THE FINANCIAL STRUCTURE OF

JAPANESE BIG BUSINESS

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of Business at Carroll College,
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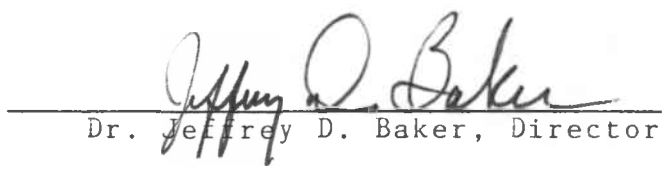
April 1, 1986

For my sister

This thesis for honors recognition has been approved

for the Department of Business.



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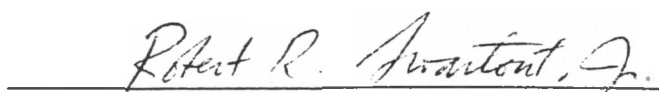

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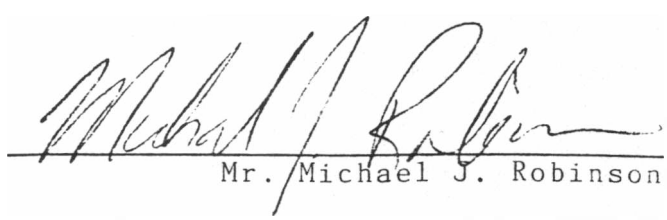

Mr. Michael J. Robinson

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PREFACE

In the summer of 1984, I had the good fortune to spend two months in Japan as an exchange student. In addition to providing an excellent opportunity to research the Japanese financial system, the trip also opened the doorway to another culture. I visited many beautiful places, including Japanese gardens, castles, and temples. I lived with four Japanese families and partook in their daily habits. I was able to learn some of the Japanese language. My most treasured experience was becoming acquainted with the Japanese people, whose sincerity, grace, hospitality, and friendliness remain ingrained in my memory. I would like to thank Kumamoto University of Commerce--the professors, administrators, and students--for making my stay very enjoyable. I would especially like to thank Yoshio Momoi, Kanako Heki, Yoshihiro Ikeda, Tadaomi Ikeda, and my host families. In addition, I would like to thank Northwest Orient Airlines for making this trip possible through the donation of the airfare.

I am grateful to several others for their assistance in the completion of this thesis. A sincere thank you to Dr. Baker, my thesis director, for all the time, patience, and advice which he has given to me. I would also like to thank my readers--Dr. Swartout, who I have enjoyed working with and have received invaluable guidance from over the

past two years; and Mr. Robinson, who has been instrumental not only in the writing of this thesis, but also in establishing my future career.

I will never forget the support and generosity I have received from my friends who have helped to make this thesis possible. I wish to express my gratitude to Marie McPherson, Milan Rahman, Lynn Connell, and Lisa Funk for their moral support as well as their technical expertise. I would especially like to thank Amy Stephens. In addition to spending her Spring Break with my thesis and me, she has helped me through the hardest time in my life. Thank you Amy--your caring and giving attitude has provided a great inspiration to me.

Finally, I would like to thank my family, whom I have recently come to appreciate and love more than ever. Thank you, Mom and Dad, for the support you have given me in writing this paper, and also for the love you have given to each of your children. Thank you Bobby, for being the best brother any girl could ever want. And thank you Denny, for the 18 wonderful years which I have enjoyed with you.

INTRODUCTION

A "miracle," a "secret," and a "paragon" are just a few of the words which have been used in reference to the Japanese economy. Many have pondered and attempted to explain the successes achieved over the past century by the business world of Japan. Some have used Japan as a model and endeavored to learn lessons from the vast economic development.

Yet, unperceived by most Westerners, underneath this miraculous economy there in fact lies a secret. Many do not realize that a "lopsided" financial structure of Big Business is at the root of the amazing growth and expansion of the economy. The Japanese financial system is characterized by the use of indirect finance and heavy reliance on bank loans. The end result of these financial practices has been a balance sheet for some firms which is unacceptable from the viewpoint of the United States and European banking institutions. Application of the traditional concepts of financial analysis leads to very unfavorable evaluation as the following two quotations suggest:

> Obviously the biggest problem that Japan has is that people still don't know whether they should believe in it. The main thing that people in financial circles realize about Japanese companies is the incredible amount of leverage. They basically are trained that that

> amount of leverage is off the graph. You can't have that much leverage and still be a company.1
> (N.Y. investment banker)
>
> Most of the debt-equity ratios of the trading companies are 35 to 1. When you look at it with the European eye, you don't understand how a company could be creditworthy with such kinds of ratios. So you are lending on an act of faith, or what your Japanese branch has told you that is standard in Japan. In Europe you usually find a debt-equity ratio of 2 or 3 to 1.2
> (U. S. banker in Paris)

To explain this phenonmenon, I will begin with a discussion of how the financial structure evolved out of various historical influences. I will then describe and analyze the system in detail. Finally, I will explain the problems Japan is facing today due to this abnormally high debt-equity ratio and the reorganization measures currently being undertaken to correct the problems.

NOTES

[1]International Business Information Inc., Japanese Corporate Finance 1977-1980 (London: Financial Times Ltd., 1977), p. 3.

[2]Ibid., p. 4.

CHAPTER ONE

HISTORICAL INFLUENCES ON JAPAN'S FINANCIAL STRUCTURE

One-hundred fifty years ago, Japan was an isolated and almost mythical land, known to Europe and the West only through the writings of a few Dutch traders and the tales of chance mariners who had dared to enter Japanese ports. During this "shogun" period, the existing feudal government (bakufu) broke off all relations with foreign countries, (except Holland) and prohibited foreign travel.[1]

If the Westerners whom the Japanese had first encountered had all been merchants, it is possible that the history of their country would have been altered, and this period of isolation would not have occurred. However, by the later sixteenth century, Roman Catholics of the East turned to Japan as a field for missionary enterprise. Before many years had elapsed, the Japanese found established in their midst a community recognizing a sovereign other than their emperor; foreigners were thereupon expelled from Japan and forbidden to return on pain of death.[2]

The arrival of Commodore Matthew C. Perry from the United States in 1853 marked the end of Japan's isolation

and the beginning of the restoration of foreign relations and trade. The government of the United States sent Commodore Perry to open diplomatic relations between the two countries. He delivered a formal letter from the President of the United States to the ruler of Japan in July 1853 and sailed away, making no attempt to obtain an immediate answer.

Aware that he would return in a few months, the Japanese busied themselves with the defenses of the country. However, they realized their preparations were not sufficient to repel Perry and decided to yield to his demands. Consequently, when the American squadron returned, a treaty was concluded whereby Japan undertook "To accord kind treatment to shipwrecked sailors; to permit foreign vessels to obtain stores and provisions within her territory, and to allow American ships to anchor in the ports at Shimodo and Hakodate."[3]

Commodore Perry found in 1853 a country still in the feudal age ruled by a warrior class often carrying on its conflicts with sword and bow. Manufacturing was of no importance, and in industry there was practically no use of iron and steel or of mechanical power. Methods of land transport were more primitive than those employed by Europe a century earlier. There was no navy, and merchant vessels were limited to small junks suitable only for navigating protected bays and inland seas.[4]

Commodore Perry arrived at a time when the Japanese were beginning to question their feudal government, and anti-bakufu forces were being formed. The end of Japan's isolation and the resumption of overseas trade put the bakufu in a very difficult position since international commerce placed a severe strain on Japan's internal economy. This in turn strengthened the position of the anti-bakufu forces. The need to replace the Tokugawa Bakufu with some form of government more capable of absorbing western ideas was felt more acutely with each passing day.

