【Research Note】

# Japanese Finance (2) : Three Key Issues*

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**【Abstract】**

By overviewing Japanese finance in the previous paper (Okabe 2019), three issues have come up particularly important since they are directly related to contemporary Japanese economy. They are (1) corporate finance and governance, (2) extremely easy monetary policy, and (3) goverment finance to fill the big gap between government expenditure and tax revenue. Main points of these issues are discussed and the author's assessment is presented.

Key words: Corporate governance, Quantitative easing monetary policy, Sustainability of fiscal deficits

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## Introduction

What I did in the first lecture (Okabe 2019) was: (1) to present a basic concept or framework to understand what finance is, (2) to provide a big historical picture of Japanese finance, and (3) to summarize the historical development of Japanese finance as a change roughly from “indirect finance” to “direct finance”.

In the second lecture (in this paper), I would like to take up three important issues of Japanese finance which are closely related to important aspects of contemporary Japanese economy itself. They are: (1) corporate finance and governance, (2) financing made easier: recent monetary policy, and (3) absorbing enormous funds by the government: fiscal policy.

## 1. Corporate Finance and Governance

I already pointed out, in the first lecture, that broadly speaking there are two kinds of financing channel for the economy, namely “direct finance” and “indirect finance,” and that the former system characterizes the “Anglo-American finance,” and the latter “Japanese-German finance.” Also did I emphasize that these financing characteristics are not only mutually contrasting but also significantly define the nature of industrial developments in each countries. Both the financial and industrial aspects of the two systems can be summarized and contrasted as in Figure 9.

### Corporate finance, corporate governance, and resulting industries

In the Anglo-American finance model, main financial transaction takes place in the open market, by selling and buying securities for raising and operating funds, respectively. While in the Japanese-German model, transaction is basically bilateral between bank and business corporations, and main financing method is by bank lending (loan). Thus, in the Anglo-American system, dependence on bank is low, and corporations borrow from bank only short-term funds; while in the Japanese-German system, dependence on bank is high, and corporations borrow both short-term and long-term funds from bank. Since dependence on bank is low in the Anglo-American, corporations need to hold high level of internal funds (reserves) for contingency; while in the Japanese-German, the need to hold internal funds is less, since banks stands ready to provide funds.

Figure 9. Two Types of Financial System and Their Properties: Anglo-American Model and Japanese-German Model

| | Anglo-American model | Japanese–German model |
|---|---|---|
| Main financial transaction | In the open market | Bilateral transaction |
| Main funding instrument | Securities | Loan |
| Dependence on banks | Low | High |
| Nature of bank loan | Short-term | Short-term and long-term |
| Importance of internal funds | High | Low |
| Shareholding by banks | Not important | Important |
| Major shareholders | Households<br>Institutional investors | Banks<br>Intercorporate shareholding |
| Block share trading | Frequent | Not frequent |
| Corporate control | Stock market | Banks (main banks) |
| Information processing | Market acquires and distributes diversity of opinion and risk; information cost is low | Intermediaries excel in acquiring less diversified information, and enjoy economies of scale in information acquisition |
| Performance characteristics | More reponsive to change | Superior at implementing corporate policies |
| Suitable economic activity | Developing new industries and new technologies (product innovation) | Improving the production process and efficiency of existing products (process innovation) |
| Industry examples | Railways and computers | Automobiles and electronics |

(Source) Okabe (2002) Table 6.

The shareholding pattern of banks is also contrasting between the two systems, as shown in this Figure 9. And importantly, the different nature of finance has resulted in the difference of how corporations are controlled. In the Anglo-American, the stock market plays a powerful role over the corporate governance. If a corporation is generating only a little profit or making a loss, shareholders readily sell the shares of that corporation and switch to hold shares of other corporations. Thus the decline of the shareprice works to give discipline for efficeint corporate management by giving pressures to a better management, and sometimes by obliging to replace the CEO of the company.

