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

by

Barbara J. Heinzen

1992

HARVARD BUSINESS REVIEW January-February 1991

"Hey, that's not fair! You're using Japanese money!"

CARTOON BY S. GROSS

A GRAPHICAL GUIDE TO FINANCING GROWTH

in the

JAPANESE ECONOMY: 1950s - 1990s

by B.J. Heinzen

Outline and List of Figures

I. PREFACE

The Preface explains how this book came to be written, considers who might find it of interest, and justifies the use of a 'graphical guide'.

II. CHAPTER ONE: AN INTRODUCTION TO FINANCE AND GROWTH IN POST-WAR JAPAN

Chapter One is a general introduction to the topic, showing the relationship of financial structures to other factors encouraging economic growth in Japan. This chapter also identifies two periods of financial structures: the post-War 'Classical System' and the emerging 'Open System' of the 1990s. The chapter closes with two key questions: Where does the money come from? and How is risk absorbed?

A. **Explaining Growth in Japan**

1. *All MF (Manufacturing) Index of Output (Figure 1)*

B. **The Pyramid of Growth**

1. *Factors Encouraging Growth (Figure 2)*

C. **Other Important Factors**

D. **Financing the Long Term View**

III. CHAPTER TWO: WHERE DID THE MONEY COME FROM?
Borrowing, Banking and Savings in the Classic System

Chapter Two answers the question: where did the money come from in the Classical System? This begins with a discussion of the origins of high gearing in Japanese companies and goes on to consider the role of the post-War Japanese savings and banking system in financing high investment and growth. In describing this system, we also see how the risk of long term, high growth loans has been managed in the banking system.

A. **High Gearing**

1. *External Sources of Company Funds 1947-1981 (Figure 3)*

2. *Origins of High Gearing (Figure 4)*
3. *Japanese Government Deficit (to come) (Figure 5)*
4. *Interest Rate Spreads (Figure 6)*
5. *Private Banking Sector Funds (Figure 7)*
6. *Consumer Prices Index 1950-1987 (Figure 8)*

B. **Banking on Negotiated Transactions**

1. *Rates of Growth v Sources of Company Funds 1950-1990 (to come) (Figure 9)*

C. **High Savings**

1. *A Higher Savings Rate in Japan 1960-1990 (Figure 10)*
2. *Higher Gross Capital Formation 1960-1990 (Figure 11)*
3. *Japanese Savings Rate 1925-1990 (to come) (Figure 12)*
4. *Composition of Personal Assets 1953-1983 (Figure 13)*
5. *Bank v Post Office Deposits (Figure 14)*

D. **Linking the Borrowers and Savers: A Funnel for Funds**

1. *Every Bank Has Its Place (Figure 15)*

E. **Summary: Savings and Banking in the Classic System**

IV. CHAPTER THREE: **HOW WAS RISK ABSORBED?**
Crossed Shares, Rising Markets and Bankruptcy in the Classical System

Chapter Three considers how the investing companies, looking for high growth, absorbed the risk of the this strategy. This leads us into a discussion of the evolution and structure of the *keiretsu* system in Japan of industrial groupings, the role of the stock market and the management of bankruptcy.

A. **Evolution of Crossed Shareholdings and the *Keiretsu* Organisation**

1. *Two Important Dynamics of High Growth Finance (Figure 16)*
2. *Mitsubishi Interests 1946 (Figure 17)*
3. *Growth of Stable Shareholdings 1950-1990 (Figure 18)*
4. *Presidents' Club Members, March 1990 (Figure 19)*
5. *Schematic Structure of Keiretsu in the Japanese Chemical Industry (Figure 20)*
6. *Interfirm Dependence & Power (Figure 21)*
7. *Keiretsu v Others 1989/90 (Figure 23)*
8. *Keiretsu Group Sales v. Others (Figure 24)*
9. *Keiretsu v Others 1989/90 - Equity Ratios (Figure 25)*
10. *Mergers and Acquisitions in Japan (Figure 26)*

B. **Role of the Stock Exchange**

1. *Shareholders & Loans in a Presidents' Club Member (Figure 27)*
2. *Shareholder Composition & Shareholder Activity 1981 (Figure 28)*
3. *Share Prices Index 1950-1985 (Figure 29)*

4. *Growth = High Gearing (Figure 30)*
5. *Shareholding: Growth = Capital Appreciation (Figure 31)*
6. *FEER (Far Eastern Economic Review Graphs of World Stock Exchanges 1987 (to come) (Figure 32)*

C. **Managing Bankruptcy in Japan**

1. *Banks Monitoring and Problem Loans (Figure 32)*
2. *Bankruptcies by Size of Firm (Figure 33)*
3. *The Process of Bankruptcy in Japan (Figure 34)*
4. *Implicit Contracts Create Long Term Relationships (Figure 35)*
5. *Bank Margins and Discount Rate Changes (Figure 36)*

D. **Summary: How Was Company Risk Absorbed?**

V. **CHAPTER FOUR: A Short Summary of the Classic System: 1950s-1980s**

1. *The "Classical" System 1950s-1980s (Figure 37)*

VI. **CHAPTER FIVE: The Emerging Financial System of the 1990s**

This chapter is not yet written, but will look at the emerging financial system in Japan. From 1975-1985 a number of pressures built up in Japan forcing the Ministry of Finance to begin experiments with various forms of financial deregulation and internationalisation. During the 'bubble economy' of 1985-1991, the rising values of shares and land both put additional pressure on the economy. Since the fall of the land and share prices, new stresses have been added, but the process of reform continues.

The chapter will discuss the evolution of the Japanese economy and financial system since 1975 and postulate changes in the future.

A. **1975-1985: A Slow Transition**

1. **Macro-economic changes**
2. **Household and individual changes**
3. **International changes**
4. **Regulatory changes**
5. **Company changes**

B. **The Rise and Fall of the Tokyo Stock Exchange**

1. **The Rise**
2. **The Fall**

C. **And the Consequence Was ...**

1. **Where Does the Money Come from?**
   a. **Sources of funds**
   b. **Dividends**

2. How Is Risk Absorbed?
   a. Stable crossed shareholdings
   b. Main bank relationship
   c. Bankruptcies

D. Possible Future Changes

1. Reform of land laws and taxes
2. Universal banking
3. Better disclosure laws
4. Increase in corruption?
5. Growth of consumer market and consumer credit?
6. Continued hierarchy of institutions?

MOF + BOJ
Big Banks and securities firms
Insurance companies and other financial groups

7. Survival or transformation of *keiretsu* industrial groups?

VII. CHAPTER SIX: CONCLUSIONS

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
August 1992

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-striken 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 kew 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 techological 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 committment 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 Japanee 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 depositers, albeit within a structure of controlled interest rates. This competition to bring depositers 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 responsiblities 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 corporte 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 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 subsidary 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 downsteam industries around Mitsubishi's own basic chemical plants.

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