahi Optical Co Ltd (Pentax)
C. Itoh
Onoda Cement
Densetsu Kogyo (chemicals)
Ebara Corp (engineering)
Fuji Electric (Fuji Denki)
Fujitsu (electronics)
Furukawa Co (mining)
Furukawa Electric Co (Fuyo Denki Kogyo)
Hanshu Paper Co Ltd
Hitachi Co Ltd
Iseki & Co (agricultural machinery)
Ishikawajima-Harima Heavy Industries
Izumi Motors
Japan Metals & Chemicals Co
Kametsu Goshu (trading house)
Kawasaki Heavy Industries
Kawasaki Steel Corp.
Kawasaki Steel Works (Shippin)
Kawasaki Steel Works (Shippin)
Kobe Steel
Korhaku Co (Aishima)
Lion (deodorants)
Mitsui Coluaba
Mitsui Express
Mitsui Kangyo Nakamura Securities
Mitsui Kinokuniya
Mitsui Zosen Co (synthetic rubber)
Mitsui Iwai
Sanryo Co Ltd (pharmaceuticals)
Seibu Department Store
Shibuya Warehouse
Shimizu Corp (Construction)
Shinsei (Cosmetics)
Yasuhara Electric KK (Denki)
Yokohama Rubber (direct supplier Mitsui Zosen)

KYOKO GROUP - HIRUKAI - 29 MEMBERS
Established 1966

Financial Institutions
Fuji Bank
Yasuda Fire & Marine
Yasuda Life
Yasuda Trust & Banking

Non-Financial Corporations

Canon
Hitachi Co Ltd
Keihin Electric Express Railway
Kubota Ltd (steel)
Kureha Chemical
Mitsubishi
Mitsubishi Oil & Gas (Mitsui Yushu)
Mitsui or Mitsui Reizo (refrigerated warehouse)
Mitsui Selko (Beiering)
Nissan Motors
Nissan Flour Milling
Nissan Shokai Industries (textiles)
NKKK (steel) (moving into chemicals)
Oki Electric Industry
Sanyo Kokusaku Pulp Co.
Sapporo Beer
Shoju Denko
Shoju Line Ltd (Kaiun) Shipbuilding
Taisei Corp (Construction)
Toho Railway
Tonen Oil Co. (Jiji) with Exxon & Mobil
Toho Rayon
Tokyo Ranso Co Ltd (building)
Yokohama Electric Corp. (Denki)

SANWA - SANSHU-KAI - 41 MEMBERS
Established February 1967

Financial Institutions
Nippon Fire & Marine
Nippon Life
Sanwa Bank
Toyo Trust & Banking

Non-Financial Corporations

Daihatsu Motor Co Ltd (Hitachi Group)
Fujiwara Pharmaceutical
Hankyu Corp
Hitachi Cable Ltd
Hitachi Chemical Co Ltd
Hitachi Co Ltd
Hitachi Metals Ltd
Hitachi Zosen Corp (Shipbuilding)
Itohan Foods Inc
Iwatani International Corp (Iwatani Sangyo)
Kansai Paint
Kobe Steel Ltd
Kyocera (ceramics - front runner in bio ceramics)
Maruzen Oil
Nakayama Steel Works Ltd
Nichimen (trading house)
Nippon Express
Nissan Steel
Nissan Iwai
Nitto Denko Corp (electronics, IC, tapes)
Obayashi Corp (construction)
Orient Finance Ltd (consumer credit)
Osaka Cement
Owashi Electric Co Ltd
Sekisui Chemicals
Sekisui House (housing, pre-fab.)
Sharp Corp.
Shin Meiwa Industry
Takashi Maya Department Store
Tandei Seiyaku Co Ltd (pharmaceuticals)
Teijin
Tohoku Soda Co
Toyo Construction
Toyo Tire & Rubber (Toyo Gomu)
Toyo Industries (Dye Kozan)
Daitoku (textiles)
Yamada - Shinjoh Steamship
New merged with Japan Liner as Naniwa Line