On the other hand, in the Japanese-German system, banks (especially, so-called "main bank"[1] in Japan) have a strong voice to client corporations in two capacities, not only as a lender (creditor) but also often as a shareholder of the corporation (mutual shareholding or cross-shareholding relationship) . This kind of monitoring of the client corporation by bank was usually considered as an important disciplining mechanism in Japan, substituting for the pressure coming from capital markets (Okabe 2007).

Have the two financial systems had any different implications to industries? Yes, it is quite likely so, both on theoretical grounds and as actual developments. First, direct finance (Anglo-American finance model) is conduisive to supply funds to risky project since it collect funds by issuing company shares which are risky assets for the holder, while indirect finace involving a bank (Japanese-German finance model) is suitable for less risky projects. Secondly, in terms of information processing in financing activities, market finance and bank finance have different superiority, as shown in the bottom half of Figure 9.

Thus, Anglo-American model is suitable for developing new industries and new technologies, while Japanese-German model is suited for improving both production prosesses and efficiency of existing products. In short, the former is suitable for "product innovation," as has historically been demonstrated in inventing railways, computers, and biotechnology; while the latter is suitable for "process innovation," as seen in the production of automobiles and electronics, in which Japan and Germany have been champions.

## Increasing the character of Anglo-American financial system

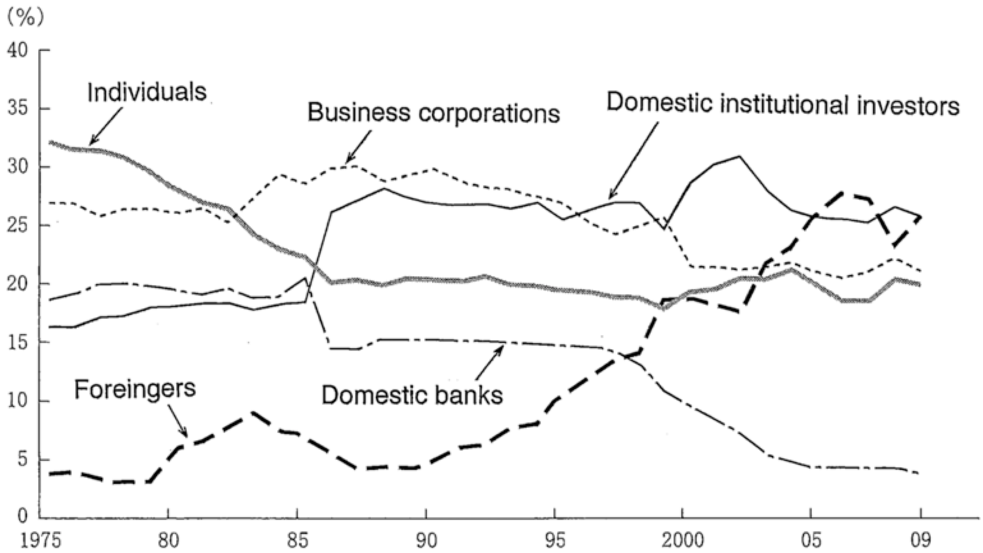
So far, we have distinguished two prototype financial systems and characterized that the Japanese financial system is a contrasting type against the other. But in recent years, it is important to know that the Japanese financial system has been adding the characters of Anglo-American financial system. This is because Japanese corporations now rely increasingly in funding on international capital markets rather

[1] "Main bank" is a bank with which a business corporation maintains a continuous financial transaction, usually by maintaining a borrowing-lending relationship and by cross-shareholding. Typically, Jpanese corporations used to have one or two main banks (Okabe 1999: chapter 1) .

than Japanese banks, due both to financial deregulations and to the interest of overseas investors to hold Japanese shares.

As seen in Figure 10, we observe a remarkably rapid increase of shareholding of Japanese corporations by foreigners. During the period of 1970 through the late 1990's, foreigners holding of shares of Japanese corporations was only 5~10%, but in recent years it has risen rapidly to about 30~32%.

Figure 10. Company Shares Held by Types of Shareholder




(Source) Okabe (2012) Figure 8.