In the final peaceful solution the Shogun returned his powers to the Emperor in 1867, and in 1868 a new government was formed with the Emperor Meiji at its head. The many efforts at modernization are known as the Meiji restoration.

> The basic policy of the Meiji government was to preserve independence by opening up the country and building up the nation's military power through intercourse with the rest of the world. This plan was in fact carried through by the progressive political leaders of the time.6

The zaibatsu played an important role in carrying out the industrial modernization programs of the Japanese government following the Meiji Restoration. The zaibatsu were commercial and industrial combinations which spread widely across fields of banking, manufacturing, mining, shipping, and foreign marketing. Each centered around its own bank, which financed the component parts.

The zaibatsu were of three types. The all-embracing

zaibatsu had capital holdings not only in such financial sectors as banking, trust, and insurance, but also in a wide range of industrial and commercial sectors. Financial zaibatsu had their capital mainly in banking but used the capital to participate in industry. Industrial zaibatsu had most of their capital in industry.

With the zaibatsu, a single holding company owned the shares of all affiliated firms and held absolute control over their personnel and management decisions. The zaibatsu constituted a closed organization with all power concentrated in a family head who was the sole proprietor of the holding company. Strong ties were maintained between the zaibatsu and the political parties.[7]

In the 1930's, a powerful political movement brought animosity towards the zaibatsu and the existing political parties, which were accused of conspiring to oppress the people and destroy traditional Japanese morality.[8]

Following World War II, the zaibatsu were completely disbanded during the American occupation (1945-52). On October 31, 1945, fifteen Japanese firms (zaibatsu), their subsidiaries and affiliates were, by a directive of the military occupation, restricted from sale, trade, transfer or adjustment of their capital securities. One week later, the four major holding companies (honsha), Mitsubishi, Mitsui, Yasuda, and Sumitomo, were directed to transfer all securities and ownership of other firms to the Holding

Company Liquidation Commission for the purpose of public distribution of these securities. More zaibatsu soon shared the same fate.[9]

In 1947, the Law Relating to Prohibition of Private Monopoly and Maintenance of Fair Trade, usually referred to as the Anti-Monopoly Law, was enacted to prevent reappearance of monopolistic domination of the economy. The law states that "No company engaged in financial business shall acquire or hold stock of another company in Japan if by doing so it holds in excess of 10% of the outstanding stock...."[10]

The dissolution of the combines was an integral part of the broad program to encourage wide distribution of income, ownership, and forms of activity and organization that were considered likely to strengthen the peaceful disposition of the Japanese people and to make it difficult to marshall economic activities in support of military ends. There was no intent of effecting a reform of the existing social system. The purpose was to bring about a psychological and institutional demobilization, since the zaibatsu had served as an instrument of the government in international politics.[11]

As a result of the "zaibatsu busting," numerous smaller companies emerged immediately after the war. However, economic reconstruction requiring huge amounts of capital soon put banks in the limelight, with major commercial banks replacing the zaibatsu and increasingly relied upon as the primary source of corporate funds. The rapid economic

growth, so characteristic of postwar Japan, made corporate survival dependent on expansion. Banks were and are the key.

The year 1955 marked the end of the postwar reconstruction period and the beginning of the period of rapid economic growth. The Economic Planning Agency summarized this transition in the 1956 edition of its Economic White Paper with the brief remark that the economy of Japan could no longer be termed "postwar."[12]

Japan's annual growth rate, in real terms, for the period 1955-70 was 10.2 percent. Broken down further, it was 8.5 percent for 1955-60, 9.8 percent for 1960-5, and 11.2 percent for 1965-70. In other words, it was gaining momentum as time went on.[13]

The high growth rate has been termed a "miracle." Japan's growth rate for 1946-55 has been estimated at 8.9 percent. This is very high, but this period can be regarded as an exceptional case, because of the prevailing "recovery conditions." The chaos that came with defeat in the war caused a very sharp fall in production during the period immediately after the war; and therefore, when the country settled down, there was a recovery period until previous economic levels were reached.

However, by 1955, these special conditions no longer prevailed, and a fall in the growth rate would have caused no surprise. In fact, growth continued at a similar level

until 1970. Most advanced industrial nations achieved a higher growth rate after the war than before, but the statistics for 1950-70 show that Japan's was significantly higher than any of the others. (See Figure 1.)

A number of theories have been put forward by both Japanese and foreign observers as to why Japan was able to achieve such a high rate of economic growth following the Second World War.

The outbreak of the Korean War in 1950 provided Japan with an opportunity for recovery. Special procurements by the U. S. Forces stationed in Japan stimulated Japan's latent industrial capacity and encouraged enterprises to step up production and increase investments in new production facilities. The recovery was accelerated to such an extent that nearly all economic indicators had reached prewar levels by the mid-fifties.[14]

The most fundamental reason for growth seems to be the world-wide postwar revolution in scientific technology. Every country had the chance to harvest the effects of these changes, but Japan was in an especially strong position to take advantage of the opportunity. The country possessed an accumulation of human talent and scientific technological know-how that had been building from the Meiji period.[15] Also, the dissolution of the zaibatsu weeded out some of the old leaders of the Japanese economy and consequently removed some of the more conservative elements in the economy. In

INTERNATIONAL COMPARISON OF

ECONOMIC GROWTH RATES

COUNTRY	PERIOD	GROWTH RATE %
Japan	1889-1938	3.2
Japan	1946-1955	8.9
Japan	1955-1970	10.2
Japan	1970-1980	4.8
USA	1960-1970	3.9
West Germany	1960-1970	4.7
France	1960-1970	5.6
UK	1960-1970	2.8

Figure 1

Source: Yutaka Kosai and Yoshitaro Ogino, The Contemporary Japanese Economy (Armonk: M. E. Sharpe, Inc., 1984), p. 13.

their place, men of new vitality and rather progressive tendencies took the helm of the economy.

Some of the theories for growth are discussed by Edwin O. Reischauer, a scholar long interested in Japan, who observed the reconstruction and development of Japan's economy both as a historian and as a U. S. ambassador to Japan. The factors Reischauer mentioned in his book, The United States and Japan, can be summarized as follows:

1. The hard-work ethics of the Japanese, their high levels of education and technical skills, and their ability to maintain political and financial stability.
2. The concentrated effort of the Japanese to rebuild their industries by putting almost all of their capital into industrial facilities.
3. The fact that Japan obtained access to greatly expanded energy resources as it became able to import large quantities of high-grade coal and petroleum.
4. The existence of a major export market for Japanese goods in the United States where very few restrictions were placed on Japanese goods from the beginning.
5. The fact that Japan had lost its territorial possessions in the war and could therefore divert money that would otherwise have been necessary for the defense of colonies to stimulating the rapid growth of domestic industry.
6. The opportunity for a new start with modern facilities that resulted from destruction of productive facilities during the war.
7. The low level of defense expenditures due partly to the people's general disgust with militarism and partly to the nation's assurance of security under its continuing agreement with the United States.
8. The delicate balance attained between free enterprise and government guidance and control.16

The huge amount of funds required for this economic expansion was obtained through indirect financing, mostly bank loans. This unique financial structure will be explained in the next chapter.

