

“Tragedy of the Nouveau Rich” Encountered by
the Japanese Economy: Based on the Post-War
History of the Financial System

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[The Realities of the “Lost Decade”]

The 1990s, the last decade of the 20th century, is said to be the “lost decade” for the Japanese economy and companies. Among the capitalist countries, Japan consistently achieved relatively high growth for three quarters of the century since the 1910s, except for the period immediately after the defeat in the Second World War. However, as it entered the 1990s, Japan swiftly tumbled to become an underachiever from being an honor student among the leading industrialized nations.

To have an accurate view of the path the Japanese economy is to take in the years ahead, it is essential to accurately figure out what happened during the 1990s when problems emerged in an intense manner. And it is necessary to build an interpretive model with logical consistency that would explain the past and the present of the Japanese economy, going beyond the positive view of Japan after the oil crisis through the 1980s and the negative view of Japan in and after the 1990s.

As is well known, Japan’s economic crisis during the 1990s, dubbed the “lost decade,” was directly attributed to the accumulation of debt from the standpoint of businesses and the accumulation of nonperforming loans from the perspective of banks. These two “accumulations” were brought on by a lack of financial expertise among businesses and a lack of monitoring capability among banks.

During the 1980s, a massive amount of funds flowed into the financial markets in Japan as a result of the widening trade surplus as export surplus gained momentum amid strong international competitiveness among major industries. Under such new circumstances, many businesses started to shift their focus of their financing method to equity financing instead of relying on banks. This shift became evident during the bubble era in the second half of the 1980s, and the term “*zaiteku*” (financial technology) became an important buzz word within Japan’s business circles.

However, a lack of financial expertise hurt many businesses, with many failing in *zaiteku*. The failure of *zaiteku* left many businesses with accumulated debt.

Meanwhile, banks were forced to look for new borrowers on the back of changes in the state of affairs, which were characterized by the flow of funds into the financial markets and businesses getting rid of its dependence on indirect financing. As a result, banks started to provide risky loans using land as collateral without conducting sufficient monitoring. It is a well-known fact that these risky loans resulted in the accumulation of nonperforming loans after the burst of the economic bubble at the beginning of the 1990s.

Given these circumstances, we could say that the crisis that emerged in Japan during the 1990s was caused by the following three factors: (1) excess funds due to a surplus in exports, (2) the lack of financial expertise among businesses, and (3) the lack of monitoring capability among banks. Of these three factors, the first is a relatively new phenomenon in the context of Japan’s economic history. The Japanese economy had been suffering almost consistently from an underlying trend of carrying a trade deficit from the start of industrialization in the Meiji era to the mid-1960s when innovation occurred in

the production system, as mentioned later. To use a metaphor, we could even say that the crisis that occurred in Japan during the 1990s was a “tragedy of the nouveau rich.” The Japanese economy that had been suffering from a lack of funds for many years suddenly came to holding a massive amount of money and was caught in a pitfall while running about in confusion without knowing how to manage it.

[Borrowing-Dependent Corporate Finance and Main Banks]

Here, let us review the developments in overall corporate finance in Japan after the Second World War.

In Japan after the war, long-term one-to-one funding transactions between businesses and banks were prevalent. This refers to the well-known practice of one bank providing the largest loans to the same company, or in other words, individual companies having their main bank.

During the period of strong economic growth, Japanese companies became increasingly dependent on bank lending amid a robust demand for funds. This, in turn, pushed down their shareholder equity ratio. Among all incorporated businesses capitalized at or above 10 million yen in the manufacturing sector, their dependence on bank lending rose from 30% to 38%, while their shareholder equity ratio fell from 30% to 18% between 1960 and 1975. However, when belt-tightening among companies started to take root after the oil crisis, these trends started to reverse. Consequently, the rate of dependence of all incorporated manufacturing businesses (capitalized at or above 10 million yen) on bank lending fell to 24% in 1991, while their shareholder equity ratio bounced back to 33%.

However, what requires attention here is that in the context of international comparison, even at the end of the 1980s, fund-raising by Japanese companies was still heavily dependent on bank lending. And to facilitate such bank-dependent corporate financing, main banks played an important role.

For businesses, the presence of a main bank matters a great deal in terms of securing a large and stable source of funds. Also, we should not forget the fact that a main bank has the impact of strengthening a company’s creditworthiness and can provide a company with an advantage in various types of transactions.

Meanwhile, what is the significance of the main bank for banks? Regarding this point, it has been indicated that “creating a main bank makes it possible for banks to save credit costs by concentrating on monitoring and analyzing functions, and the merits of becoming a main bank include allowing individual banks to increase their monitoring and analyzing capabilities, thereby attaining an advantageous position in terms of taking in deposits.”