For example, in the case of Toyota Motor Corporation and Nissan Motor Corporation, which are the two biggest Japanese automakers and once used to be typical Japanese corporations, have come to be popular for overseas investors so that the percentage of shares held by foreigners have risen to 22% and 62%, respectively. Thus they are now internationally held global corporation as far as shareholding is concerned. This naturally has resulted for them to place importance on profitability, which was not a main concern when domestic mutual shareholding (cross-shareholding) was prevalent as a symbol to express mutually close relationship.

Thus, the increased shareholding by foreigners seems to influence the behavior of Japanese corporations more, since foreign investors' main objective of shareholding of Japanese corporations is to obtain the profit so that the profit rate (return on equity: ROE) is their main concern. Thus, the movements of stock markets, both domestic and international, seem to have more influence to give behavior discipline to Japanese corporations.

## Conversion to Anglo-American finance and governance system?

Does the above-mentioned trend, triggered by financial globalization, imply that the Japan’s corporate finance and governance system converge to the Anglo-American system? The answer is probably “no.”

Because, it is important to note that the development of any social and economic system reflects the history, the size, and the prevailing culture of a nation. Anglo-American system has been as a system developed for a society of continuous inflow of immigrants of people with heterogeneous cultural backgrounds, and as a system for a relatively large country. So that it has a plenty of strength, such as openness, transparency, and rule-based treatment, which the Japanese system needs to increase more or less in future.

However, the character of the Japanese society and its economic system naturally has different nature from that of UK and US. For instance, the awareness of human network seems to be more important in social and economic life in Japan and implicit mutual agreement seems to be more prevalent. So, in Japan legal procedure and the number of lawyers are far less than in the US[2].

Another reminder is that the financial system that supported Japan’s super-high growth period cannot be obviously imitated or be regarded as an exemplary system in today’s world. In financial and economic system, one size does not fit all. Japan needs to develop its own ingenious system eventually, taking such traditional characteristics of the past in consideration, as cross-shareholding, corporate grouping, and main-bank system.

## Importance of Personal and Organizational Integrity

Finally let me add that in corporate governance, as well as in our daily life, the

[2] Accoding to Ramseyer and Rasmusen (2010) "Are Americans More Litigious? Some Quantitative Evidence", the number of lawyers per 100,000 people in Japan is only 23, whereas 391 in US, and 251 in UK.

concept of "integrity" needs to be understood and be a compass of activities for all the stakeholders of a corporation. How ingenious a system of corporate governance may we install, someone can always find a loophole if one try to do so. In order for any system of governance, for-profit as well as non-profit, to function efficiently to achieve its own mission, integrity is the last resort (Okabe 2017a, 2017b).

Integrity can be understood as to contain three key elements: consistency, morality, and accountability. Consistency means the quality of always behaving in a similar way, in terms of one's belief, value, or action. Morality is the quality of being right, honest, fair, sincere, or acceptable, as is highly praised in most human society. And accountability is a situation in which someone is responsible for things that happen and can give a satisfactory reason for them.

Figure 10a. Significance of Integrity

Integrity ==

- Consistency
- Morality
- Accountability

If these traits are lacking in the behavior of managers or in an organization, the governance of corporation or any system will not achieve its fundamental goals.

## 2. Financing Made Increasingly Easier: Recent Monetary Policy

For anybody in Japan, financing has been made increasingly easier after 1990. I will discuss here why that was the case, and what kind of policy have been implemented by the Bank of Japan, the central bank in Japan, to encounter the deflationary economic situation.

### Deflationary Trend for Nearly 30 Years After 1990

After the burst of the bubble economy in 1990, Japanese economy fell into a sharp recession and has been experiencing deflationary trend for nearly 30 years.

Inflation rates (percentage increase of consumer price index) kept declined and turned negative in many recent years (Figure 11).