NOTES

[1]John Orchard, Japan's Economic Position (New York: McGraw-Hill Book Company Inc., 1979), p. 1.

[2]Robert Porter, Japan: The New World Power (London: Oxford University Press, 1915), p. 41.

[3]Ibid., p. 64.

[4]Orchard, Japan's Economic Position, p. 1.

[5]Nippon Steel Corporation, Nippon: The Land And Its People, 2nd ed. (Tokyo: Nippon Steel Corporation, 1984), p. 45.

[6]Ibid., p. 49.

[7]Ibid., pp. 95-97.

[8]Byron K. Marshal, Capitalism And Nationalism In Prewar Japan (Stanford: Stanford University Press, 1967), p. 104.

[9]Robert J. Ballon, Iwao Tomita, and Hajime Usami, Financial Reporting In Japan (Tokyo: Kodansha International Ltd., 1976), p. 11.

[10]Ibid., p. 12.

[11]Chitashi Yanaga, Japan Since Perry (New York: McGraw-Hill Book Company Inc., 1949), p. 637.

[12]Nippon Steel Corp., Nippon: The Land And Its People, p. 81.

[13]Yutaka Kosai and Yoshitaro Ogino, The Contemporary Japanese Economy (Armonk: M. E. Sharpe Inc., 1984), p. 2.

[14]Nippon Steel Corp., Nippon: The Land And Its People, p. 81.

[15]Kamekichi Takahashi, The Rise And Development Of Japan's Modern Economy, trans. John Lynch (Tokyo: The JiJi Press Ltd., 1969), p. 6.

[16]Edwin O. Reischauer, The United States And Japan, 3rd ed., cited by Nippon Steel Corporation, Nippon: The Land And Its People (Tokyo: Nippon Steel Corporation, 1984), pp. 87-88.

CHAPTER TWO

THE FINANCIAL STRUCTURE OF JAPAN

A business can rely on two basic types of financing when it wants to obtain necessary funds for its operation: internal and external financing. While the sources of the former exist within the business, those of external funds must be found elsewhere. Internally generated funds include depreciation reserves, other reserves and retained earnings; external money includes receipts from stock issues, borrowed money, and corporate bonds.

Internal funds plus receipts from stock issues are called owned capital financing as these funds belong to the company's shareholders. On the other hand, corporate bonds, accounts payable, and borrowings are called borrowed capital financing.[1]

In Japan during the High Economic Growth Period, commodity prices went up violently. Japanese businesses were constantly in a state of excessive investment and insufficient real depreciation reserves. They were eager to enlarge their market shares and introduce new technologies. All of these factors contributed to their heavy dependence upon external financing. By categories, the ratio of

financing by stock issue was small, whereas that of borrowed capital was very great.[2]

The method of external financing can additionally be separated into direct and indirect financing. The former involves direct issuance of shares and bonds by a firm; in the latter a financial institution stands between the supplier of funds and the borrower.[3]

Japanese corporations depend heavily on indirect financing, mostly bank loans. This method accounts for about 80 percent of total financing. Most countries would consider this practice extremely dangerous and unthinkable. In the West it is generally assumed that when a company reaches 80 percent in its capital structure, it is on the verge of bankruptcy. However, Japanese corporations have held this structure for 20 years and have remained successful. (See Figures 2 and 3).

The percent of equity finance of Japanese corporations is therefore extremely low compared with European and United States companies in all industries. For example, the leading domestically owned petroleum company, Idemitsu, has a debt-to-equity ratio of about eleven to one. Debt ratios such as the former mean that Japanese companies need not finance their growth out of retained earnings. Once they earn enough to cover the interest on their debt, there is little financial constraint on growth.[4]

In the United States, business firms rely on retained

TYPICAL CAPITAL STRUCTURE OF

A JAPANESE CORPORATION

		Percentage	
Liabilities			80
Current Liabilities		55	
Accounts Payable	20		
Short-term borrowing	15		
Others	20		
Fixed Liabilities		25	
Long-term borrowing	15		
Bonds	5		
Others	5		
Net Worth			20
Paid-in Capital		10	
Capital Surplus		2	
Earned Surplus		8	

Figure 2

Source: Robert Ballon, Iwao Tomita, and Hajime Usami, Financial Reporting In Japan (Tokyo: Kodansha International Ltd., 1976). pp. 65-66.

SOURCES OF CORPORATE FUNDS
(percentage)

	1935	1950	1960	1970	1972	1973
External sources	48.4	60.0	57.1	51.3	59.2	60.2
Stocks	32.9	3.7	9.2	4.1	3.4	3.2
Bonds	1.0	5.1	3.0	1.5	1.1	2.2
Loans and Discounts	14.4	51.2	44.9	45.8	54.7	54.8
(Banking Accounts)	7.3	34.2	25.9	20.8	31.1	21.6
Internal sources	51.6	40.0	42.9	48.7	40.8	39.8
Depreciation	37.5	17.5	24.3	29.5	27.8	32.3
Retained Profits	14.1	22.5	18.6	19.2	13.0	7.5

Figure 3

Source: Robert Ballon, Iwao Tomita, and Hajime Usami, Financial Reporting In Japan (Tokyo: Kodansha International Ltd., 1976), pp. 70-71.

earnings and depreciation reserves for about 70 percent of the funds they require. In West Germany, the corresponding figure is about 50 percent. Japanese firms, on the other hand, secure between 70 and 80 percent of their funds from outside sources.[5]

To understand Japan's unique financial structure, one must first understand the modern zaibatsu combines. Political decisions at the highest level, foreign investment, loan capital, military contracts, information, personnel--all tend to flow along the channels controlled by the major financial-industrial groups that dominate Japanese life. These groups represent an unprecedented concentration of economic power in Japan, exceeding that of the zaibatsu at the close of World War II.[6]

Unlike the old zaibatsu, which dominated the prewar economic scene under a system of highly centralized family control through holding companies, the new postwar big business structure is composed of enterprise groups. These groups are of two kinds: those organized around the former zaibatsu and using the old names (Mitsubishi with thirty-eight separate corporations and a research institute; Mitsui with twenty-two corporations; Sumitomo with fifteen corporations), and those held together by large banks (Fuji, Dai-Ichi, and the Industrial Bank of Japan.)[7]

These postwar zaibatsu groups, known as keiretsu, cannot be described in American business terms. They are not

really monopolies since they strongly compete with each other and no one group completely dominates a given field. Actually they are horizontal groups of companies, each group containing many varied industries as well as a bank, a trust company, insurance companies, trade companies, and a real estate company. Member companies tend to cooperate with other companies outside the group. When entering new fields such as atomic energy or petrochemicals, where investment requirements are beyond the capability of any one company in the group, several or most members will combine to finance the venture jointly. Within each group, the bank is the primary source of financial support.[8]

Being supported by a bank is advantageous to a corporation. The company's capacity to think in long-range terms is made possible in part by its relatively greater reliance on bank loans than on the sale of securities to meet their capital requirements. Since stock accounts for less than one-sixth of a company's capital needs compared to one-half in the United States, stockholders lack power to pressure companies to show a profit each year, and banks are as interested in a company's long-range growth as the company itself. When companies are able to pay interest, the banks want to continue to lend them money for banks are as dependent on quality companies to lend to as companies are dependent on the banks for borrowing.[9]

According to Takashi Toyoda, manager of the Foreign

Business Department of the Kumamoto Sogo Bank, the company and the bank have a friendly relationship. He said, "It is our great pleasure for our customer to have prosperity because we can share the prosperity. Sometimes we help the company and teach the best ways to run the company."[10] He added that after workers retire from the bank, they may go to work at a company financed by the bank. Before they retire, they work at the financed company and learn the job for two or three years, then retire at the bank and work at the company. Upper division bank employees can obtain a high position at enterprises.

