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MONETARY THEORY AND CHANGES OF FINANCIAL INSTITUTIONS*

TOSHIYA HANAWA

Introduction

The wave of financial deregulations and automation, with the development of globalization, has brought big changes to the financial institutions. In Japan, there is no exception. Japanese financial system has been segmented and divided for the sake of efficiency and safety. The separation between long-term and short-term finances, and the separation between banking and securities companies are its examples. Such a system had been appraised to have been the impetus of Japanese High Growth. But it is necessary to face the change now.

Hicks has written that “monetary theory is less abstract than most economic theory; it cannot avoid a relation to reality, which in other economic theory is sometimes missing. It belongs to monetary history, in a way that economic theory does not always belong to economic history. Indeed it does so in two ways in which need to distinguished.”1 Apparently monetary theory is deeply involved with financial institutions. Keynes is a good example. On the one hand, there was Gold Standard which was old and should be overthrown; on the other hand, the new Investment Markets which should be substantiated. Keynes attacked Gold Standard as a vestige of the past, and changed it to Managed Currency System. Investment Markets were conducted into monetary theory, by Keynes, and became the origin that would produce the new interest theory as liquidity preference.

Keynes' monetary theory has become the standard monetary theory, reflecting well the changing state of financial institutions would never become too abstract to be applied in every countries. From here, considering the monetary theory in our country, that we have accepted it without perceiving the differences in financial institutions in between. In fact, if the financial securitization, deregulations, and globalization can be fully executed here, isn't it the first time that the monetary theory in our country will become identical with that of the advanced countries? Be the case, what should we do to the monetary theory, which has been coping with the financial institutions up to now?

The financial institutions keep changing. When thinking over the destination of the changes, at first, it is necessary to understand fully the theory concerning the financial institutions in the High Growth period. This paper is written from the awareness of the points raised above.

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I. Real Bill Doctrine and Bank

One of the characteristics of Japanese financial institutions is the separation of long-term and short-term finances. The separation depends not on the length of time, but rather on the nature of capital. Namely, the short-term finance means the working capital for enterprises, while the long-term finance the inventory investment capital, that both concern the stable managing principle of banks, expressing the close relationship between banks and capitalistic economy.

In modern capitalistic economy, the money, except the state money as money proper, takes the shape of acknowledgements of debt as bank money, which occupies a predominant weight in transactions. What we mean acknowledgements of debt here is based upon the fact that in the settlements of transactions, bank note is a convenient substitute for money proper. Banks supply bank money, wherewith the principles concerning the banks' activities are required. That is to say, the ones who propose the Currency Principle expect a certain volume of money to be held in gold, while the ones who propose the Banking Principle expect a norm to the banks' activities. The Real Bill Doctrine indicates exactly the above norm. According to it, as long as banks provide the working capital from the discount of commercial bill, the stable management of banks can be sustained; The capital for inventory investment should be provided through savings, which come from the results of general economic activities, and should not be supplied from credit creation of banks. Of course, banks have to check commercial bill very carefully. In other words, the discount of accommodation bill is not necessarily to be rejected. If well inspected, the stable managing principles of individual bank still can guarantee an appropriate level of money supply at a macro level. It points that the Real Bill Doctrine was considered to be that banks have an automatic self-adjusted mechanism in adequate money supply. It is necessary to distinguish the banks, as suppliers of working capital, from the supply mechanism of the investment for fixed equipment. That was exactly the supporting idea of the separation between short term and long-term finances.

If the Real Bill Doctrine is the principle of behavior for commercial banks, then the raising and investment of inventory capital have to resort to the investment banks. But such investment banks as American investment banks, and British merchant banks, should be thought as securities firms, which execute the underwriting, recruitment, purchasing, and selling of negotiable securities, rather than as banks. The long-term financial institutions, such as Long Term Credit Banks in Japan, are purely Japanese-style ones. The European Continental universal banks execute both banking and securities business; while the British-American style does not allow that, yet even it does not have the long-term financial institutions like Long Term Credit Banks in Japan either. In Europe or in the U.S., the raising and investment of inventory investment capital are financed through the security

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3 Hanawa, T., Money and Monetary Economy, Toyokeizai, 1980.
4 Higuchi, G., Theory of Banking, Toyokeizai, 1963.
market. The intermediary activities by long-term financial institutions, like in Japan, are never to be considered. Well, it might have been a historical result, that does not mean anything inefficient. We will discuss it later. Here let us make some more consideration into the separating principles of long-term and short-term finances, which are based upon the Real Bill Doctrine.