[Equity Financing and Banking Reorganization]

Although Japanese companies were highly dependent on bank lending in the context of international comparison during the 1980s, such dependency was weaker than what was seen during the 1960s and 1970s. This lower rate of dependency relative to the 1960s and 1970s reflected the shift in the financing method among businesses; they shifted from being dependent on bank lending toward focusing more on equity financing against the backdrop of a widening trade surplus and the inflow of a massive amount of funds into the Japan’s financial markets. This shift gained momentum during the

period of the economic bubble in the second half of the 1980s and even continued in and after the 1990s on the back of progress in financial deregulation.

The shareholder equity ratio among Japanese manufacturers started to climb in the 1980s and continued to rise in and after the 1990s. Catapulted by this trend, the shareholder equity ratio of Japanese companies as a whole started to show a clear upward trend beginning at the end of the 1990s. The major factor behind the rise in the shareholder equity ratio was the emergence of equity financing, primarily through the issuance of shares, convertible bonds and warrant bonds (bonds with equity warrants).

Changes, such as seen in the inflow of massive funds into the financial markets and businesses breaking away from being dependent on indirect financing, forced banks to look for new borrowers of their funds. As a result, amid the economic bubble, Japanese banks started to provide risky loans using land as collateral without conducting enough monitoring. As is well known, these risky loans resulted in the accumulation of nonperforming loans after the burst of the economic bubble.

The accumulation of nonperforming loans dealt a heavy blow to the management of banks. In 1997 and 1998, Hokkaido Takushoku Bank, the Long-Term Credit Bank of Japan and Nippon Credit Bank, among others, successively went bankrupt, bringing about a situation dubbed the “Heisei Banking Crisis.” Even the six major banks -- namely Mitsubishi Bank, Sanwa Bank, Sumitomo Bank, Mitsui Bank, Fuji Bank and Daiichi Kangyo Bank -- that helped drive the largest lines of credit for the six *keiretsu* groups during the period of strong economic growth were forced to consolidate and reorganize into three mega banks (Mizuho Bank, Sumitomo Mitsui Banking and the Bank of Tokyo-Mitsubishi UFJ) by 2006.

[Revision of the Prevailing Historical View]

The result of the discussions up to now strongly suggests that the essence of the crisis in Japan that emerged during the 1990s was not a crisis of the overall economic system (or the overall corporate system), but a crisis of the financial system (or the corporate finance system). Given that Japan maintained a large current account surplus even during the 1990s (Japan’s trade surplus, which was 10 trillion yen in 1990, widened to 14 trillion yen in 1999, the last year of the decade), we should state that the production system basically remained healthy, while the financial system plunged into crisis mode.

If that is the case, the prevailing notion of lumping Japan’s economic system and corporate systems together and stating that they “succeeded” after the oil crisis through the 1980s but “failed” in and after the 1990s lacks precision. In reality, we should say that the production system continued to “succeed” throughout the phase starting with the oil crisis through the 1980s and the period in and after the 1990s, while the financial system continued to “fail” consistently during the phase starting from the oil crisis through the 1980s and the period in and after the 1990s. Only after introducing an accurate historical view can we build an interpretive model that explains the two phases in a unified and consistent manner.

[Prescription for Financial System Reform]

If the essence of the crisis in Japan that emerged in the 1990s was tantamount to a crisis of the financial system, how should the financial system be reformed?

In this context, it is more important than anything for (1) businesses to acquire expertise on equity financing. Quality companies existed in Japan even after the burst of the economic bubble, and the common thread among these companies was that they gained investor support by implementing appropriate management strategies and successfully executing equity financing. As with these companies, Japan's businesses in general should acquire the expertise to gain support from investors by devising appropriate management strategies, or in other words, acquire expertise in equity financing.

Regarding the question of how the financial system should be reformed, it is also necessary to have an answer prepared for financial institutions and not only for businesses. In this respect, it is important to (2) make progress in financial business reform and establish a two-pillared approach to create (i) universal banks with strong international competitiveness and (ii) prime regional banks with meticulous monitoring capability.

