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JAPANESE FINANCIAL LIBERALIZATION
— From Whence It Came —

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The past two decades have witnessed a wave of financial liberalization of international banking and capital markets in response to changes in the world's economic environment.(1) Britain deregulated interest rates in the early 1970s, abolished foreign exchange controls in the late 1970s and ended the London stock exchange cartel in the "big bang" of 1986. In the United States, Wall Street underwent its stock exchange "big bang" in 1975 and interest rates were fully freed in the early 1980s as inflationary forces precipitated disintermediation.

The liberalization of Japan's financial markets first began in the mid-1970s spurred on by the 1973-74 oil price shock and the subsequent end of the 1955 to 1973 High Growth Period (HGP). Japanese financial liberalization, however, has not paralleled that of its economic counterparts despite Japan's emergence as the world's largest creditor nation. The speed and degree of financial liberalization has generally lagged behind that of the United States and Europe hindering the ability of Japan's financial markets to keep pace with the economic strength of the country. Change has been gradual at best and restrictions and disincentives to the free flow of capital are prevalent even today.

The focus of this paper is to add to the understanding of the factors influencing the speed and degree of Japanese financial liberalization. To do so, it is necessary to examine the financial environment prior to liberalization and the conditions which fostered the liberalization process. Part I discusses the structure of the Japanese financial system during the High Growth Period and Part II investigates the financial conditions which led up to the initial liberalization process.

I. The Post-War Financial Structure—The High Growth Period

The end of World War II left the Japanese nation in economic and financial ruin. Supplies of raw materials and capital were scarce, putting severe constraints on production activities. To foster economic growth it was necessary to develop a financial system which would provide a conduit for transferring needed financial resources to the deficit sectors of the economy. This would create an economic environment conducive to encouraging investment, industrialization, and exports. To Japan's benefit, the financial system, which was instituted under the regulation and administrative guidance of the Ministry of Finance (MOF) and the Bank of Japan (BOJ) contributed to just such an environment. Highly structured, regulated, and segmented this system formed the roots of the modern Japanese financial system and is generally credited with playing a major contributing role in the economic "miracle" of the High Growth Period.[(2)]

An important aspect of the financial system of the HGP was the relatively stable flow of funds pattern (Table 1).
The personal sector was characterized by large surpluses, averaging 9.2 percent of GNP for the period 1965-1972. While both the public and corporate sectors were in deficit, the public sector deficit was relatively small for the same period. The corporate deficit, for example, averaged 6.2 percent of GNP while that of the public averaged only 2.6 percent of GNP. The stability of this flow of funds pattern provided a favorable climate in which to carry out the policy aims of the regulating authorities—namely, the transfer of the surpluses of the personal sector to finance the deficits of the corporate sector.[(3)]

Several important characteristics of the financial environment of Japan, particularly with regard to the financing of corporate deficits, during the HGP are evident.[(4)]

(1) *The Predominance of Indirect Financing*

First, and perhaps the most salient feature of the financial system during the HGP, was the predominance of indirect financing.[(5)] Japanese financial institutions obtained a majority of their financing needs from

financial institutions as opposed to raising funds in the capital or equity markets (direct financing). Indirect financing accounted for over 85.0 percent of the corporate sectors source of funds for 1965-1972 and reached over 90 percent in 1973. Table 2 shows the extent to which the corporate sector used external funds for their borrowing needs for the years 1964, 1970, and 1974.

In a study of both the United States and Japanese financial systems, Cargill,[6] calls this phenomenon "one of the most significant differences between the two systems," noting that for the United States in 1973 only 75.0 percent of corporate sector funds were raised through

Table 1 Surplus or Deficit (–) Position of Major Nonfinancial Sectors in Japan, 1965-1975 (As a percent of GNP)