Figure 11. Inflation Rates in Japan

(Percentage increase of consumer price; Fiscal year)

| | | |
|---|---|---|
| 1999 | -0. 5 | |
| 2000 | -0. 5 | |
| 2001 | -1. 0 | |
| 2002 | -0. 6 | Average |
| 2003 | -0. 2 | -0. 4 |
| 2004 | -0. 1 | |
| 2005 | -0. 1 | |
| 2006 | 0. 2 | |
| 2007 | 0. 4 | |
| 2008 | 1. 1 | |
| 2009 | -1. 7 | |
| 2010 | -0. 4 | Average |
| 2011 | -0. 1 | -0. 6 |
| 2012 | -0. 3 | |
| 2013 | 0. 9 | |
| 2014 | 2. 9* | *Consumption tax rate |
| 2015 | 0. 2 | raised (5→8%) |
| 2016 | -0. 1 | |
| 2017 | 0. 7 | |

In order to combat against this situation, Bank of Japan has tried to revitalize the economy by loosening monetary policy initially by lowering interest rate levels. The official discount rate was 6.0% in 1990, and has been lowered successively to record 0.1% in 2001. Unfortunately, this policy measure could not stop persistent deflation (Figure 11, as referred above). Thus the Bank introduced "zero-interest rate policy" in 1999 to supply large amount of funds in the market, to invigorate investment activities of businesses. But again, the policy failed to stop continuous decline of the consumer price.

So that the Bank introduced this time an innovative policy called "quantitative easing (QE) monetary policy"[3] starting in 2001. This meant a powerful injection of money into the economy, but did not succeed to reverse the deflationary trend, and the

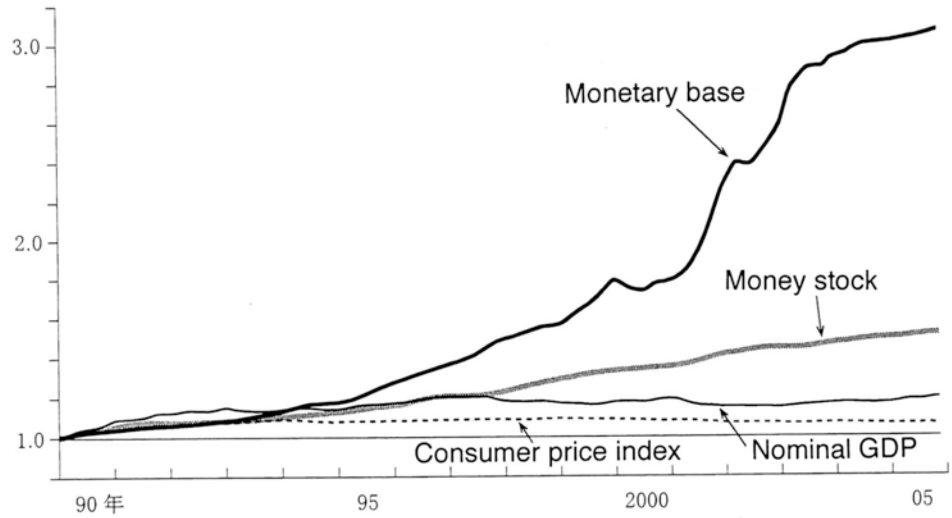
[3] Bank of Japan was the pioniner in the world to introduce this policy, and subsequently this QE policy was also utilized in the US (by the Federal Reserve Board) and in Europe (by the

average inflation rate in 2009-2012 remained a negative -0.6% (see again Figure 11) . The theory behind the QE policy was as follows: Bank of Japan first increases monetary base (base money, or high-powered money) by purchasing government bonds in the market; then it was expected that private banks increase lending aggressively, which should result in the increase in money stock in the economy. So, both nominal GDP and consumer price were expected to rise eventually. Put simply, the supposed mechanism was as follows (so called the quantity theory of money):

Monetary base ⇧ → Money stock ⇧
→ Aggregate demand ⇧ → Price level ⇧

But apparently, the theory did not work as expected, and deflation could not be stopped (Figure 12) .

Figure 12. Levels of Money, Nominal GDP, and Consumer Price
(The level of the first quarter of 1990 = 1)




(Source) Okabe (2012) Figure 13.

## Reasons why Deflation could not be Stopped

Why monetary policy, even with an innovative approach, could not stop the prolonged deflation? Here, let me point out two factors.

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European Central Bank).