The separating principles of long-term and short-term finances are regarded as thoughts from the classical school that were criticized by Keynes. Namely, the short-term finance, as supply of transactionary money, is the money supply which bases upon the holdings of gold and the credit creation from discount of commercial bill, while the banks are considered to get involved in these affairs. In contrast, the long-term finance is to supply the inventory investment capital from savings. As to the ways of financing in primary finance or secondary finance is not important in essence. What is important, is to use savings as the capital of investment, that we may call it Savings-oriented theory. In terms of principles of separation, if the capital of inventory investment is to be covered by credit creation money, it might cause inflation. In order to keep the stability and growth of economy, the investment for fixed equipment needs to come from saving funds, not from credit creation money.

Keynes attacked the classical theories, and asserted the theory Effective Demand. Frankly we may call it Investment-oriented theory. According to it, the investment is considered to be the impetus of economic development, when decided, that the savings have not been constituted. Thus the investment for fixed equipment could not be financed by saving funds. Saving funds are considered to come from the national incomes, which are constituted after the investment has been executed. So at the time of proceeding investment, the investment for fixed equipment has to depend on credit creation from banks, rather than from saving funds. This is exactly a criticism to the separating principles of long-term and short-term finances described above, for the commercial banks are assumed to be responsible for supply of long-term finance, too. Of course, we do not mean here to deny the possibility of capital raising for individual enterprise. Borrowings from others, issuing of corporate bonds, and utilization of self-reserved profits are possible selections for enterprises. But, at a macro level, they do not mean a big deal. Keynes claimed here that only the borrowings from banks' credit creation money should be counted.

Well, in the beginning, the enterprises borrow from banks to proceed investments, along with investments coming national incomes, which bring about savings. It is necessary to return the short-term borrowing, borrowed from banks at first, back to banks by way of issuing corporate bonds to absorb the long-term savings. Whether it can be functioned smoothly or not is an important topic in Investment-Savings relationship. How to cope with the behavior of banks’ money supply and the propensity for holding money (or in contrary, the propensity for holding bonds) is really conceived to be the core subject in finance. Then, such opinion could not be unrelated to the changes of financial institutions, namely the growth of investment system. We shall think it over in the second section.

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6 Hanawa, T., Money and Monetary Economy, Chap. 2, 1980.
II. Development of Investment Markets and Theory of Interest Rate Determination

"With the separation between ownership and management which prevails today and with the development of organised investment markets, a new factor of great importance has entered in, which sometimes facilitates investment but sometimes adds greatly to the instability of the system." The 'stabilized' investment to the society in total are made through the organization of investment markets that enables the buying and selling of securities smoothly 'liquid' investment possible to individual. But such investment markets, which emphasize 'liquidity,' make the speculators appear at the same time, disturbing the sound investment based upon the forecasting of expected return in the long run, that has been claimed to destabilize the economic system.

"If I may be allowed to appropriate the term speculation for the activity of forecasting the psychology of the market, and the term enterprise for the activity of forecasting the prospective yield of assets over their whole life, it is by no means always the case that speculation predominates over enterprise. As the organisation of investment markets improves, the risk of the predominance of speculation does, however, increase." That's why in the U.S., the danger is more perceived than that in Britain, for the investment markets in States are much more developed.

"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirl-pool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done." Keynes worried about the instability of the economic system. In "The General Theory of Employment, Inretest and Money," the decision of interest rate was considered to be so important that it mentioned investment markets, which were thought uppermost to be the bond market. In bond market, the perpetual bond takes a leading part, that the interest rate system could be said to be decided by difference of credit to the perpetual bond.

The financial deregulations now give a strong impact to the development of markets, that effects of speculation advance in an global scale.