Another advantage of being backed by a bank unfolds when a business encounters economic difficulty. The business does not face as great of danger of bankruptcy because, before this happens, the bank will send a financial manager or team to the corporation.

For example, in 1975, Sumitomo Metal had been selling sheet steel to Toyo Kogyo, a member of the Sumitomo keiretsu, on concessional terms for a year. Toyo Kogyo, the producer of Mazda automobiles, was struggling to stay afloat. Normally the auto maker would have to pay within 120 days, but in early 1974 it was allowed 210 days, and this later increased to 230 days. The two Sumitomo banks helped out with $76 million in loans in November 1974 and $51 million more in January 1975. Sumitomo Bank even converted its fleet of nearly 1500 cars to Mazdas and encouraged other

Sumitomo companies to follow suit. "Toyo Kogyo cannot fail because Sumitomo stands behind it," says Shozo Hotta, the chairman of Sumitomo Bank and elder statesman for the whole keiretsu.[11]

In Japan, the banks themselves never go bankrupt because they are backed by the government. The Ministry of Finance supervises the Bank of Japan, which in turn lends money to the 12 largest commercial banks that are a primary source of corporate funds. Although the companies may have large debts to banks, the Bank of Japan, backed by the Finance Ministry, stands behind the banks that lend to the companies. This is done because virtually all major companies are considered important to the economy as a whole.

The Ministry of Finance also regulates stocks and insurance companies, and it has taken measures to ensure that most of the capital for major companies comes from banks rather than investors. This is done because it is easier for the finance ministry to control the fluctuating stock market.[12]

The commercial banks are aggressive lenders with almost 100 percent of their deposits out on loan. This makes them extremely dependent for funds on the central bank. In addition to employing the usual monetary tools (discount rates, open-market operations, and reserve requirements), the Bank of Japan determines the availability of funds for commercial bank loans by imposing penalty rates on borrowings in excess

of certain limits by individual banks.

The central bank essentially stands as guarantor to the commercial banks and thus ultimately to the borrowing corporations. By channelling funds through the commercial banks to specific companies, the Bank of Japan can save companies that are in trouble or can put them out of business. No major company's loan is likely to be recalled unless the central bank wants it recalled.[13]

Japan's financial system has been highly effective in channelling savings from households through the banking sector to provide sufficient funds for the massive rates of economic expansion which have been experienced during the post-war period. At the individual level, tax incentives and the apparent riskiness of equity investments have resulted in a trend toward putting an increasing percentage of monetary assets into bank time deposits, even though rates of return after discounting for inflation have been very low. At the firm level, two factors--(1) demands for expansion to maintain or increase market share, and (2) the high aftertax costs inherent in selling equity shares at a fixed par value with a constant percentage dividend--have made it disadvantageous for Japanese firms to finance through sale of equity.[14]

Specifically, it was more convenient to obtain loans for project financing than to obtain this financing from stocks or debentures. It was also cheaper in the sense that interest burdens generated by borrowings and bond flotations

can be computed as expense under the Japanese tax law. On the other hand, the usual method of stock issues was at face value, and a large amount of corporate profits flowed out of the company in the form of dividends that are not regarded as expenses under the tax law.[15]

The operation of the stock market, as it developed after World War II, considerably reduced the attractivenss of equity financing. Japanese investors expected a relatively fixed cash dividend yield of 10-20 percent of par value, in addition to rights offering at par value.[16]

According to Dr. Shozo Ichimura, a professor of Business Economics at Kyushu University, equity is also difficult because people want to save. "The level of living standard is low and the people have not so much money so they want to deposit their money because deposited money is safer than equity money."[17]

In a sense, the individual who makes deposits at a bank entrusts them to investment specialists (the bankers) and therefore takes a very conservative risk.

> His risk is comparable to that of an investment in capital stock with two exceptions: one, returns on investment take the form of fixed interest rather than the fixed dividend prevalent in the stock market, and two, he enjoys the lesser risk of bank closure over corporate bankruptcy.[18]

The Japanese people have shown a remarkable and steadily rising propensity to save, even under the adverse economic

conditions of the early postwar years and during the subsequent period of a huge increase in consumer spending. Saving rates were two or three times higher than in the West and during the 1960s came close to 40 percent of GNP. Corporations reinvested the vast bulk of their profits and even urban workers saved about 20 percent of their disposable income, which is a far higher rate than in any Western country. In part this may be attributed to traditional frugality, but it is also linked to the system. Low retirement pay and social security benefits necessitate lifelong saving in preparation for retirement, and wages are paid in a way that makes saving particularly easy. Around 20 to 30 percent of total wages and salaries comes in the form of a special bonus payments at New Year's and midsummer. Since these are additional to the regular monthly or weekly payments in which the family is accustomed to live, they can easily be put away in savings.[19] (See Figures 4 and 5).

The banks were very anxious to finance the rapid expansion of the industrial sector. They were the link between savers and investors--the corporate business sector as the principal investor, and the personal sector as the principal saver.[20]

During Japan's period of high economic growth, enterprises did not find it difficult to bear large interest burdens since it was usually possible for them to obtain larger amounts of profits by using the borrowed money to

INTERNATIONAL COMPARISON OF

PERSONAL SAVINGS LEVELS

	1960	1970	1975
Japan	17.3	20.0	24.9
USA	4.9	8.2	8.5
UK	4.7	5.6	10.0
West Germany	14.9	16.6	14.5
France	9.7	16.9	17.7
South Korea	1.3	4.5	5.0

Figure 4

Source: Yutaka Kosai and Yoshitoki Ogino, The Contemporary Japanese Economy (Armonk: M. E. Sharpe, Inc., 1984), p. 12.

SOURCES OF SAVINGS

(Unit--thousand billion yen)	1955	1960	1965	1970	1975
Personal Savings	0.9	1.9	3.8	9.6	27.4
Corporate R.E.	0.2	1.0	1.0	4.8	3.0
Government Savings	0.4	1.2	2.0	5.6	2.8
Depreciation Provisions	0.8	1.7	4.2	9.9	18.5
External Surplus	0.1	0.0	0.4	0.8	0.0

Figure 5

Source: Yutaka Kosai and Yoshitaro Ogino, The Contemporary Japanese Economy (Armonk: M. E. Sharpe, Inc., 1984), p. 13.

expand business operations. However, now that the Japanese economy is shifting over to a lower growth rate pattern, the attitude of business toward capital investment is becoming more conservative. The next chapter explores the changes Japan is facing in the period of transition to an economy with a stable growth rate.