First, the resession was so severe and was accordingly required innovative approach or philosophy to economic policy. But the latter was lacking. When the gap between aggregate demand and aggregate supply is large, or when the gap has a “structural” nature, it is not easy to close the gap by simply prescribing a simple Keynesian policy to increase aggragate demand by monetary and fiscal policies. In this case, the gap cannot be easily closed owing to its structural nature, so the deflation continued:

$$\text{Demand} < \text{Supply} \quad \rightarrow \quad \text{Price level} \Downarrow$$

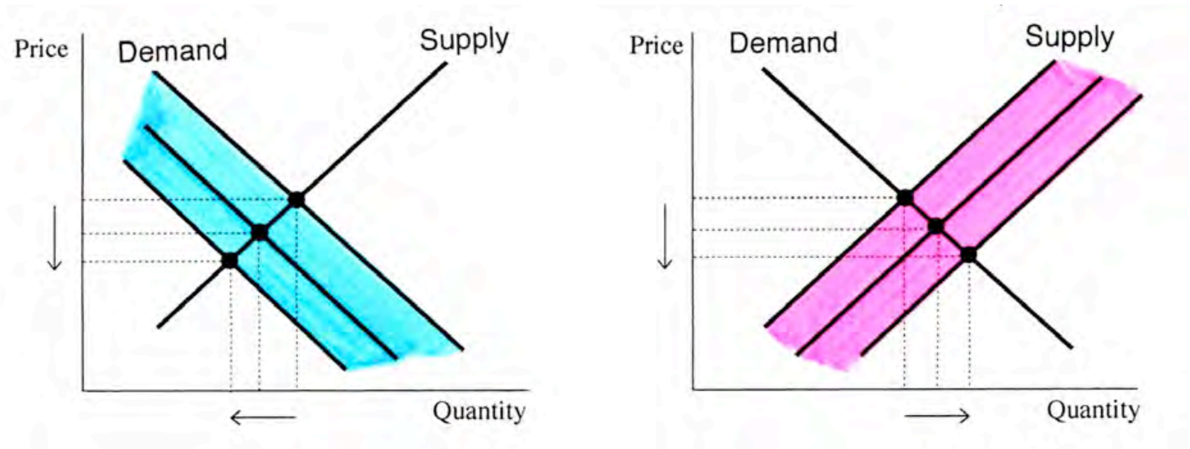
Specifically, after the burst of the buble, the Japanese economy desperately required to change its charactor from “process innovation” economy to “product innovation” economy, but Japan failed to do so. The change in the philosophy of economic policy was critically important, because the Japanse economy could not compete any more in the world where China and other Asian economies were making a big progress in process innovation. If the philosophy of economic policy at that time changed drastically, then the result would have been a surge in new types of investment demand in research and development, in factories, in coporate system. So the demand-supply gap would have been smaller and deflationary pressure would have been less.

Second, there have been factors from supply side to contribute to the decline of the price level. An example is an increase in imports of such cheaper products as fiber products and foodstuff, especially from China. This obviously contributed to the decline of domestic consumer prices. Another example is the technologial advance which cut production cost substantantially and continuously. For example, the price of personal computer has continously declined, thus contributing to the decline of general price level.

Above two factors remind us to conceptually distinguish two types of deflation: bad deflation and “good deflation”. In Figure 13, the case (1) is a bad deflation, because the decline in price level is caused by the downward shift of aggregate demand curve. In this case, output hence income is also likely to fall, and there is a fear of deflationary spiral. In order to stop this vicious circle, there is an urgent need of public policy, both monetary and fiscal policies, to push up the aggregate demand curve in order to reverse bearish business and consumer sentiments.

While case (2) is a "good deflation". This is because consumers can acquire more goods and services for a given income, and also because there is little fear for the income and outout to decline[4]. This corresponds to the second case mentioned above, and the decline of prices of this nature should be welcomed. What is important is that we first need to distinguish the nature (the element) of deflation, and to acess the degree of the "good factor" of the deflation, before policy implementation.

Figure 13. Two Contrasting Cases in the Decline of the Price Level




(Source) Okabe (2015) Figure 13.