Well, Keynes distinguished investors into conventional investors and speculative ones. In development of financial markets, compared to the leading existence of speculators, the responsibility of conventional investors is extremely important. That is to say, the development of financial markets has made reappraisal of investment possible at any time, which surely does not mean we have to concern ourselves any time, but rather depend on our conventional habit to decide. "The essence of this convention lies in assuming that the existing state of affairs will continue indefinitely, except in so far as we have specific reasons to expect a change. This does not mean that we really believe that the existing

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8 Keynes, J.M., ibid., pp. 158-159.
Keynes, J.M., ibid., p. 159.
state affairs will continue indefinitely." Thus unsatisfactory concentration can be said to explain well investment of securities today. The conventional investors combine their portfolio, which can be changed according to different situations.

Confronted with the conventional investors who depend on their inertia convention, the speculators might have been expected to seduce the former by their excellent judgements and skills. Yet what the latter concerns is not the long-term forecasting of return on investments, but rather being able to forecast the changes of conventional appraisal one step earlier than the others. Namely, "the social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future. The actual, private object of the most skilled investment today is to beat the gun," as the Americans so well express it, to outwit the crowd, and to pass the bad, or depreciating, half-crown to the other fellow." So it is important here that the speculators do not even require gulls amongst the public to feed the maws of the professional; the battle can be played by professionals amongst themselves.

Then let us consider the situation, concerning the critical rate of interest, of being bullish or bearish. The bullish speculators will prefer bonds to money. In contrary, the bearish ones will do the opposite. It is reasonable to postulate the dispersion of speculators' expectations as a normal distribution. To take the investors into consideration in total, when interest rate is high, the demand for monetary assets is weak, and when interest rate is low, the demand for monetary assets is strong. Thus in a certain level of interest rate, the assets

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10 Keynes, J.M., ibid., p. 152.
11 Keynes, J.M., ibid., 152-153.
12 Keynes, J.M., ibid., p. 155.
will all be held in the state of money. It is the "liquidity trap." In this situation, the total asset (W) is composed of money (M) and bond (B). W is the perpendicular line. W/i means, with the rise of interest rate (i), the line of W/i will become right-downward.

Even if interest rate is determined by demand and supply for monetary assets, at such interest rate, it is very important to take account of capital gains and losses. For the investors anticipate capital gains to buy, instead of income gains. We believe here in the determination of interest rate will reveal the meaning of the development of securities markets. Though in the U.S. and Britain the bond market has been well developed from 1930's, in Japan it was not developed until recently, with the large issue of government bond. Consequently, the disruptions of interest rate by the investors happen in the recent years. The old system of interest rates is preferrably considered to be ordered.

We may call the determination of interest rate as a direct finance type, while the specific type of High Growth period in Japan is called indirect finance type, that we will check in next section.

III. Method of Interest Rate's Decision in Secondary-finance

In Japan, the securities market is different from that of Europe or America. Especially the bond market is not mature. In consequence, the raisings and management of capital by way of issuing bonds were not emphasized. In substitute, the groups of banks are considered. The problem is the method of interest rate's determination at that time.

In the field of Keynes' direct-finance, the portfolio selection and money supply of banks were important factors. Above all the liquidity preference or bond preference of investors is important. Well in the field of secondary-finance, it is possible to consider two investment objects. One is demand deposit, the other is time deposit, which we may call the latter bank debenture bond. Namely, corresponding to bond in direct-finance, in indirect-finance it is time deposits of banks. From the perspective of investors, in direct-finance, the holding of bond will incur capital gains or losses while in indirect-finance, such kind of risk does not exist. Then who will be the risk-takers in indirect-finance as those in direct-finance.

In indirect-finance, on one hand there is the last enterprise unit, on the other hand there is the last household unit, and in between there is the bank (or financial institution). In the raisings and management of capital concerning Savings-and-Investment, it is functioned through the bank, which has the ability of asset convertibility that transfers the primary securities, like corporate bond, issued by enterprise, into indirect securities (deposit money and time deposit). Now we take it as granted, here we want to emphasize that in the way of indirect-finance, the bank, as a new existence, bears the risk that is carried by investors in direct-finance. As in direct-finance the interest rate is thought of as the current rate of return that includes capital gains and losses, the lending interest rate must be considered as the expected lending interest rate as well.

The expected lending interest rate is analyzed as followings. Suppose an enterprise decides to invest, due to the fact that the route of direct financing is closed, it has nothing but to rely on borrowings from the bank.