Year	Personal	Corporate Business	Public Sector: Central Government	Public Sector: Public Corporation & Local Authorities	Total
1965	7.9	–4.5	0.0	–3.2	–3.2
1966	9.1	–4.8	–0.8	–3.3	–4.1
1967	9.4	–7.3	–0.7	–2.4	–3.1
1968	9.1	–6.7	0.0	–2.8	–2.8
1969	8.7	–6.9	0.6	–2.2	–2.8
1970	8.2	–7.2	1.3	–2.3	–1.0
1971	9.6	–6.3	0.9	–2.8	–1.9
1972	11.5	–7.9	0.6	–3.3	–2.7
1973	8.8	–7.6	1.1	–3.9	–2.8
1974	10.3	–8.5	0.7	–4.4	–3.7
1975	10.5	–4.1	–2.7	–4.6	–7.3
1976	11.4	–3.9	–3.5	–4.1	–7.6
1977	11.2	–2.6	–4.0	–3.3	–7.3
1978	11.1	–1.0	–5.4	–3.7	–9.1
1979	9.2	–3.1	–4.5	–3.5	–8.0
1965-72 average	9.2	–6.5	0.2	–2.8	–2.6

Source: Bank of Japan, Flow of Funds Accounts

Note: Flow of funds positions are on a calendar year basis. The personal sector includes households and unincorporated businesses.

indirect financing.

The factors contributing to this predominance of indirect financing are numerous.[7] First, the equity and capital markets were considerably underdeveloped. Equities were not an attractive funding source because of the tax advantage of debt over equity, because of the practice of issuing stock at par value rather than market value, and because of the existing regulations regarding new stock issue.[8] Crum and Meerschwam[9] claim that "equity financing came to be seen as more of a way to cement a long-term relationship rather than as a purely financial transaction or as a way to exercise corporate control." Companies, for example, sold new equity at par value giving existing shareholders the right to purchase at bargain prices resulting in permanent shareholder relationships. But this practice was not cost-effective, and thus, loans obtained from banks became the preferred form of new capital.

The immature capital markets have also been attributed to the low stock of financial assets held by the non-financial sectors (primarily the public).[10] This low stock of assets, argue Hamada and Horiuchi, made transactions costs in financial markets quite substantial, contributing to the personal sector's concentration of savings in the form of bank and

Table 2 Funds Raised by the Corporate Sector Externally (billion yen)

Year	1964	1970	1974
Borrowings	3426	9417	13129
from private financial institutions	3056	8546	11611
from government financial institutions	369	871	1517
Securities	923	1347	1414
Foreign credits, etc.	297	431	1447
Total	4646	11195	15990

Source: BOJ Economic Research Department, *Special Papers*

postal-savings deposits. "Thus, the low level of accumulated financial assets and the associated transaction costs allowed the banking sector to become a predominant influence in postwar financial markets."

The underdevelopment of the securities market was influenced by the central government's strict policy of maintaining, at least up until 1965, a balanced budget. Although public corporations and local authorities were in debt positions, the surpluses of the central government contributed to the absence of any significant government debt up until the 1970s.[11]

Tight controls on international capital flows, which effectively isolated the domestic financial markets, also prevented the development of a bond market for outside debt.

(2) *Portfolio and Interest Rate Constraints*

Second, there were significant portfolio and interest rate constraints on major participants in the financial markets. Government authorities determined most interest rates, and the financial system was divided into various segments, each subject to certain borrowing and lending restrictions.

The thirteen largest commercial banks, based in major population centers (appropriately termed city banks), were the major source of short-term lending to the domestic corporate sector, primarily large corporations. Regional banks, smaller in size and primarily located in rural, agricultural areas, were also involved in short-term lending, but mainly to small and mid-size firms. Long-term credit and trust banks provided long-term funds for industry. Funds were raised by these institutions through bank debentures issued at regulated interest rates. Trust bank funds were raised by accepting deposits of more than two years.

An important role in the transfer of funds was also played by public financial institutions, which included credit associations, credit cooperatives, and agricultural cooperatives. These institutions served to allocate financial resources within given geographic areas for long-term credit needs at reduced rates of interest. In addition, the postal savings system,

with over 22,000 branches nationwide had the ability to collect an enormous amount of deposits. The relative safety, high rate of return, and tax advantage of postal deposits made this system a popular alternative to bank deposits and provided the government with needed funds. The proportion of government funds to the total amount of long-term equipment funds supplied to private businesses was high during the 1960s, providing evidence of the importance of government funds in the economy.[12]

The concept of market segmentation was, and remains to this day, an outstanding and unique feature of Japan's financial system.[13] It provided the financial regulators with the tools to channel funds to specific markets along a path predetermined by the regulators themselves.