Companies in Chemicals data base
Source: private sources

Figure 20

*** SCHEMATIC STRUCTURE OF KEIRETSU IN THE JAPANESE CHEMICAL INDUSTRY ***

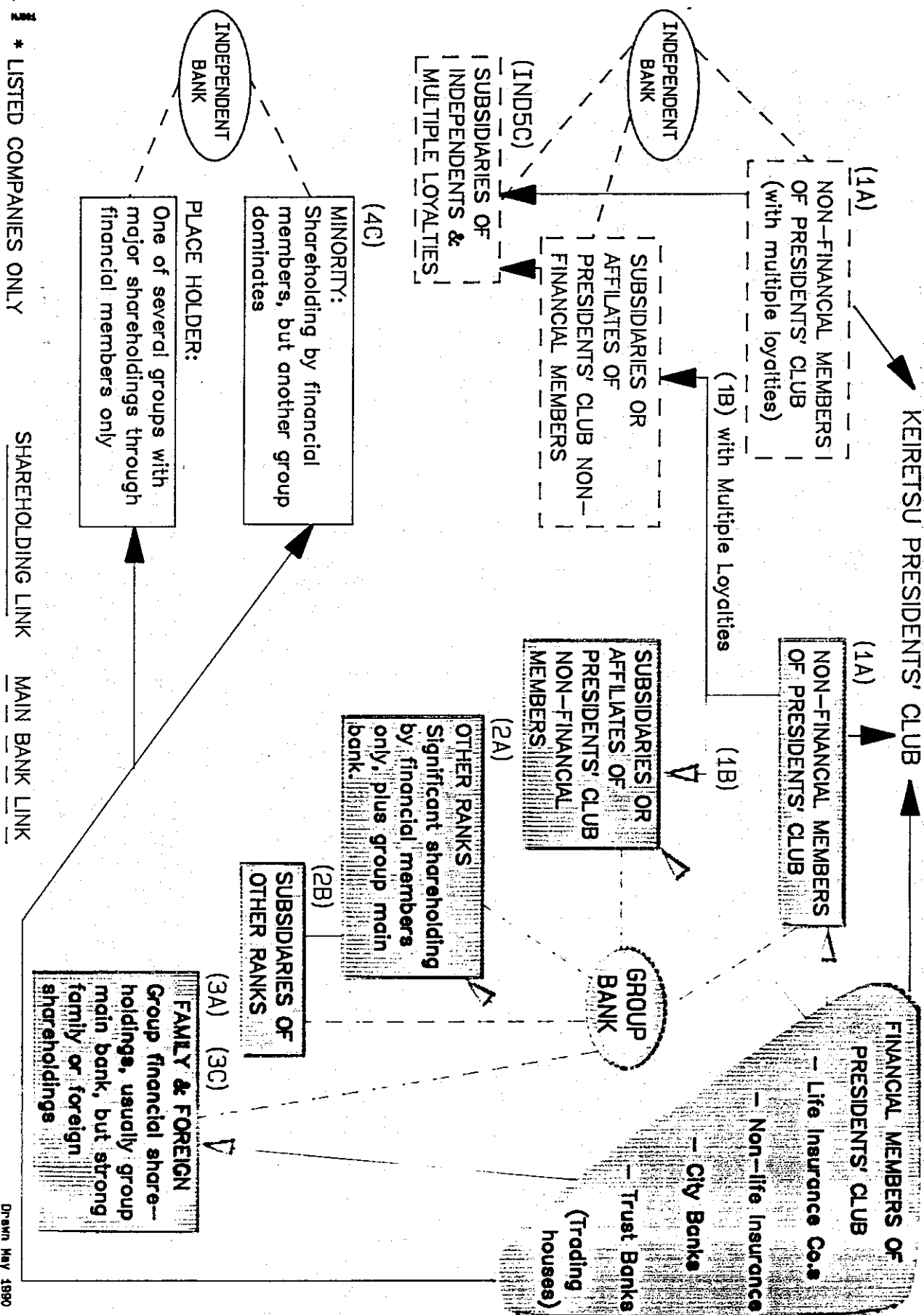


Figure 21

INTER FIRM DEPENDENCE & POWER THE MITSUBISHI GROUP, 1978 PRINCIPAL SHAREHOLDERS

	Meiji Life Insurance	Mitsubishi Bank	Tokyo Marine & Fire Insurance	Mitsubishi Corporation	Mitsubishi Heavy Indus.	Mitsubishi Trust Bank	TOTAL	Net Power Index	
Meiji Life Insurance	0	23*	0	16	0	6	12	0	+91
Mitsubishi Bank	0	0	18	18	16	9	34	61	+2
Tokyo Marine & Fire Insurance	0	17	18	8	6	6	6	37	-10
Mitsubishi Corporation	0	7	7	8	4	14	32	43	-11
Mitsubishi Heavy Indus.	0	8	0	3	7	7	18	44	-26
Mitsubishi Trust Bank	0	4	6	8	6	6	24	70	-46

* Power index computed on the basis of % of shares & value of loans as 1/10 the value of shares

(MO Figure 22)