L: Lending by bank

a: A certain part of L to be kept in time deposit, requested by bank as risk guarantee
Demand deposit, the borrowed funds has to be kept in the form of demand deposit, and has no interest

- **i₀**: Interest rate of time deposits
- **i₁**: Interest rate of lending
- **γ**: Expected rate of default, which decreases only returns on lending
- **γB**: Effective interest rate of lending
- **γF**: Effective interest rate of borrowing

From above, we may get

\[
\begin{align*}
\gamma B &= i_L - i_D - r(1 - a)D/L \\
&= i_L - i_D - r + r\alpha \\
&= i_L - r + (r - i_D)\alpha
\end{align*}
\]

\[
\Rightarrow \frac{d(\gamma B)}{d\alpha} = r - i_D \geq 0
\]

Then, the effective interest rate of borrowing (**γF**) is as follows.

\[
\begin{align*}
\gamma F &= \frac{i_L - ai_D D}{L - aD} \\
&= \frac{i_L - ai_D}{1 - a}
\end{align*}
\]

\[
\Rightarrow \frac{d(\gamma F)}{d\alpha} = \frac{i_L - i_D}{(1 - a)^2} > 0
\]

Then, the increase of **α** will make the increase of **γB** as long as **γ > iD**, and **γF** will increase as long as **iL > iD**.

The bank will consider to change, according to the economic situation and credit level of enterprise. Under such indirect-finance, it is not investors, but bank, which is thought of carrying risk.

Now we get the representative bank into our idea. But in fact, bank knows how to face different risk. That is to say, there are conventional banks, and speculative banks. The former will take a conservative attitude in financing, putting more weight in controlling the situation; while the latter is always aggressive to act. There are bullish and bearish banks, too. Let's suppose that in a certain critical interest rate of expected lending (call rate), the bank makes it no difference between lending to enterprise and release of call. The bullish banks try to cross over the critical point in interest rate, that they hope to lend rather than to hold the call. In contrary, the bearish banks will do the opposite. Yet
the critical point is different in each bank, that we postulate it to be normally distributed. Hence, taking the society in total, the call holding (releasing) curve is drawn as right-downward curve concerning the effective interest of lending. Usually, such a kind of micro-economic character was not well observed. But in discussing the act of banks, it should be taken as an important focus.

IV. Investment and Speculation of Enterprise

Investment relates to gains of income, while speculation relates to gains of capital. The former being the forecasting activity of expected returns for assets in the consecutive period, limited not only to real assets, but also to monetary assets, that we always call it security investment. The latter being the forecasting activity of market psychology, it certainly will behave bullish, or bearish.

Well, Keynes did not put investment against speculation, but put enterprise against investment. Because investment is related to the investment for fixed equipment of enterprise, speculation is connected only to the phenomenon of security world. Apparently it is just a pattern of phenomenon, yet if limited to it that will be wrong.

For example, now even if we consider the case of business world, we should relate it to the speculative activity. Namely, when the enterprise begins production, it has to get some stock of money, then invests it to get the profits. During the lengthy process of production the business world is incurring outgoings in terms of money—paying out in money for wages and other expenses of production—in the expectation of recouping this outlay by disposing of the product for money at a later date. That is to say, the business world as a whole must always be in a position where it stands to gain by a rise of price and to lose

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by a fall of price. Whether he likes it or not, the technique of production under a regime of money contract forces the business world always to carry a big speculative position; and if it is reluctant to carry this position, the productive process must be slackened, which is considered to be the cause of unemployment.14

Well, it is understandable to distinguish business activity between conventional one and speculative one. The former follows the convention to invest and produce, which it is not necessary to take all the conventional business activities as the same, whereas it is better to consider that they will adjust themselves to the changings. In comparison, the speculative ones are aggressive. In between, there are bullish enterprises, and bearish ones. That is supposed to say that, when an enterprise wants to invest, taking the expected rate of returns as a standard, it makes no difference to it between real asset investment and bond investment in the expected rate of returns. If it estimates it would get expected returns over the critical rate, the enterprise will sell the bond held and do real asset investment. We may call such kind of enterprise as bullish enterprise. To the contrary, if it estimates it would get expected returns below the critical rate, the enterprise will stop real asset investment and hold the bond. We may call such kind of enterprise as bearish enterprise. Naturally the level of critical rate of expected returns differs from each other, here let us postulate it to be normally distributed. Then we can get the bond holding curve of enterprise as a right-downward curve pivoting on rate of expected returns (bond rate).