We need to note that there is a risky aspect of the extremely easy monetary policy in recent years prevailed in Japan. That is, the powerful injection of monetary base in financial markets by the Bank of Japan was possible by acquiring an enormous amount of government bonds. That is, monetary policy inevitably had a big implication for fiscal policy, to which we now turn.

## 3. Absorbing Enormous Funds: Recent Public Finance

Monetary policy of the Bank of Japan had enormous effects on government finance, visibly and invisibly. Here we first review the trend of the widening gap between government expenditure and tax revenue, then point out that the Japanese government debt outstanding is unusually high among major countries. We then discuss its implication and the future.

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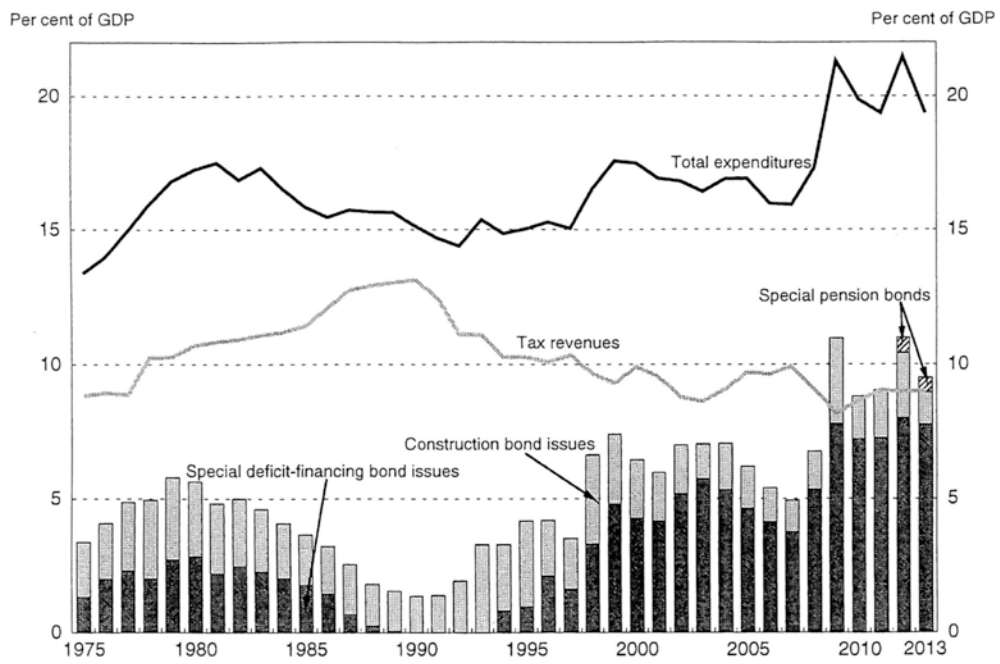
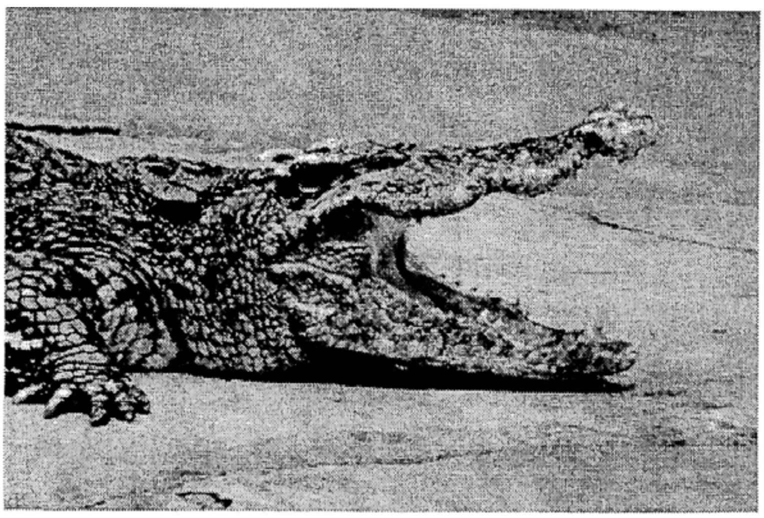
[4] The rightward shift of supply curve might have come for still other reason than this. That is, the strong demand for labor are partly accommodated by the increase of non-regular workers. They are often called "marginal" or peripheral workers, and incude such workers as housewives, young workers, old age workers, or foreign students in Japanse universities,