The constraints on interest rates were based on the Temporary Interest Rate Adjustment Act of 1947, which allowed the MOF to set not only the discount rate but almost all others as well. Interest rates were, for the most part, set below market rates based on the assumption that, by reducing financing costs, investment and exports would be stimulated. The effectiveness of this policy, and the extent to which interest rates were fixed, however, has come into question by more than one writer.[14]

Bank of Japan economist Yoshio Suzuki[15] writes that "it is unclear as to whether the policy of artificial suppression of interest rates actually lowered the financial costs of Japanese corporations." His reasoning is based on the fact that in addition to controlled interest rates, certain financial markets were formed in which interest rates were determined freely, so that the "effective" interest rates borne by firms did not remain low, as intended by policy. There was, in fact, a dual structure of interest rates in force. Although savings deposits, issue terms for bonds, bank debentures, and loan trust rates were fixed, there were relatively freer rates which included call rates, the bill discount rate, the *gensaki,* or repurchase agreement rate, and bond yields in the secondary market. These "freer" rates were higher than controlled rates.[16] Hamada and Horiuchi[17] note that the policy of requiring a "compensating balance" reduced the effectiveness of the regulation of interest rates as it raised the effective interest rates to a level much higher than the regu-

lated nominal rates. And they conclude that the effectiveness of the regulation of interest rates has yet to be adequately explained.

Even if the artificial suppression of interest rate theory is rejected, the importance of the interest rate and portfolio constraints on financial institutions can be based on the grounds that they prevented competition among the various financial institutions which created a stable environment from which the Government, particularly the Bank of Japan, could carry its policy aims.[18] According to Suzuki,[19] interest rate controls—particularly those on deposit interest rates—and the segmentation of banking into long-term and short-term financial businesses are the primary forces which contributed to stability within the financial system. And as a result of this atmosphere, he argues, "financial institutions were able to respond to the flourishing demand for funds by corporations."

(3) *The Concept of Overloan and Overborrowing*

Third, the banking sector was constantly in a state of overloan and the corporate sector was in a state of overborrowing.[20] The state of overloan denoted a condition in the private sector in which banks extended more credit than they acquired from their deposits or own capital, while overborrowing referred to the heavy reliance on external sources of capital by the corporate sector. Banks in this overloan position, primarily the city banks, were able to obtain funds from the Bank of Japan. This put the city banks in the position of being chronically in debt to the BOJ. The corporate sector, meanwhile, obtained funds from the banking sector.[21]

The factors contributing to the overloan and overborrowing characteristics of the financial sector are similar in nature to those identified with indirect finance i.e., interest rate constraints. The low rates of interest served to create an excess demand for funds in the corporate sector which was further intensified by the rapid rate of economic growth. As equity financing was rare, borrowing from the Bank of Japan was the only viable alternative; and the BOJ was willing to supply the funds demanded.

The important aspect of this overloan-overborrowing position was

not so much in how it affected the balance sheets of the banking and corporate sectors, but that it ensured a close relationship between the Bank of Japan and financial institutions. This enabled the BOJ to allocate credit to those areas where it would have a maximum effect on economic development.

The use of discretionary monetary policy was limited by the fixed exchange rate regime of the Bretton Woods system which prevailed prior to 1973. The need for the government to maintain fixed exchange parities meant that domestic monetary policy was subject to foreign influences, and the need to maintain balance of payments equilibrium produced a wide range of fluctuations in the growth rate of the money supply.[22]

Bank of Japan policy was, however, a major force in the economy. The major policy instruments of the Bank of Japan — credit rationing at the discount window, variations in the discount rate, purchases and sales of commercial bills in the interbank market, and loan limits on individual banks referred to as "window guidance" — were used to control the cost and volume of loans to the corporate sector by financial institutions.[23] Given the reliance of the banking sector on the BOJ for loans (overloan), along with the predominance of indirect financing in the business sector, the BOJ was able to regulate credit creation by varying the amount of reserves available to the banking system. At the domestic level, BOJ policy was transmitted through changes in the amount of credit available to the financial system and thus, the BOJ was able to influence the level of corporate investment spending. This investment spending played a principal role in determining the level of aggregate demand and, hence, the overall level of economic activity. As Crum and Meerschwam note:

> "The Bank of Japan and the Ministry of Finance, working together, encouraged a national financial environment that provided overall stability and fostered desired economic development. By limiting the alternatives available to suppliers and demanders of funds, and through skillful use of a regulated environment that nurtured strong interdependencies and existing relationships, the Bank and

the Ministry succeeded in both shaping Japanese industrial policy and in maintaining their own power." [24]

II. The Catalyst for Financial Liberalization

The financial structure of the High Growth Period served the economy well. Economic growth averaged 10 percent through the early 1970s and Japan's position in the world economy expanded at a similar rate. This unprecedented economic expansion came to a sudden halt, however, with the onset of the First Oil Crisis in 1973-74. This decline in economic activity was evidenced in the changing flow of funds pattern.

First, the supply-side shock reduced the demand for capital and decreased the deficits of the corporate sector (refer to Table 1). Second and more importantly, the slower economic growth led to significant changes in the government debt position. Government debt increased in both real terms and as proportion of GNP, severely constraining the existing financial order. This was the primary factor which put into play the forces of financial liberalization. [25]

The Government Bond Market and the Role of Government Debt

The macroeconomic management of Japan during the postwar economic development period was primarily monetary. Contrary to the practice in other developed countries, fiscal policy was not used periodically to boost the level of economic activity. [26] An economic downturn in 1964-65, however, produced changes in this state of affairs. The earlier success of monetary policy to counter recessionary gaps was not repeated and a fiscal policy focusing on increased government spending provided the only alternative solution. And, since the slowdown also produced shortfalls in tax revenues, paying for this spending entailed deficit financing.

Financing the fiscal deficits required the absorption of government bonds into the balance sheets of the financial sector. But the conditions of bond issue by the Japanese government were subject to strict regulations and special authorization laws needed to be passed before new debt could be issued. Public placement of bonds was forbidden

by the BOJ, for fear of excess money creation, and instead bonds were required to be placed directly with purchasers.

Placing the debt directly with purchasers could be accomplished either through public tender or issuing the debt by public flotation. These two options, however, put the government authorities in a policy dilemma. Such methods of debt issue, although popular in deregulated markets, implied that the level of the interest rate would be determined in the marketplace. Thus, direct placement required giving up control of some interest rates—a solution the BOJ and the MOF did not deem feasible at that time.

The solution to the problem of placing government debt was accomplished through the creation of a bond underwriting syndicate, comprised of a broad range of financial institutions, including banks and securities companies. Briefly described, the syndicate would buy the bonds directly from the MOF at a predetermined rate with the understanding that the bonds would not be resold for a period of one year.[27] This arrangement allowed the authorities to set a relatively low interest rate on new issues.

Prior to 1977, an official secondary market for government debt was prohibited by the Ministry of Finance. Although securities companies operated an unofficial *gensaki* market in government debt, the limited size of the market had little impact on the system. The syndicate was originally willing to hold the debt since the BOJ agreed to repurchase the bonds at a price high enough to guarantee the syndicate members a sufficient profit. And even though this purchase of debt did result in a certain degree of money creation, again the limited size of the market helped to keep inflation under control during the first few years.

The forces of financial liberalization came into play with the increased demand on the public sector to counter the recessionary effect of the oil-shock of 1973-74. This resulted in a rapid expansion of the amount of government bonds floated. Initially, this development did not significantly alter the original relationship between the BOJ and the syndicate. But, pressures on the system began to build when the Bank of Japan, responding to criticism of excessive money growth in the 1971-73

period, ended its policy of full repurchase. This left the syndicate with large quantities of bonds in their portfolios, which proceeded to lose value as interest rates rose during the economic slowdown.

With the absence of an official secondary market the syndicate was, as expected, hesitant to continue to purchase the government debt. This forced the monetary authorities to alter their previous restrictions and beginning in April 1977, the syndicate was given permission to sell the bonds in a secondary market one year after their issue. The emergence of a secondary market also made it more difficult for the MOF to issue fixed rate long-term bonds. Thus, in response, the MOF began to issue medium-term bonds at public auctions in 1978. The unregulated nature of the secondary market meant that interest rates were market-determined, making large denomination deposits with interest rate ceilings less attractive. This fostered shifts in deposits to higher yielding assets and stimulated an extraordinary expansion in bond training in the secondary markets. Both of these developments are indications of noteworthy change in adjustment mechanism in the Japanese financial system.[28]

There were other, though somewhat lesser, pressures for change at both the domestic and international level. The declining investment opportunities of the corporate sector altered the previous close relationship between the banking and business sectors. Corporations became less reliant on indirect financing for their external funding needs which resulted in reduced profit opportunities for the banking sector. This forced banks to seek new ways to expand their lending activities and increased competition among the various segments of the banking industry.