Figure 23

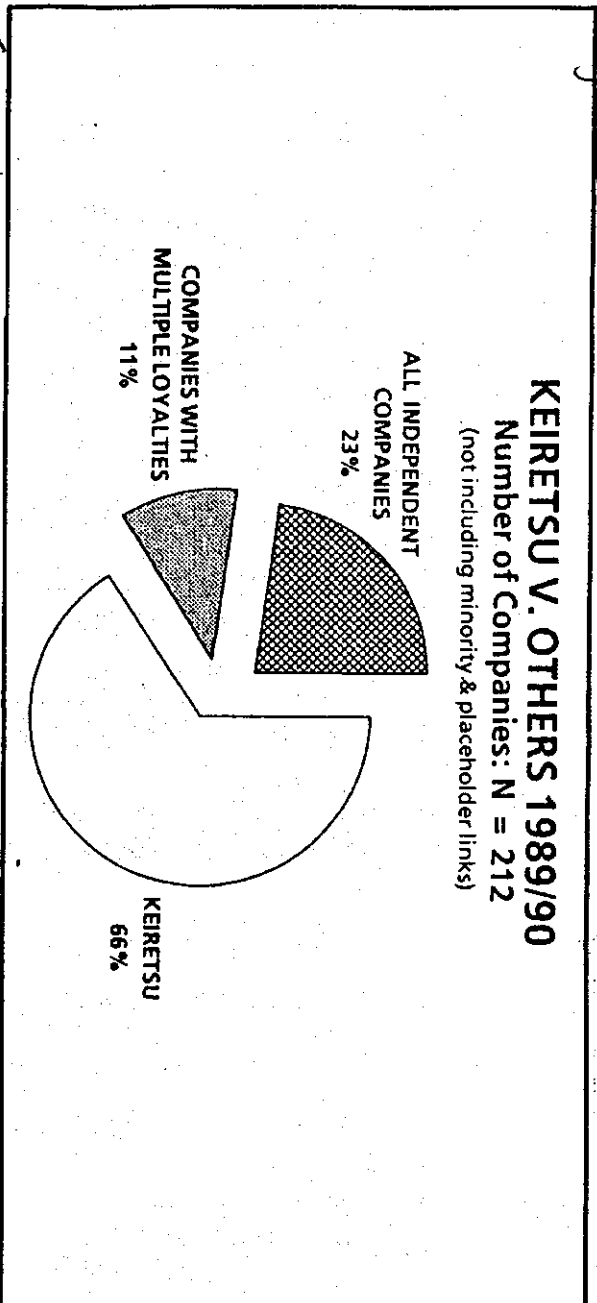


Figure 24

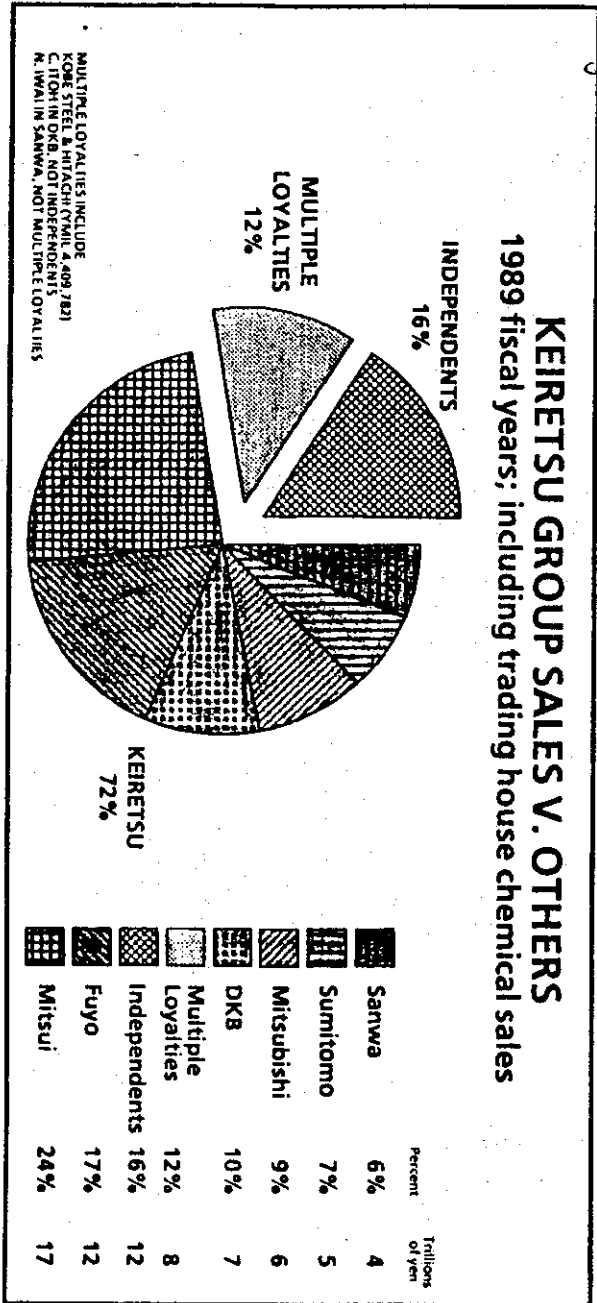
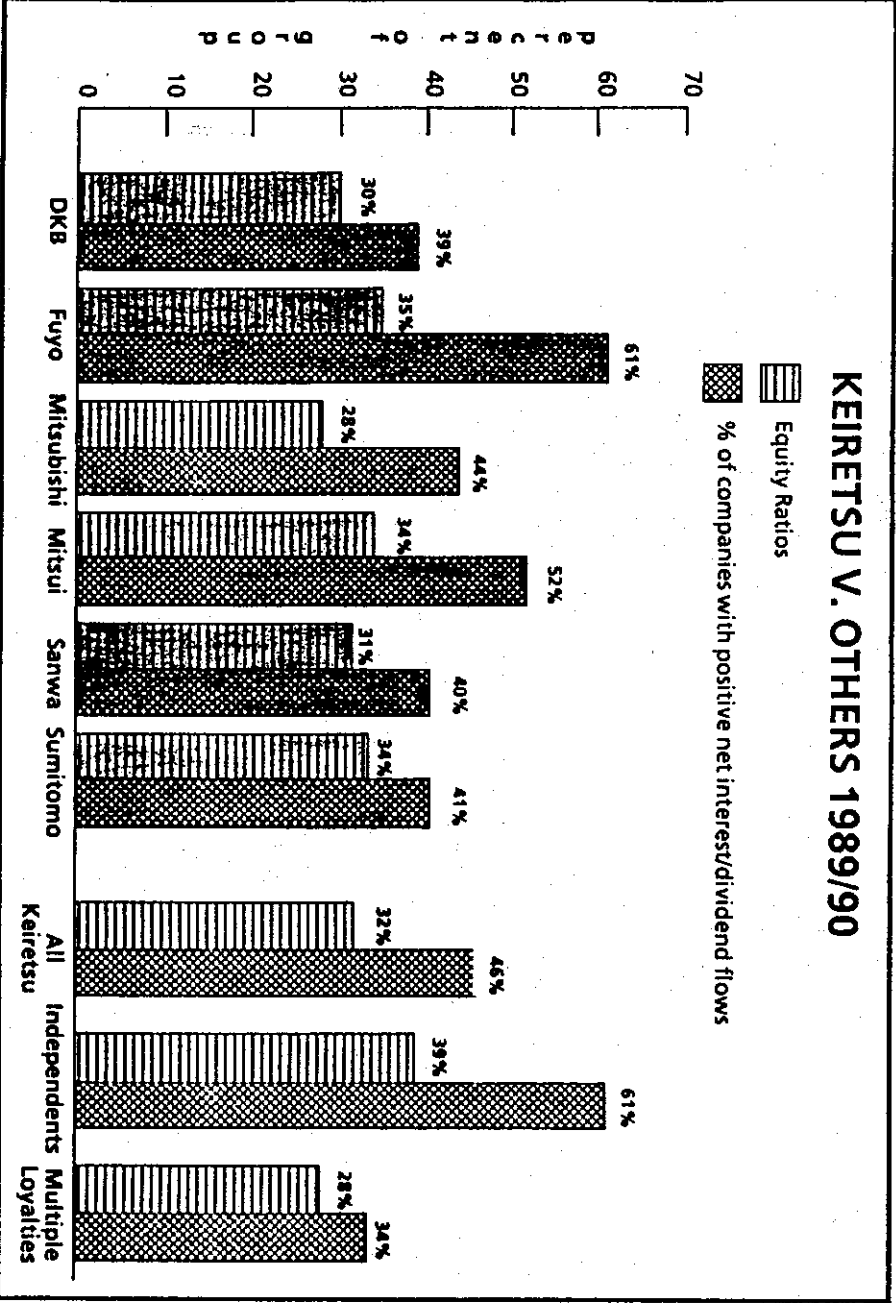