NOTES

[1]The Tsunet Yano Memorial Society, Nippon: A Charted Survey of Japan (Tokyo: The Kokusei-Sha Corporation, 1983), p. 260.

[2]Ibid.

[3]Ibid., p. 261.

[4]John Livingston, Joe Moore, and Felicia OldFather, eds., Postwar Japan: 1945 to Present (New York: Random House Inc., 1973), pp. 429-430.

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CHAPTER THREE

THE TRANSITION TO AN ECONOMY WITH A STABLE RATE OF GROWTH: CAUSES AND EFFECTS

> During the 1960's the Japanese economy was still in the process of trying to catch up with the economic level of advanced Western countries, achieving a fast growth on the strength of active equipment investments made by enterprises pivoting round technological innovation and positive fund-supplying activities of financial institutions. With the turn of the 1970's however, the world economy entered a period of stagflation following successive outbreak of uncertainties of the international currency system, the oil shock of 1973, and other events. The Japanese economy also entered a phase of transition from a period of fast growth to an era of stable growth.[1]

The above development had a large impact on the financial aspect of the Japanese economy. There have been remarkable changes in the financial structure, although it continues to be based on the fundamental characteristics described in the preceding chapter.

Of all the world's great economies, none seems better equipped to weather a capital crises than Japan, where more than one-third of its gross domestic product is plowed back into capital formation. But even Japan felt the squeeze: Inflation-fed capital demand piled up, while corporations adjusted to lower profits, a markedly smaller return on

investment, and slower growth.[2]

After the oiru shokku [oil shock] of the early 70's, services actually shrank by two percent in 1974, in contrast with an average ten percent annual growth rate in the 1960s and 1970s.[3] (See Figure 6).

The shift to a slower pace is bringing about farreaching transformations in Japanese businss, society, and politics. The Japanese financial system, as viewed by critics, is in jeopardy as the growth rate declines. The system of heavy bank "overloans" to companies worked fine during the period of rapid growth. But now the top-heavy debt loads of Japanese companies have become dangerous since interest payments, unlike dividends, cannot be suspended without crippling the whole financial system.[4]

The new trends in the financial structure include: 1) changes in the flow of funds, 2) progress of internationalization, 3) reorganization of the stock markets, 4) reliance on internal funds, and 5) intensified competition among financial institutions.

Changes in the Flow of Funds

In the past the corporate businss sector has accounted for an overwhelming part of the needs for funds. In the second half of the 1970s, however, fund needs from the corporate businss sector declined, while those of the public sector increased rapidly. In recent years, the latter has come to exceed the former substantially.[5]

TRANSITION TO AN ECONOMY WITH A

STABLE RATE OF GROWTH

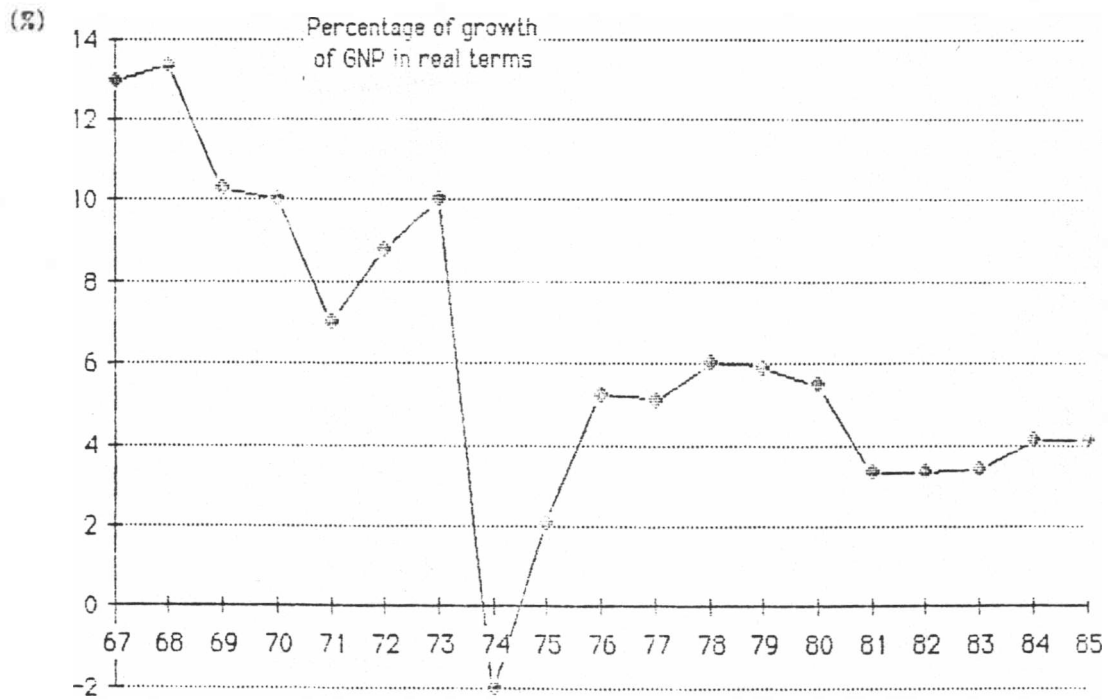

FIGURE 6

Japan's budget deficit is responsible for the growing needs of the public sector. Japan is currently running a govenment deficit that dwarfs the budget deficit of the United States. The government runs a deficit but issues quarterly carloads of government bonds. It then forces financial institutions to buy the bonds at low prices and yields set by the government. The ratio of national bonds to total lendings and securities investments increased from two percent as of the end of March 1970 to 8.5 percent at the end of March 1981.[6]

Fund needs of the personal sector, centered around housing loans, have also increased steadily. The share of lending to individuals of the total lendings of ordinary banks rose from two percent at the end of March 1970 to 12 percent as of the end of March 1981.[7] These other borrowers from the public and personal sector are competing with the corporate business sector for money. (See Figure 7).

Consumer groups, for example, are aggressively and successfully arguing that the individual has been elbowed out of the nation's credit markets by the demands of the great manufacturing and trading companies for too long. They are pointing out that while individuals provide 40 percent of bank deposits, they receive only seven percent of bank credit. Among the pressure tactics that consumer groups are using is a concerted attack on the banks' retail operations. Hundreds of consumers are walking into banks and opening one-yen accounts that overwhelm the bank's