Of the two pillars, universal banks (i) are to meet the demand of large companies for equity financing and also engage in both the securities and the banking businesses. The scope of their activity is to not be limited to the Japanese market but to extend to the global markets. A possible creation of a full-scale universal bank was highly anticipated when the Industrial Bank of Japan (IBJ) announced its plan to form an alliance with Nomura Securities. However, this alliance did not come to fruition because the IBJ chose to become a mega bank by merging with Fuji Bank and Daiichi Kangyo Bank (which resulted in the birth of Mizuho Bank). However, the mega banks that exist today cannot become the base for a universal bank as stated in (i) above because their securities business and international operations are weak. In Japan in and after the 1990s, greater opportunity existed for universal banks to take root against the backdrop of rising demand for equity financing, such as seen in the booming IPO (Initial Public Offering) market. But it was the foreign-affiliated financial institutions that took advantage of this business opportunity. And in fact, a large number of valuable players who were formerly with the IBJ played an active role at these foreign-affiliated financial institutions (the fact that Japanese city banks chose to become a mega bank, instead of a universal bank, could be seen as a reason behind the protracted economic crisis that emerged in Japan in the 1990s).

The major reason why an internationally competitive universal bank has not emerged in Japan stems from waning strength of the banks as a private company after having been protected under the “*gososendan* convoy fleet system” until the mid-1990s. In other words, the need for further deregulation and promoting competition among companies also applies to the financial sector.

Meanwhile, prime regional banks mentioned in (ii) above are those that meet the demand for loans from small companies as well as those who are looking to establish a company. Unlike large companies, even today, financing by small companies is heavily dependent on bank lending. The same dependence is seen among those looking to start a company. To appropriately meet such demand for loans, regional banks need to show meticulous monitoring capabilities by concentrating their operations on a certain region, while exchanging a great amount of information. As such, prime

regional banks, including the 77 Bank in Miyagi Prefecture, The Shizuoka Bank, The Hachijuni Bank in Nagano Prefecture, The Yamaguchi Bank, Higo Bank in Kumamoto Prefecture, and The Kagoshima Bank, could serve as a model for reference. Unlike the case in (i) above, Japan already has a model for quality regional banks as stated in (ii).

The reason behind regional banks not engaging in risky loans like the city banks during the economic bubble can be attributed to the frequency and the quality of information exchanged between banks and businesses being limited to a specific area. There is no doubt that if a regional version of the main bank system is formed by leveraging such strength of prime regional banks at the core, it would make a significant contribution to the revitalization of small companies in Japan.

[Events that Caused the “Main Bank System” Theory to Lose Steam]

In the meantime, there is a common theme between the “main bank system” theory, which was once the rage, and the argument that smooth progress in corporate financing is enabled by an intense relationship between companies and financial institutions over a long period of time. The “main bank system” theory maintained that the system would be effective in realizing the endeavors made by corporations while curbing the adverse effects of insider control as well as saving monitoring costs.

In this context, the “main bank system” theory mainly focused on the relationship between large companies and city banks. However, the relationship between the two has transformed since the 1980s as large companies gradually shifted their focus in fund-raising to equity financing. Large companies reduced their borrowings from city banks, and city banks began focusing on loans to small companies in an attempt to secure new borrowers to replace large companies. However, since an “intense relationship over a long period of time” was not established between city banks and their newly secured small corporate borrowers, information exchange remained insufficient and city banks were unable to fully exert their monitoring capability. With the combined impact of the long post-bubble recession, a considerable portion of city bank loans to small companies was frozen and turned into bad debt. This reinforced a sense of distrust in the monitoring capability of city banks, and rapidly led to the waning influence of the “main bank system” theory. This is the general series of events that caused the theory to lose steam.

[Main Bank System Will Only Function in a Regional Setting]

Does the waning influence of the “main bank system” theory mean that it is impossible to operate a main bank system for small companies? The answer is “No.”

The main bank system did not work effectively during the long post-bubble recession simply because the combination of city banks and small companies was a mismatch. Changing this combination to regional financial institutions (regional banks, shinkin banks, and credit unions, among others) and local small companies would enable the main bank system to operate effectively.

The ability of the main bank system to work effectively depends on whether an intense information exchange takes place between companies and financial institutions and whether monitoring of financial institutions is fully functioning. To realize an intense exchange of information, it is desirable to establish a face-to-face relationship as much as possible. The extent to which this type of

relationship can be established is geographically limited. At the most, it seems that one prefecture is as far as it can go for this type of relationship to work.

It is extremely difficult for a worker at a city bank with nationwide operations to build a face-to-face relationship with the manager of each small company that does business only within a specified local region. On the other hand, for regional banks, shinkin banks and credit unions that operate in a prefecture or a smaller area, it is possible to build such a relationship with small local companies. We could say that the main bank system will function between local financial institutions and small local companies, or in short, it is in regional areas where the main bank system will function.