Figure 25



MERGERS & ACQUISITIONS IN JAPAN

Figure 26

"THE GROUPER FISH BOTH CREATES AND GANNIBALIZES ITS YOUNG."



1979 = 1482 mergers & acquisitions in Japan,
most within the same group.

(1979 = 1516 M+A in the USA)

SHAREHOLDERS & LOANS of a PRESIDENTS' CLUB MEMBER

THE "KR" KEIRETSU - 1987

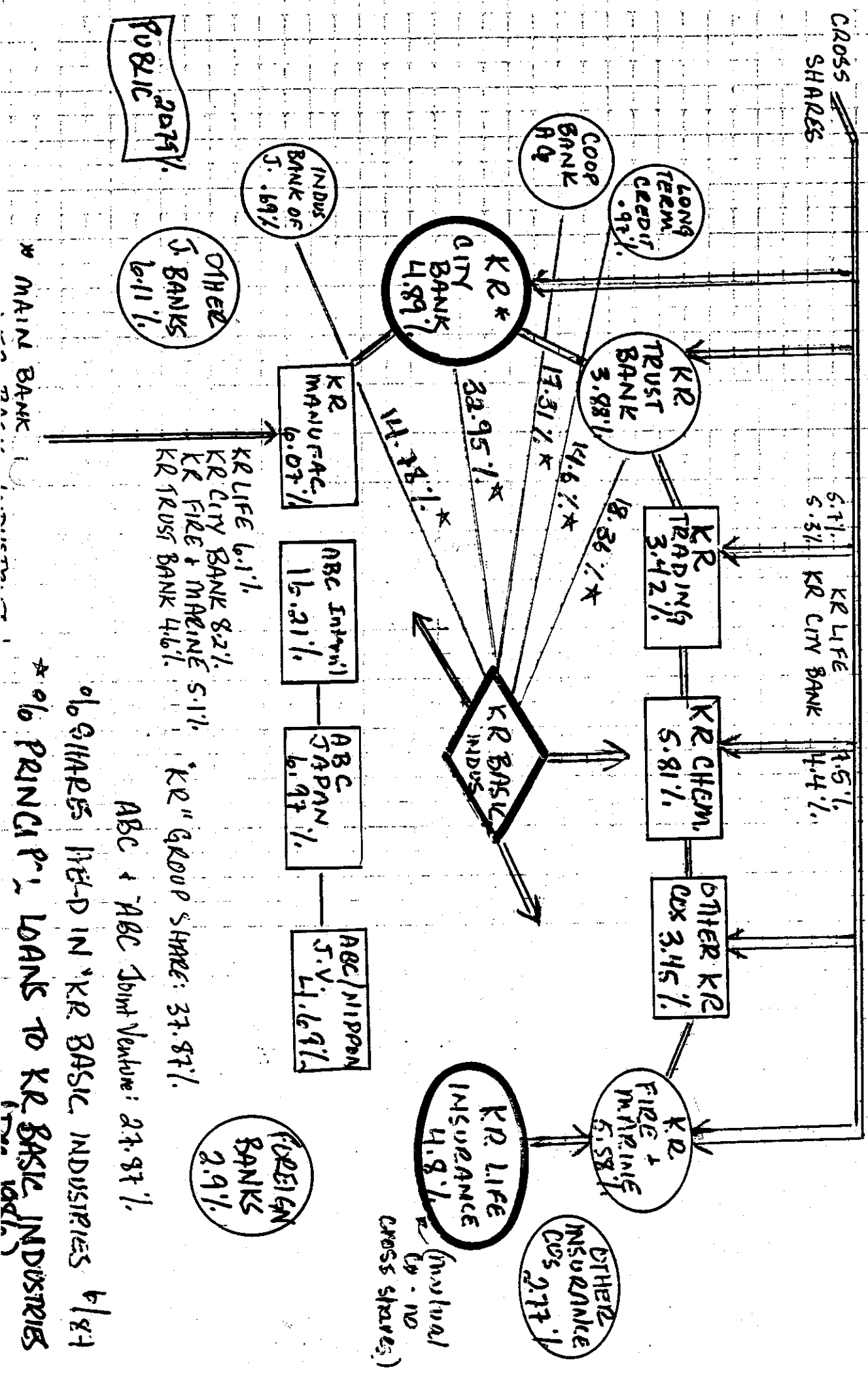


Figure 28

SHAREHOLDER COMPOSITION & SHAREHOLDER ACTIVITY

1981

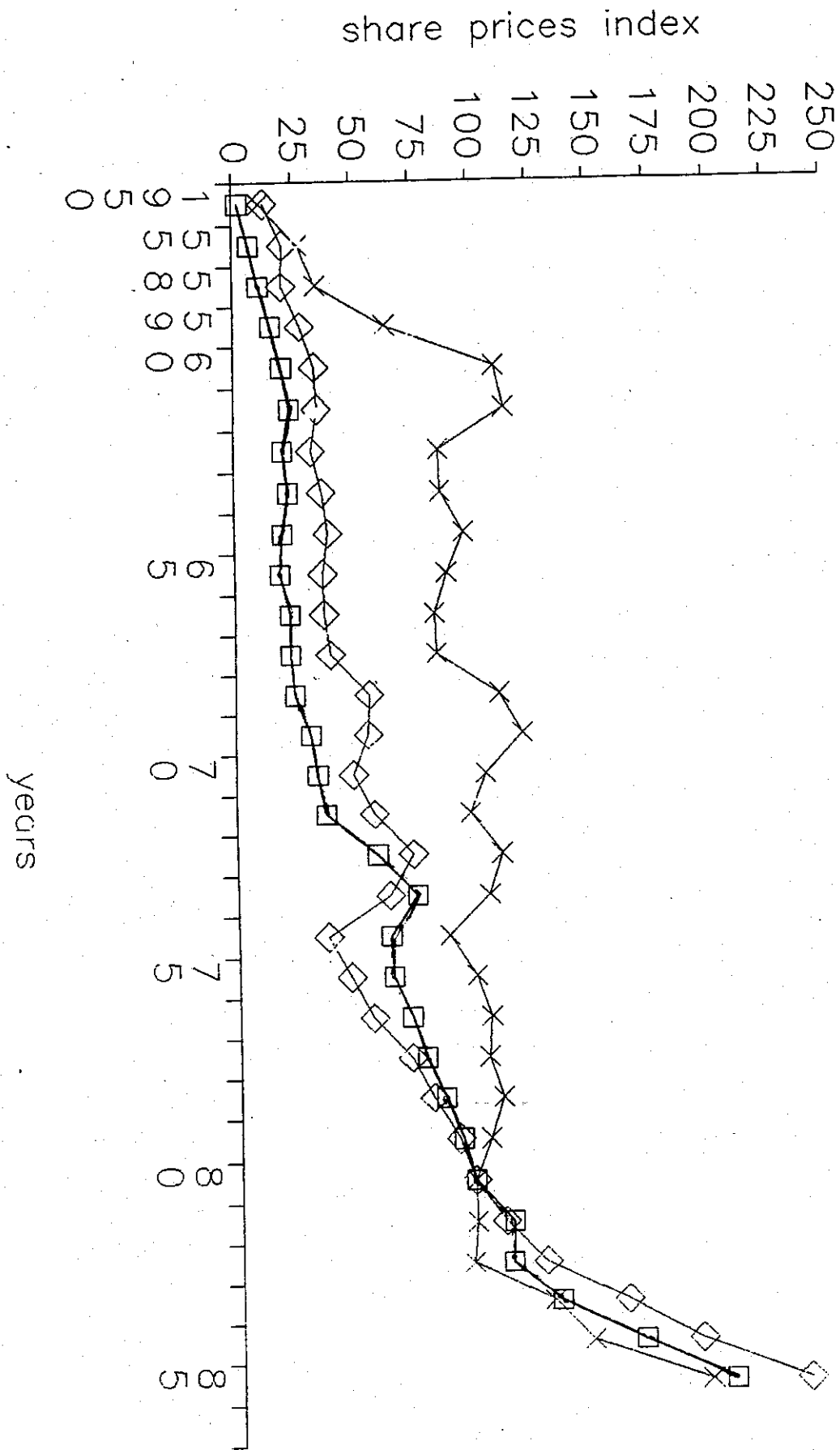
	<u>HOLDINGS</u>	<u>TOTAL TRANSACTIONS</u>	
	<u>TOKYO STOCK EXCHANGE</u>		
	(% MARKET VALUE)	(% MARKET VALUE)	
Government	0.4 %		
Financial Institutions	38.2 %	2.9 %	Banks
		0.8 %	Insurance Cos.
Intercompany Holdings	26.2 %	6.9 %	Non-Financial Corp
Securities Brokers	1.5 %	27.7 %	Self-Dealings by Securities Houses
Foreign Investors	5.8 %	10.0 %	Foreigners
Individuals	27.9 %	42.2 %	Individuals
(Directorate Holdings	<u>2.4 %</u>		
TOTAL	100 %	<u>90.7 %</u>	