DEMAND AND SUPPLY OF FUNDS

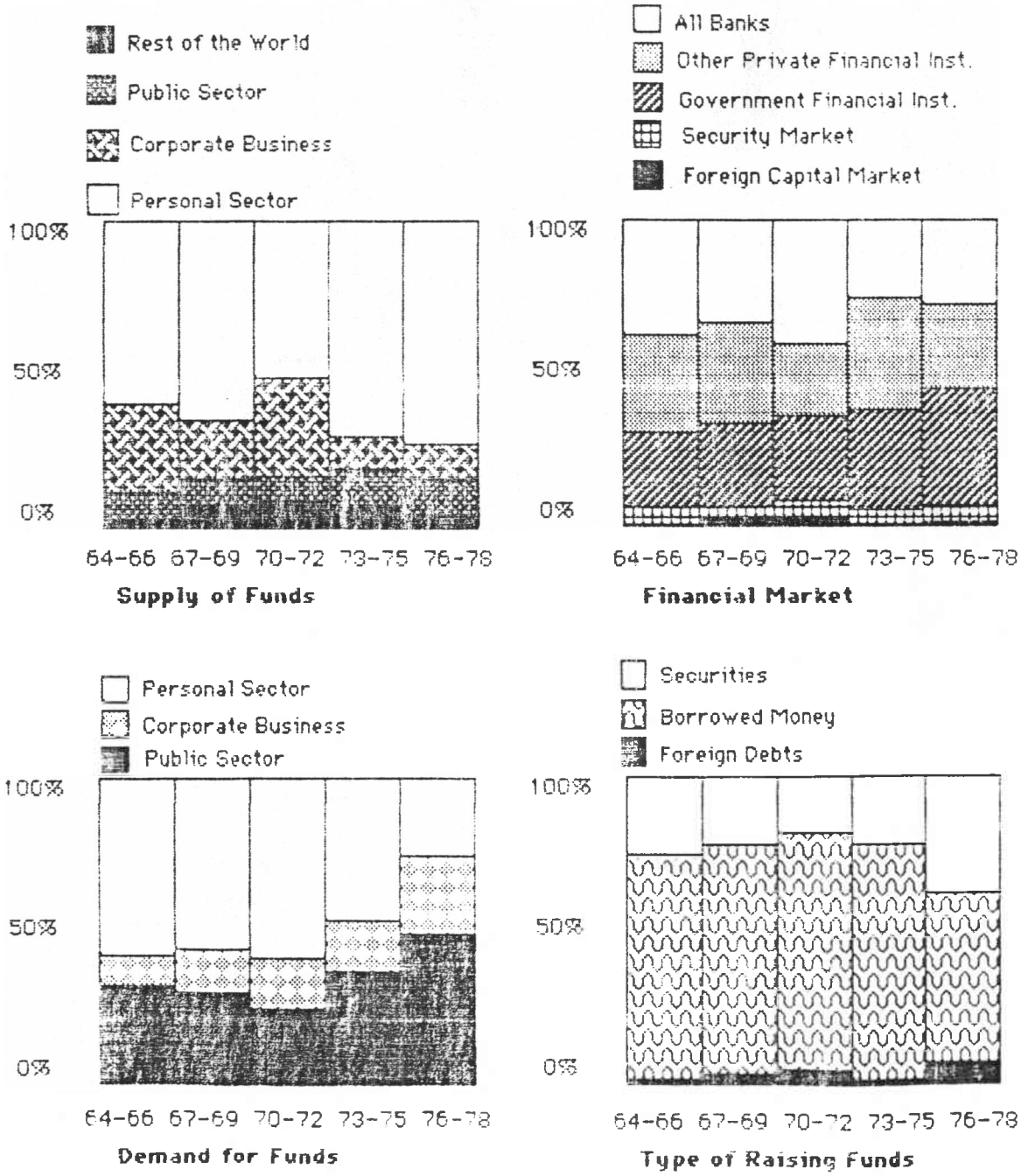

Figure 7

Source: Bank of Japan "Flow of Funds Accounts in Japan," "Economic Statistics Monthly." Cited by Federation of Bankers Associations of Japan, Banking System in Japan, 8th ed. (Tokyo: Federation of Bankers Association, 1982), p. 15.

record-keeping systems. In addition, consumer groups are accusing the trading companies of using increasingly scarce bank credit to hoard commodities and fix prices.[8]

In response, the Finance Ministry has issued new guidelines that prohibit commercial banks from lending more than 20 percent of their capital to any one company. (In some cases, the amount of bank loans to a single big customer has hit 40 percent.[9]) Therefore, as banks are required to respond to the fund needs of various economic sectors, Japanese industry will have to diversify its sources if it is to continue to receive vital injections of money.

Progress of Internationalization

The environment for some industries in Japan has become an increasingly difficult one in recent years. In part this has been a goal of government policy, which has generally aimed at providing incentives for shifting resources into less labor-intensive, more capital-intensive, higher value-added uses. The pressures on the textile industry are a case in point. Rising domestic wages and greater problems in availability of sufficient labor encouraged major textile fiber makers and trading companies heavily involved in the textile industry to begin to invest in Southeast Asia and other low wage areas in the 1960s. These plants have provided intense competition for many segments of the domestic textile industry. Government policy has in effect sanctioned this, and imports have risen very rapidly, from 4.4 percent of domestic demand in 1970 to 16.2 percent in 1973.[10]

(See Figures 8 and 9).

As productivity in the leading export sectors of the economy such as automobiles, shipbuilding, and steel continues to rise at a faster pace than in industries overseas, this also will continue to place pressures on less competitive sectors, particularly labor intensive industries with lower value added.[11]

The major reasons for Japanese firms to invest abroad include the rising cost and declining availability of labor in the domestic market, the need for a stable supply of raw materials (investments develop new sources and thereby assure a stable supply), and international marketing considerations (competitive frictions with other advanced nations may cause protectionism to grow in strength, and in turn investments overseas will be needed to maintain and increase share in overseas markets). Other considerations of varying degrees of importance are the increasingly strict regulations concerning pollution in Japan, the growing pressures against using remaining seaside areas for industrial sites, and growing demands from developing nations for more processing of raw materials in the country of origin.[12]

The implications for Japanese banks are clear. The main growth area in lending in the coming years is likely to be overseas rather than in Japan.

In response to the increasing internationalization of the Japanese economy, Japanese banks have made marked progress in their international operations. The number of

INTERNATIONAL COMPARISON

OF OVERSEAS INVESTMENT

	1967		1974	
	Amount (Billion $)	% of GNP	Amount (Billion $)	% of GNP
Japan	1.5	1.2	12.7	2.8
U. S.	59.5	7.4	118.6	8.5
U. K.	7.5	15.8	32.6	17.1
F. R. Germany	3.0	2.4	15.3	4.0
France	6.0	5.2	11.6	4.2
DAC members	104.2	6.7	226.1	6.7

Figure 8

Source: Ministry of International Trade and Industry, cited by International Business Information Inc., Japanese Corporate Finance 1977-1980 (London: Financial Times Ltd., 1977), p. 135.

PER CAPITA LEVELS OF

OVERSEAS INVESTMENT

(Unit: U.S. Dollars)

Japan(1974)	$115
Japan(1980)	400
U. S.	560
U. K.	582
F. R. Germany	246
France	221
DAC members	350

Figure 9

Source: Ministry of International Trade and Industry, cited by International Business Information Inc., Japanese Corporate Finance 1977-1980 (London: Financial Times Ltd., 1977), p. 135.

overseas branch offices rose sharply from 52 in March 1965, to 159 in March 1981. All of the city banks have branch offices in London and New York, which are leading international financial markets.[13]

In former times, a Japanese bank's international operations centered around trade finance for foreign trade of Japanese enterprises. This was also a period of fund shortages and foreign currency shortages for Japanese banks, which depended on the intake of Eurodollars and borrowings from U.S. banks for fund-raising. However, since 1970, they have conspicuously developed their activities to participate in international syndicates or to lead them as managers. Nowadays they are engaged in diversified activities, ranking equally with firstclass banks of the world. International banking is one of the strategic objectives of Japanese city banks. As of March 1981, the assets held by their overseas branch offices accounted for nearly 16 percent of their total assets. Regional banks and smaller financial institutions are also increasing their foreign exchange transactions in line with the internationalization of enterprises with which they have business transactions.[14]

In addition to their overseas branch offices, Japanese banks have established locally-incorporated subsidiaries in places where they are not allowed to open branch offices or their activities are restricted. They have also participated in international investment banks jointly with other Japanese banks and securities companies.[15]

Japanese banks have no intention of missing the opportunities presented by the overseas movement of Japanese firms. This is clearly evidenced by the increase in bank representation in major financial centers and in areas where Japanese firms either have a major stake or are likely to have one in the future. (See Figure 10).