Now the official discount rate in Japan is 2.5%, showing it is a historical age of low interest rate. However the real asset investment does not increase as expected it should have, because the bond rate is comparatively higher in financial deregulations and globalization. The meaning shows that we are worrying about the same problem as that in Keynes' age. More than the capital gains and loss of bond, the capital gains and losses of real assets are thought to be far larger. In this age of rapid development of internationalization, the small country has no power to decide the level in interest return of bond

**Fig. 5. BULL AND BEAR FRIM**

**Fig. 6. INVESTMENT (II) AND FIRM'S HOLDING OF SECURITIES (SS)**
rate. So it may be said that the U.S. has responsibility to lower that level. But when deregulations of interest rate become intense, fear of inflation will come, thus interest rate in the U.S. could not be lowered down. To Fed, increasing money supply brings inflation, which has a negative impact on economy, so it is difficult to lower the interest rate. Thus isn't it effective the fiscal policy of investment tax reduction? For it can realize the higher rate of expected returns than interest return of bond rate.

V. Characteristics of Japanese Economy in the High-Growth Period

Let us take the High-Growth period as an example to inquire into the characteristics of Japanese financial institutions.

At first, a postulation of the cooperation of individual enterprise and private banks has to be raised. As we have said before, financial institutions of direct-finance, which premise that well-developed investment markets exist, are said to be typical macro-economic ones. In comparison, financial institutions in Japan surmount those in indirect-finance, which means a back-scratching alliance between individual enterprise and private bank. Why we do not use the word “alliance” here is because it has some negative nuance. Instead, we use cooperation to express a cozy relationship between them. In substance, it can be explained as that capital stock and interest rate are kept safely between enterprise and bank. From the stand point of enterprise, in the period of scarcity of capital, not only will capital stock be kept stable, but also will interest rate. That will make investment-decision easy. For example, if a enterprise wants to invest at level of (rate of expected returns minus borrowing interest rate), if borrowing interest rate is stable, it just has to estimate rate of expected returns. On the other hand, to bank, in order to stabilize returns at the time of excess capital, it is necessary to keep an adequate interest rate and to have guarantee of lending quantity. Here it is all right to call it Main-Bank system.

Incidentally, financial deregulations and globalization have begun to dismantle such cooperation. In this way, at the same time when enterprises begin to desert banks, the weight of unregulated rate financial instrument becomes heightened; whereas it can be thought of as beginning of the risk-transfer from banks to enterprises. The more Japanese financial institutions become direct-financed, the trend will tend to be more apparent. The introduction of new short-term prime rate can be said to be exactly the first step.

Secondly, the postulation is the cooperation of private banks and financial authorities. There are lender-banks and borrower-banks, which transact each other in call market. In foreign countries, it is nothing unusual. Here we want to point out that the Japanese characteristics are 1) in total, the banks keep the state of over-loan, while the Bank of Japan stays often dependent on over-borrowing, and 2) the call market is restricted only to inter-bank market.

The first point portrays that the Bank of Japan shoulders the over-loans of private banks, in order to decrease the risk they should incur. In fact, if it exceeds the limit, it should be taxed a high interest rate by the rule of penalty rate. In Europe and the U.S., the responsibility of central bank, as lender of last resort, is so emphasized that a regular dependence does not exist. In Japan, such phenomenon will decrease little by little because it also comes to the stage of excess capital. The inter-bank money market at the second point
has taken the existence of indirect-financial institutions as the necessary premise. With the rapid development of financial deregulation and securitization, the open money market is advancing into the market-type like that of Europe and the U.S., which centers on TB.