JAPAN COMPANY HANDBOOK
 JAPANESE LANGUAGE EDITION:
 13 % ISSUED SHARES CIRCULATE FREELY

Figure 29

SHARE PRICES INDEX: 1950-1985

three countries - 1980 = 100



a. Share

x Germany ■ Japan ◇ UK

years

Figure 30

GROWTH = HIGH GEARING

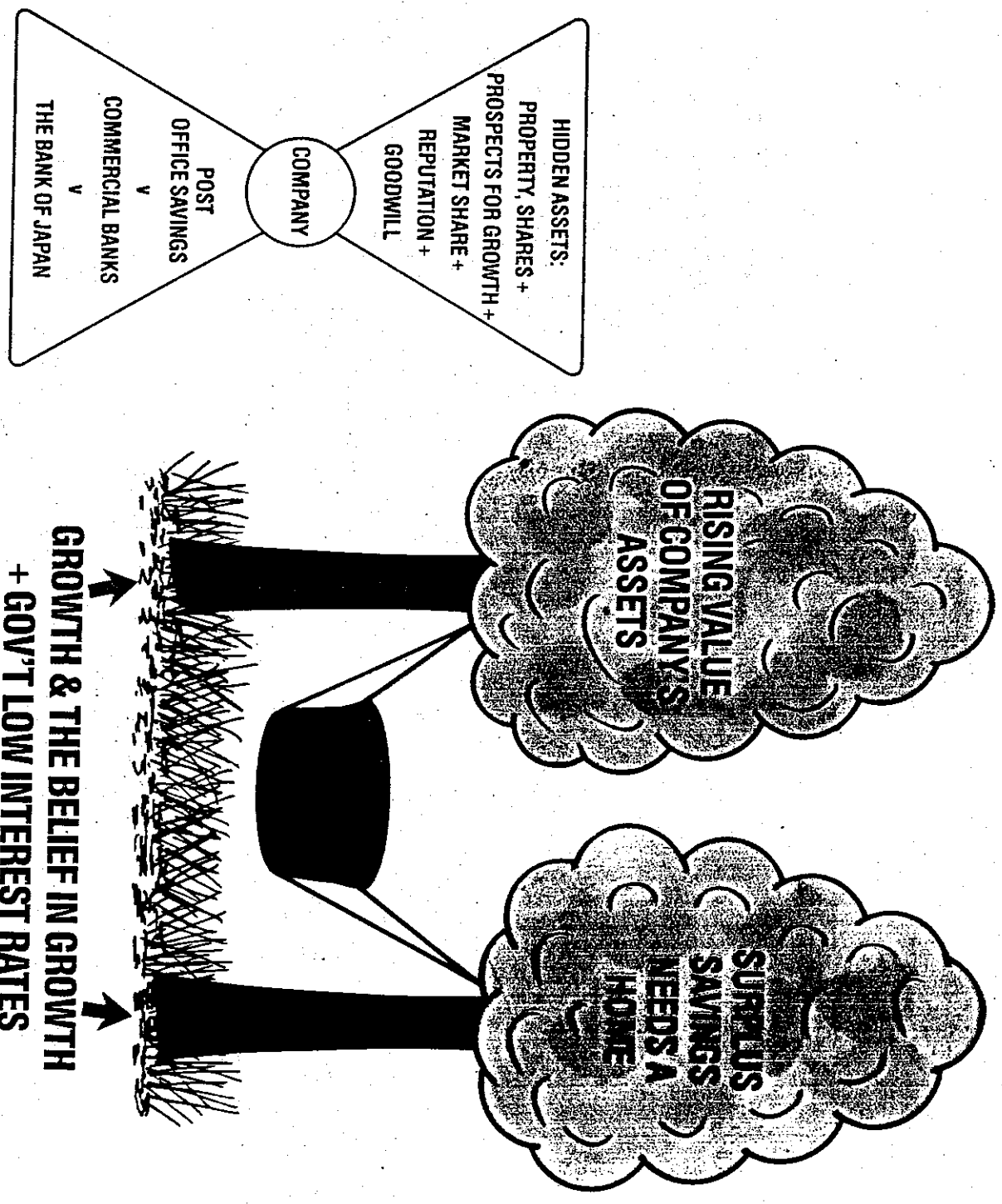


Figure 31

SHAREHOLDING = GROWTH = CAPITAL APPRECIATION

(Not Dividends)

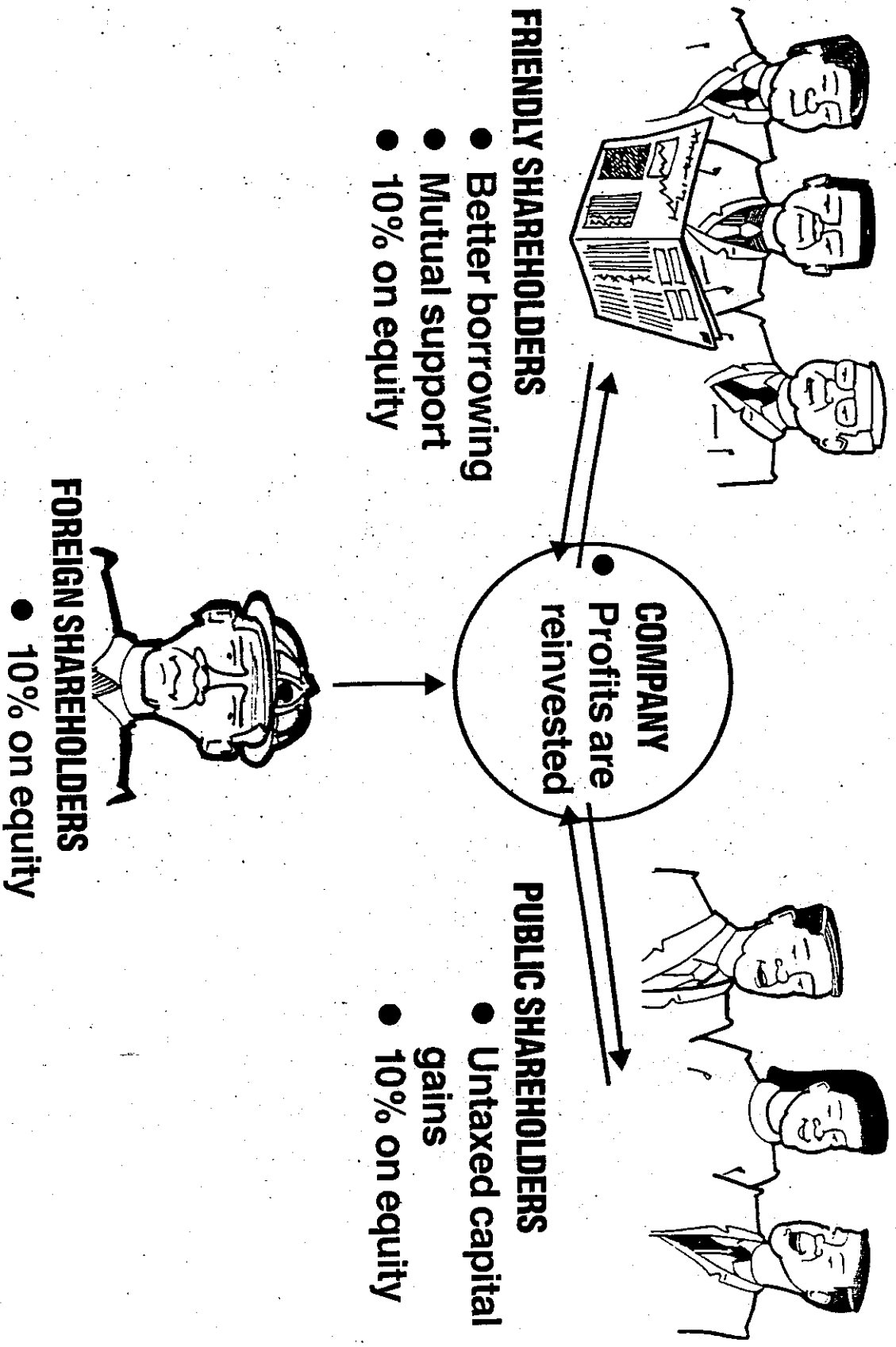


Figure 3D

BANKS' MONITORING AND PROBLEM LOANS.