Reorganization of the Stock Market

The financial crisis brought on by the oil shocks forced Japan to adopt a tight-money policy from 1973 to 1975. This, in turn, dampened the reliance of Japanese corporations on the banking industry.

> The credit squeeze began officially in 1973, when the Bank of Japan raised the discount rate, then at a postwar low of 4.25 percent to five percent. During 1973 alone, it boasted the rate four more times and brought it to nine percent.[16]

The tightness of credit caused the corporations to be more and more concerned about the ability of the banks to stand by them in times of need, or even to be relied upon too exclusively for expansion after the squeeze was over. According to Dr. Shozo Ichimura, "After the oil shock, the Japanese company suffers from high business risk so they avoid high leverage. They issue equity in order to avoid bankruptcy or default."[17]

Many of the reasons behind the lagging development of equity markets in Japan were discussed previously. These included tax incentives and the apparent riskiness of equity investments at the individual level. At the firm level two

OVERSEAS REPRESENTATION

OF JAPANESE BANKS

	Branches	Representative Offices	Subsidiaries & Affiliates
U. S.	38 (18)	12 (9)	12
Canada	--	8	--
Latin America	3 (1)	11	4 (3)
Europe	39 (19)	21	8 (6)
Asia	25 (7)	21	8 (6)
Oceania	--	13	--
Middle East, Africa	--	17	--

Figure 10

Source: Ministry of International Trade and Industry, cited by International Business Information Inc., Japanese Corporate Finance 1977-1980 (London: Financial Times Ltd., 1977), p. 138.

Note: Figures in parentheses are the number of banks having representation. Subsidiaries and affiliates include banking subsidiaries, underwriting companies, merchant banking operations and leasing companies.

factors have made it disadvantageous for Japanese firms to finance through the sale of equity: 1) demands for expansion to maintain or increase market share, and 2) the high after-tax costs inherent in selling equity shares at a fixed par value with a constant percentage dividend.

Another important factor influencing the development of the market is the fear of takeover bids. The Japanese firms have what might be described as a phobia against takeover, particularly by foreign interests. This fear is rooted in the system of permanent employment. The lack of mobility inherent in the system makes it very difficult for the workers and management of a firm to find comparable work opportunities if they should be discharged as a consequence of takeover. For this reason, Japanese firms request their banks and other creditors to hold their shares on a permanent basis.[18]

Another problem has been that companies have not been required to consolidate accounts or engage in extensive disclosure. This has allowed the companies to hide losses or bankruptcies in the operations of its subsidiaries.[19]

As the aforementioned suggests, there is a strong built-in bias in the financial system in favor of bank intermediary financing. Although this has been a prime enabling factor in allocating resources for rapid growth, it has created at least two problems of considerable seriousness. Many corporations have little leeway in their financial service payments because of the high dependence

on debt, and the average individual has been deprived of a better inflation hedge.[20]

The conditions for developing a broad group of individual shareholders are numerous and involve substantial renovation of the financial system and the incentives which it creates. Some of the changing conditions include alteration of incentives for individual stockholders, alteration of corporate incentives, and alteration of incentives in the financial sector.

Several measures are under consideration to increase individual shareholding: more attractive dividend payout, free stock distribution from capital surplus, stock split, use of no-par value shares, preferred stock, and convertible bonds. In April 1975, the Ministry of Finance enforced sweeping new regulations aimed at providing incentives to small investors. These included tax favors, stricter requirements for listing and delisting, and better disclosure.[21]

The key factor in altering incentives which determine corporate financial decisions on raising funds through equity versus other means has been the replacement of offering shares at par value with offering at new market price.

This change has met with some opposition. It is still difficult for the average Japanese shareholder to adapt to the idea that he is entitled to per-share net assets on the balance sheet of the company, and that therefore no premium on stock can be taken away from new shareholders.[22]

Securities companies also are having problems adapting to the new market-price offerings. They appear convinced that, if new shares are offered at market price, the premium should be returned to shareholders in the form of higher dividend rates or stock dividends. The basis for this thinking relies on the argument that the present shareholders expect dividend rate on par and, therefore, the rate should be raised when its basis is changed to market price.[23]

Even though it takes time to change the beliefs of other investors so that they consent to market price offerings, much progress has been made. International pressure has also promoted a change to market price offering; a steadily increasing number of foreign investors do not accept offering at par.[24]

One of the changes which would greatly alter incentives in the financial sector would be a greater role for banks in underwriting equity issues. The assignment of a greater role in underwriting to banks could have the opposite effect from that intended because it would extend the influence of banks over an even wider area. For this reason, specific supervision by monetary authorities and temporary restrictions on portfolio composition might be needed to assure that the expanded role for banks in underwriting did not in fact result in a reduced role for equity finance.[25]

The decline of the stockholder's equity ratio has been steady and virtually uninterrupted since the war. The

economic incentives which lie behind this mode of behavior are completely justifiable when the institutional and economic framework surrounding Japanese companies is taken into consideration. Only when a different set of incentives is created will the stockholder's equity ratio begin to move upward.

Reliance on Internal Funds

As the previous section suggests, there appears to be a possibility for improving the stockholder's equity ratio through increased sale of equity, provided the proper incentives are created. Another possible means of improving the ratio would be through greater funding by means of internally generated cash--that is, through larger depreciation flows, through making more funds available from tax-exempt reserves or through a reduction in corporate taxes.

Reliance on internal funds has increased as a consequence of higher profitability and more liberal provisions for reserves and depreciation over recent years. However, further expansion of use of internal funds seems unlikely. The primary reason for this is rooted in the Japanese business nature: the executives are not motivated by profits--to them a rather theoretical consideration--but by an expanding market share, a vital corporate necessity.