The corporate and personal sectors also contributed to changes in the financial structure through their search for higher rates of return and lower costs of borrowing. As corporations began to look to the international market in an effort to diversify their portfolios, increased demands for freer capital flows were forthcoming. This spurred the creation in the domestic market of new financial instruments with more flexible rates of interest to compete with those from abroad.[29]

III. Conclusion

This essay has focused on two major aspects of the postwar Japanese financial system: (1) the highly structured and regulated system which provided the environment conducive to economic growth, and (2) the changes in this environment which led up to financial liberalization. In particular, it has shown that the forces of liberalization initially came into play as a result of the failure of the regulated system to absorb the increased government deficits. And once liberalization began in one financial sector it put pressure on the other sectors to liberalize as well.

A complete list of all the changes that have taken place in the financial markets of Japan since the end of the High Growth Period is beyond the scope of this paper. Moreover, the financial markets of Japan are continuously adjusting to the changing economic environment.[30] But despite these many developments, the domestic market still remains highly regulated. The globalization of Japan's financial markets is not yet a reality, and calls for the further lifting of controls on interest rates, deregulating financial transactions within Japan, and increasing access to the domestic market by foreign financial institutions still remain. Regulation has long been a part of the Japanese market, and, as evidenced from the success of the High Growth Period, it has served a useful purpose. Nevertheless, today it is no longer a question of whether further liberalization is going to continue, but rather to what degree and speed.

Notes

(1) For an excellent discussion of the product and process changes that have occurred in international financial markets and an analysis of the factors leading to these changes see: Levich, Richard M., "Financial Innovations in International Financial Markets," *NBER Working Paper #2277*, June 1987.

(2) Most studies of the Japanese economy conclude that the highly regulated structure of the financial system was a major contributing factor to the rapid development of the HGP. A brief list includes, for example, Cargill, Thomas F., "Japanese Monetary

Policy, Flow of Funds, and Domestic Financial Liberalization," *Federal Reserve Bank of San Francisco Economic Review*, Number 3 Summer 1986, pp. 21-31; Minami, Ryoshin, *The Economic Development of Japan*, MacMillan Press, 1986; and Suzuki, Yoshio, *Money, Finance, and Macroeconomic Performance in Japan*, Yale University Press, 1986. For a somewhat different perspective on the structure of the financial system see Sakakibara, Eisuke and Robert A. Feldman, "The Japanese Financial System in Comparative Perspective," *Journal of Comparative Economics*, Vol. 7 March 1983, pp. 1-24.

(3) Cargill, T.F., *op. cit.*, pp. 21-23.

(4) See Horne, James, *Japan's Financial Markets*, George Allen and Urwin Press, 1985.

(5) Ikeo, Kazuhito, "A Micro-Theoretic Analysis of Japanese Financial System," *Kyoto University Economic Review*, Vol. LVI October 1986, pp. 26-36, states that "predominance of indirect finance" was the magic phrase which dominated all theories related to the financial system in postwar Japan.

(6) Cargill, Thomas F., "A U.S. Perspective on Japanese Financial Liberalization," *BOJ Monetary and Economic Studies*, Vol. 3 May 1985, pp. 112-161.

(7) The predominance of indirect finance, according to Suzuki, Yoshio, *The Japanese Financial System*, Clarendon Press, 1987, has its historical roots in the early attempts of Japan to become a modern nation. The discussion in this paper will be limited to the three contemporary reasons for this practice during the HGP.

(8) Cargill, T.F., (1985), *op. cit.*, p. 119.

(9) Crum, M. Colyer, and David M. Meerschwam, "From Relationship to Price Banking: The Loss of Regulatory Control," in McGraw, Thomas, *America vs. Japan*, Harvard Business School Press, 1986, pp. 261-297.