ROUTINE MONITORING: Regular contact & information (a difference of degree, not kind)

PROBLEM LOAN IDENTIFIED
RETURNED TO BANK'S LOAN COMMITTEE

PROJECT TEAM APPOINTED
to recommend whether:

1 CALL A MEETING OF CREDITORS

2 SEND IN ADVISORY MANAGERS.

3 NEGOTIATE CHANGE IN TERMS + CONDITIONS OF LOANS

** DIFFICULTIES PERSIST **
** BANKRUPTCY (TDSAN) DECLARED **
"A situation, not a legal status" (1960s BS in 1975)

79% INTERNAL PROCEDURES

21% LEGAL PROCEDURES

MAIN BANK TAKES LEAD TO

REHABILITATION

consisting of

LIQUIDATION

1 CALL CREDITORS MEETING
2 APPOINT ADVISORY MANAGERS
3 NEGOTIATE LOANS

4-5%

100% BANKRUPTCY (2000 companies)

Bankruptcies by Size of Firm (fiscal year)				
Capital Size	Year	Debt/e Equity Ratio	Bankruptcies ^b	Bankruptcy Rate (%) ^c
below 5 million yen	1983 1984	89.3 89.3	14044(1,040,008) 14999(1,152,033)	1.20 1.27
5-10 million yen	1983 1984	85.3 85.7	2853 (367,325) 3196 (464,490)	0.94 1.01
10-50 million yen	1983 1984	84.4 85.5	2140 (863,659) 2431(1,117,509)	0.79 0.62
50-100 million yen	1983 1984	88.7 85.9	113 (150,356) 147 (290,555)	0.50 0.61
above 100 million yen	1983 1984	81.0 80.5	45 (162,760) 68 (619,518)	0.27 0.40

Source: Ministry of Finance, Annual Report of Corporate Statistics, (1984; 1985) and Tokyo Shoko Research.

Notes: a) {(Total assets - equity)/Total assets} all at book value.
 b) Number of firms. (Liabilities in millions of yen in brackets).
 c) Number of bankrupt firms as % of population of firms.

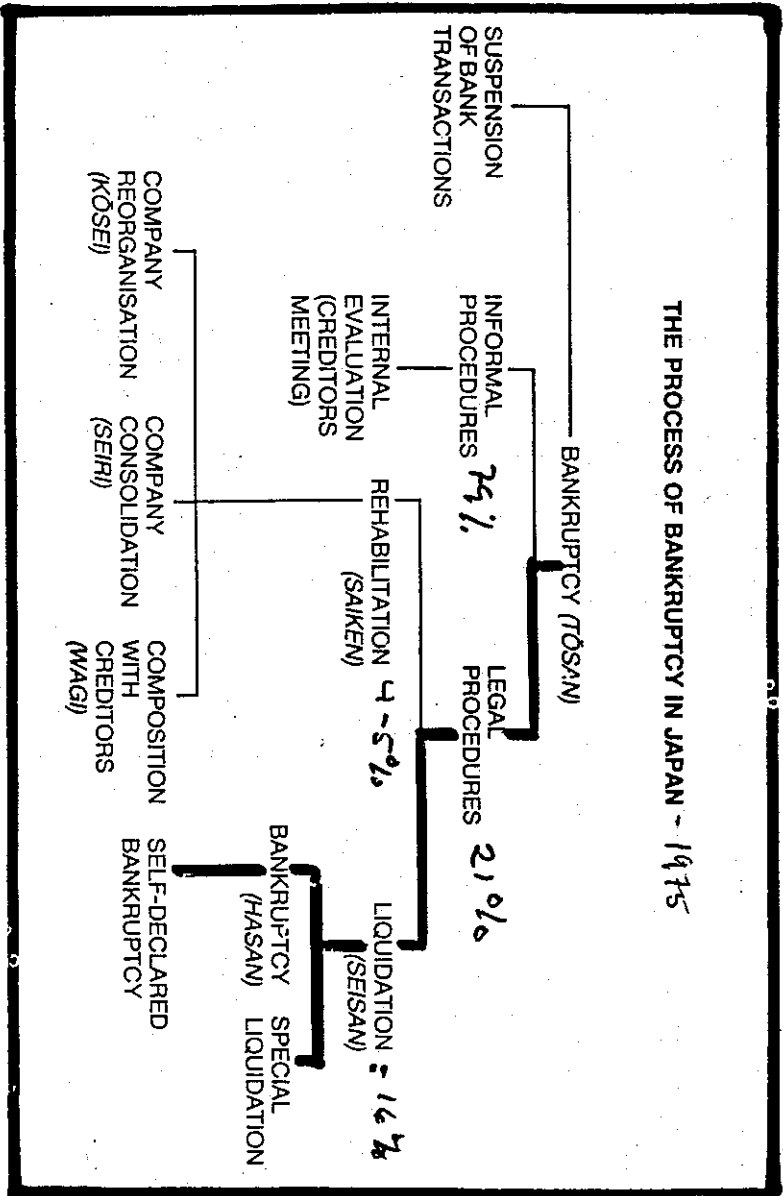
US Rate
0.33%

Japan
all firms
1.00%

Source: J. Corbett, Nov 1987 Oxford Review of Economic Policy.