Intensified Competition among Financial Institutions

A characteristic of the Japanese financial system has been the existence of various specialized financial

institutions. In periods like the past era of fast economic growth, when demand for funds expanded rapidly, these specialized financial institutions and ordinary banks nicely complemented one another. Following a decline in fund needs after the Japanese economy entered into a period of stable growth, their competitive relations have come to attract much attention. The trend has been accelerated by the fact that various types of financial institutions expanded their operation into each other's spheres.[26]

> Nineteen eighty-three marked the start of an age of turbulence for the Japanese banking industry. The boundaries separating banks and securities firms were blurred further and even the most optimistic bank executives now admit that it won't be long before they are unable to collect ample deposits at low costs. Banks, as a matter of fact, are now engrossed in developing new and attractive commodities and are beginning to offer "electronic banking" services to both individual and corporate clients by establishing online hookups with these customers. Future historians may well refer to 1983 as Year One of the Great Financial Revolution.[27]

The Banking Law was amended in May 1981 for the first time in 52 years. The amended law was put into action in April 1982 and reflected the changes in the economic and social environment that had taken place in recent years. The amendments included a clear definition of the securities business of banks (responding to the massive flotation of national bonds by the Japanese government), and legal clarification for supervision and control over foreign bank's branch offices operating in Japan.[28]

Due to this revision of the country's Banking Law, in 1983 Japanese banks gained entry into securities business

for the first time. They started marketing, at their counters, newly issued long-term and medium-term government bonds and engaging in dealing operations. In the nine-month period between April and December 1983, the 13 city banks sold a total of 651.3 billion yen long-term and medium-term government bonds.[29]

Banks had for some time been suffering from a slowdown in deposits and had therefore been looking for new commodities to revitalize their static source of fund collection. Government bond-based time deposits provided the first answer.[30]

Banks also came up with a variety of other new commodities and services in their efforts to attract clients. For example, they created subsidiaries to deal in mortgage securities (boasting higher interest rates than regular deposits) and started handling them at bank counters. There are also many banks, especially city banks, which have launched a service in which clients' ordinary deposits are automatically turned into higher-interest time deposits when the deposit amounts exceed certain levels, for maximization of interest revenues for clients. The service is identical in nature to what is known as the "sweep account" in the United States.[31]

Another new and important business Japanese banks started in 1983 is "electronic banking" services for their corporate clients. In this new system, banks and their client corporations are hooked up via on-line devices, so

that the clients can instantly check up on the movements of their accounts, including outstanding balances. Such services actually were started by city banks for their main customers in the spring of 1983 and have been rapidly spreading to regional banks ever since.[32]

The increase in competition and changing financial conditions have caused the Japanese banks to implement reorganization measures. As an example, in January of 1983, the Dai-Ichi Kangyo Bank, Japan's largest bank, implemented a series of reorganization measures to ensure that it stayed ahead of changing financial conditions.

In the 1982-83 annual report of the Dai-Ichi Kangyo Bank, the reorganization measures are attributed to a changed environment:

> The sluggish demand for business funds in Japan brought intensified competition among banks for smaller interest margins. At the same time, the advent of new investment instruments with liberated interest rates has meant even greater competition among financial institutions for the funds available.[33]

In addition, the need for change was increased due to the recent relaxation of regulations that formerly guided Japanese banks and securities houses.

To meet competition among the banks, the Dai-Ichi Kangyo Bank established four new headquarters--the Planning, National, International, and Corporate Banking Headquarters. The purpose of the new Planning Headquarters was to strengthen the planning capabilities by increasing the efficiency of management resources as well as fundraising and banking

operations. One of the major changes introduced by the Planning Headquarters was electronic banking.

The new National Headquarters were to direct the upgrading of services to both individual customers and small to medium-sized enterprises. This included the expansion of both financial and non-financial services such as computerized financial counseling services to entrepreneurs and private individuals. The International Banking Headquarters were established to strengthen every area of international business.

The Corporate Banking Headquarters have the major emphasis now as the corporate sector is showing increasingly weak loan demand and requires more sophisticated financial schemes. In corporate banking, the Dai-Ichi Kangyo Bank is now heading toward a "Relationship Management System" or total financing services for corporate customers.[34]

The other banks of Japan are following the example of reorganization set by the Dai-Ichi Kangyo Bank and implementing similar changes. They are engrossed in developing new and attractive commodities and are beginning to offer electronic banking services to both individual and corporate clients by establishing on-line hookups with these customers. In addition, Japanese banks are placing extra emphasis on international relations.

Despite these changes, many industry sources worry that the business environment surrounding banks will become increasingly severe in the future. They cite the following

two reasons as the basis for their pessimism:

1. Bank deposits are steadily flowing out to loan trusts and other high-interest financial commodities and banks are being forced to raise high-interest funds from the markets of CDs (certificates of deposit), call money, and bills and notes.

2. Inter-bank scrambling for big-time clients is becoming increasingly fierce as such clients are now coming to depend more and more on self-financing, rather than on bank borrowing.[35]

The transformations in the Japanese financial structure are meeting some of the challenges that Japan faces in adjusting to a slower pace. However, the current situation means that the bank system and overall financial structure of the Japanese economy will be forced to continue making changes.

NOTES

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[33]Dai-Ichi Kangyo Bank Ltd. Annual Report: April 1, 1982-March 31,1983. 8th ed. (Tokyo: n.p., 1982). p. 4.

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CHAPTER FOUR

CONCLUSION

There is no doubt that Japan still is and will remain one of the world's leading economic powers. However, Japan's economy is entering a phase of maturity similar to that of older industrial nations. Thus since the 1973 oil crisis, real economic growth has declined to the minimum needed "just to insure the stability of Japanese society"--and to about one-third to one-fourth the levels of the previous "boom decades."[1]

During my two month stay in Japan in 1984, I spoke with numerous professors, businessmen, and bank employees regarding the financial structure of the country. Several indicated a concern for the large amount of debt for which companies are liable. They expressed the view that the Japanese financial system is so deeply ingrained in the society as a whole that it would take many years to change. One professor believed that the financial structure was the result of a strong personal characteristic of the Japanese --trust.

> The small percent of self-finance of Japanese business shows the strength of trust between business and bank. But in western countries, the self-finance percentage shows the weakness of trust in contract society;

> because as long as it is capitalism, there is always a risk to any business.[2]

Another characteristic of the Japanese which contributes to the financial structure of the country is the traditional frugality of the people. The Japanese have a strong tendency to save, and would rather entrust their funds to a bank to earn a steady, although perhaps lower, rate of interest, than take their chances investing in the stock market.

The Japanese firm has two extreme alternatives. One alternative would be to allow the stockholder's equity ratio to continue to decline. This could conceivably work for some firms, taking into consideration the strong relationship between business and banking. However, the majority of the firms would eventually face bankruptcy, given the present economic conditions. Nearly 1500 companies went bankrupt in April 1983, for example, leaving a trail of unpaid debts. During 1982, 17,000 firms bit the dust, including 43 hospitals.[3]

At the other extreme, Japanese firms could pattern their financial structure after a European or American model, lowering the stockholder's equity ratio from 80 percent to 50 or 60 percent. The potential exists for some Japanese firms to improve their stockholder's equity ratio through increased issue of equity at market value, a more active stockholder relations program, improvement of profitability through better allocation of resources within the

firm, and judicious use of the opportunities presented by overseas equity markets.[4] However, rapid movement away from the dependence of debt financing appears unlikely because of the incentives created by the financial system, and the downward effect it might have on growth at a time when Japan is struggling to adjust to a new lower growth rate.

The actual course taken by Japanese firms will probably lie between the two extremes. A characteristic that Japan has been noted for, and that has been used to explain Japan's success, is its ability to take the best from other societies and incorporate these ideas into its own society. This characteristic could lead to the Japanese modifying their financial system, but undoubtedly holding onto parts of their original system, as debt is a valuable tool for growth. The ability of Japanese firms to maintain higher ratios of debt to equity will also give them a considerable advantage in terms of growth potential in the international economy.

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