(10) Hamada, Koichi, and Akiyoshi Horiuchi, "The Political Economy of the Financial Market," in Yamamura, Kozo, and Yasuda Yasukichi, eds., *The Political Economy of Japan — The Domestic Transformation*, Stanford University Press, 1987, pp. 223-260.

(11) As will be discussed later, the change in the size of the government debt was an important factor contributing to financial liberalization.

(12) See, for example, Hamada, K., and A. Horiuchi, *op. cit.*, pp. 242-243.

(13) Crum, M.C., and D. Meerschwam, *op. cit.*, p. 267.

(14) See, for example, Argy, Victor, "International Financial Liberalization — The Australian and Japanese Experiences Compared," *BOJ*

Monetary and Economic Studies, Vol. 5 May 1987, p. 167; Feldman, Robert A., *Japanese Financial Markets—Deficits, Dilemmas and Deregulation,* Press, 1986; and Suzuki, Y., (1986, 1987).

(15) See Suzuki, Y., (1986), *op. cit.,* Chapter 1.

(16) Argy, V., *op. cit.,* pp. 137-138.

(17) Hamada, K. and A. Horiuchi, *op. cit.,* pp. 236-238.

(18) See Ikeo, K., *op. cit.,* pp. 33-34.

(19) Suzuki, Y., (1987), *op. cit.,* pp. 22-23.

(20) Actually overborrowing is just the opposite side of the coin as overloan.

(21) Thus, overborrowing and the predominance of indirect finance were interrelated. Further accounts and explanations of the overborrowing phenomenon can be found in Minami, R., *op. cit.,* pp. 355-356.

(22) See Hutchison, Michael M., "Japan's 'Money Focused' Monetary Policy," *Federal Reserve Bank of San Francisco Economic Review,* Number 3 Summer 1986, pp. 33-46. Also, some observers claim that the focus of monetary policy was to stabilize prices and, in fact, was not very conducive to economic growth. See Hamada K. and A. Horiuchi, *op. cit.,* pp. 241-242.

(23) Cargill, T.F., (1986), *op. cit.,* p. 25.

(24) Crum M.C. and D. Meerschwam, *op. cit.,* p. 275.

(25) The author has not found any sources which contradict this view.

(26) See Horne, J., *op. cit.,* pp. 46-47.

(27) See Feldman, R., *op. cit.,* Chapter 3 for an expanded discussion of the government bond market.

(28) Hamada, K. and A. Horiuchi, *op. cit.,* p. 249.

(29) An expanded discussion of additional factors contributing to financial liberalization is available in Argy, V. *op. cit.*; Cargill, T. *op. cit.* (1985); Crum, M.C. and D. Meerschwam, *op. cit.*; Hamada, K. and A. Horiuchi, *op. cit.*; and Suzuki, Y. *op. cit.* (1987), Chapter 2.

(30) For a survey of recent liberalization measures see McCornac, Dennis, "Japanese Financial Liberalization: Navigating Toward Change," *Journal of the American Chamber of Commerce in Japan,* Vol. 25 February 1988, pp. 18-22.

日本の金融の自由化
〈要　　約〉

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日本の金融市場の自由化は，まず1970年代中頃からはじまり，1973−74年の石油価格ショックによって加速され，1955年から1973年まで続いた高度成長の終りを画している。日本の金融市場の自由化は，しかしながら，日本が世界最大の債権国となったにもかかわらず，経済の他の側面と同じ速度で進められたのではなかった。金融自由化の速度と程度は，合衆国やヨーロッパ諸国より一般的にいって遅れており，日本の金融市場の能力を，国の経済力の発展と比較した場合，むしろこれを隠すようなものであった。変化はよくいって漸次的なものであり，資本の自由な流れを制限し，また阻害する面が，今日においても目立っているのである。

本論文の中心点は，日本の金融市場の自由化の速度と程度に影響を及ぼした要因の理解に資することである。そのためには，自由化以前の金融環境と自由化の過程を促進した諸条件を吟味することが必要である。第I部は高度成長期の日本の金融制度の構造を論ずるものであり，また第II部は最初の自由化の過程へと導いた金融上の諸条件を考察するものである。