(need to present graphically)

Figure 34



It seems likely that Japanese bank-client relationships not only reduce the risk of bankruptcy but are important in avoiding its costs.

Source: J. Corbett, Nov 1981, Oxford Review of Economic Policy

Figure 35

IMPLICIT CONTRACTS CREATE LONG TERM RELATIONSHIPS

Degree of divergence in banking (exacerbated by deregulation)

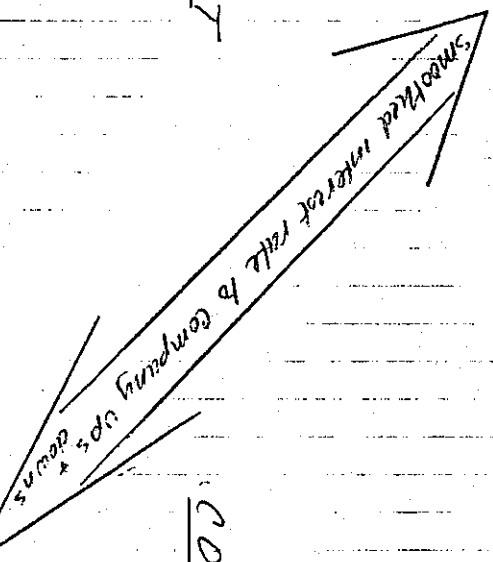
GOOD TIMES

→ FIRMS PAY HIGHER INTEREST

- BANKS EARN HIGH RETURNS

GOOD TIMES

IMPLICIT



CONTRACT

→ BAD TIMES

FIRMS PAY LESS FOR LOANS

- BANKS SHARE RISK

← BAD TIMES

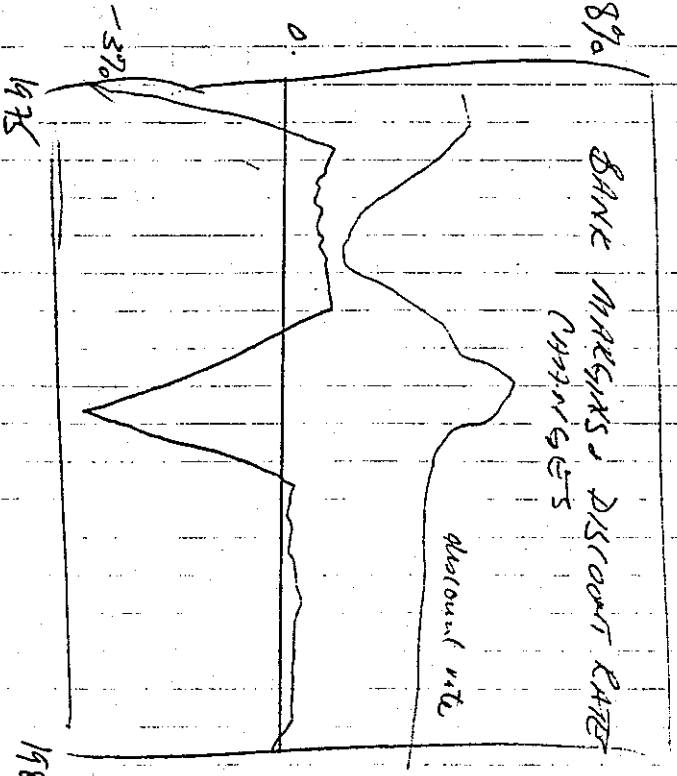
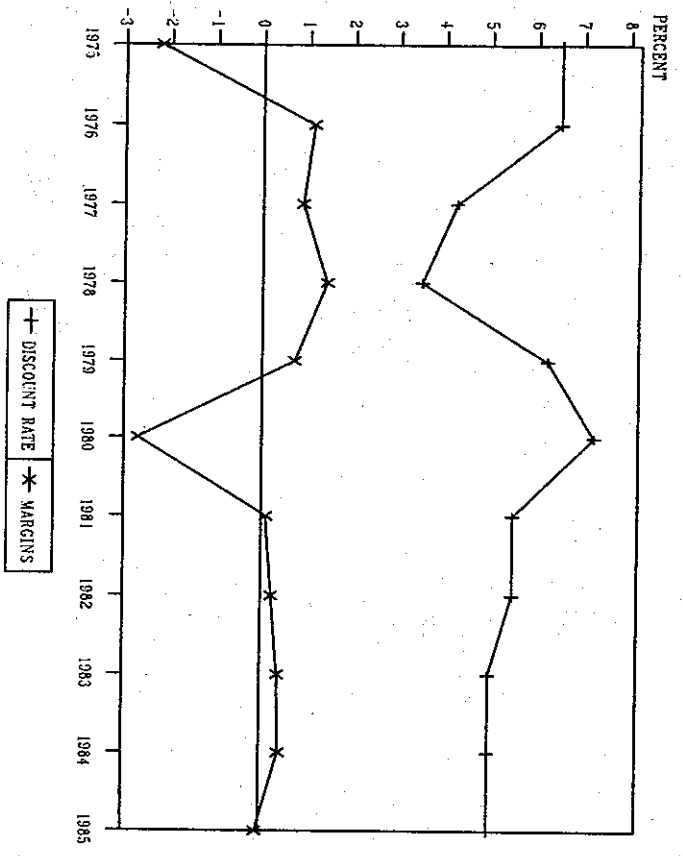


Figure 3b

BANK MARGINS AND DISCOUNT RATE CHANGES



Source: J. Cowbit, 1987

Figure 37

The Classical System

1950s - 1980s