Third, the postulation is the cooperation in the private banks. Above all we want to examine here the separation of long-term and short-term finances, a well-considered Japanese financial characteristics. Commercial banks are short-term financial institutions, afraid of burdening too much liquidity risk in long-term lending, that they are forced to keep refrain from management instability. But enterprises need the long-term capital for inventory investment. As the bond market was not well developed yet, long-term credit banks are necessarily established to supply long-term capital. In principle, commercial banks hold the bank debenture bonds, issued by long-term credit banks, which lend the long-term capital to enterprises. Thus, even if the bond market is not fully developed, due to the banks' cooperation described as above, the smooth supply of long-term capital is possible. Now, because of financial deregulations and globalization, the cooperation of private banks began to collapse. On one hand, the homogenization of banking business has come. That is to say, commercial banks began to increase middle-term deposit/lending business besides short-term deposit/lending business; while long-term credit banks began to increase short-term deposit/lending business besides long-term deposit/lending business. On the other hand, influences from foreign financial system are expected to bring pressure to Japan for the sake of reciprocity. In Continental Europe, universal banking permits business of banking and securities to operate together. In the U.S., the two business have to be separated. They both do not have the system of long-term credit banks. Meanwhile, the separation of long-term and short-term finances, if implied as the separation of banking and securities as in Britain and the U.S., would be more easily understood for the fact of conflicts of interest. However in Japan, the separation of commercial banks and long-term credit banks might be difficult to get the international understanding. Nevertheless, it shall be short-sighted to say the fate of long-term credit banks is doomed. In the well-developed securities markets, every sort of financial intermediary takes its active role. Preferably the security company becomes the so-called investment bank. From a world perspective, our long-term credit banks in Japan should be considered as the most developed form of investment bank.

Fourth, the postulation is the cooperation of enterprises and government. In the High-Growth period, our entrepreneurs are said to be full of vigor, which might be explained as a national character. Of course it is ridiculous to take national character as a determined factor, but what else could be a better explanation? The competition among Japanese enterprises is fierce. The investment of every enterprise shows a defensive character as Hicks has said. If A enterprise invests for the cause of increasing productivity, B enterprise will feel forced to join in investment counter to A. If B hesitates to do it, the result will be that B shall lose the competitiveness. Consequently, it will lead to over-supply, as a result of over investment. In foreign countries this phenomenon will happen, yet in Japan it is particular. When over-supply happens, government will interfere in enterprises activities, designate the structurally recessed industries, then solve the problem in a policy mix. As our enterprises take the common steps with government that could decrease the risk, which appeared as extraordinary vigor in foreign countries' eyes. If without government, our enterprises will have to make the decision of whether investing or not by them-
selves, which increases the risk, and there will be no one to help, our extraordinary vigor might be due to weaken. Now we have come into a Low-Growth period, along with the development of financial deregulations and globalization, the self-responsibility should be strengthened. In particular, when influences of globalization becomes stronger, help from government, which was only allowed in less developed countries, might be thought of as a hindrance to business freedom. That’s why we may say it will be impossible to keep the cooperation of enterprises and government together in Japan.

Conclusion

Now the financial institutions in Japan have come to a turning point. The separation principle of long-term and short-term finances can be a good example.

In the first section, based upon theoretical background of the separation of long-term and short-term finances, we have taken Real Bill Doctrine into consideration. Then we connect with the Savings-oriented theory of classical school, which has been criticized by Keynes, to make it clear. In the second section, we examine the meaning of liquidity preference. According to Keynes, with banks’ function of money supply and tension of investment-savings relationship, the developed bond market will produce liquidity preference as the new interest theory. If the conventional investors are passive, the speculative investors will be active. In this way, taking direct-finance as background, liquidity preference could be understood. However, in the High-Growth period, the security markets, above all the bond market was not well developed yet. That’s why in the field of monetary theory, the premise was the method of indirect-finance rather Keynes’ direct finance. Especially it is necessary to consider determination of interest rate, corresponding to liquidity preference, that we have discussed in the third section. In banks, there are conventional ones and speculative ones. As a dynamic factor, the activity of speculative banks has to be emphasized.

In the fourth section, using the same concept to analyze enterprises, there are passive conventional ones and active speculative ones. So the “animal spirit” is exactly anticipated in such speculative activity.

And in the fifth section, we use the concept of “cooperation” to see whether the spirit, which has been kept stimulating by banks and enterprises in the High-Growth period, could be sustained or not.

At last, because of financial deregulations and globalization, the past characteristics begin to get disappearing. The trend moves to direct-finance style. We had better to transform our thinking to that direction as soon as possible.