## Piling up of Government Debts

If we look at government expenditures (as percent of GDP, Figure 14), it is clear that the level has apparently risen after mid-1990s; while tax revenues have clearly shown a declining trend. This means that the gap between government expenditures and tax revenues has continuously widened since 1990 when the bubble burst (above Figure 14). The gap looks like a mouth of a crocodile! (compare two lines in Figure 14 with the picture of the mouth of a crocodile).

**Figure 14. The Gap between Government Expenditure and Tax Revenue: "A Crocodile Phenomenon"**



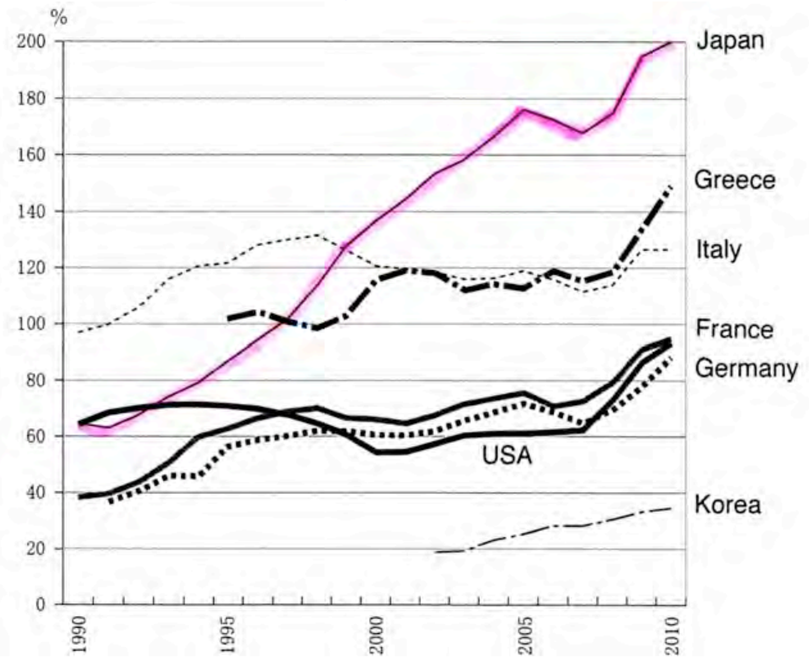



whose wages are far less than regular workers. See Genda (2017: pp. 294-296).

Why has the gap widened? It is basically for two reasons. First, deflation or sluggish economic activity resulted in insufficient tax revenues. Second, and more importantly, "ageing" of the Japanese population has tended to expand government expenditure rapidly, in terms of social insurance payments especially the public pension payments and medical insurance payments.

The point is that this gap has had to be urgently financed by issuing government bonds: to be exact, by issuing the so-called "deficit-financing bond" to finance deficit[5]. The issuing of that kind of bonds has markedly increased after mid-1990s (see the dark bottom bar chart in Figure 14). As a result of increasing issue of government bonds, the government debt of Japan (as percent of GDP) is now more than 200%, and extremely high among major countries (Figure 15). It is actually higher than Greece (around 130%), where in 2009 the window dressing (covering up) of the high level of government deficit triggered a financial and social crisis not only for the country but also for EU and world financial markets.

Figure 15. Government Debt in Selected OECD Countries
(Ratio of Gross government debt to GDP)




(Source) Okabe (2012) Figure 15.

[5] Japanese government has issued basically two kinds of bonds to finace government expenditures: "construction bond" (usually redeemed as a "positive" bond) to finace varioius public works, and "deficit financing bond" (redeemed as a "passive" bond) to finace a general shortage of tax revenues.

Why Japan has not faced a similar tragic situation as Greece? One reason is that, although Japanese banks and citizens kept acquiring bonds in the market to some extent, it has been the Bank of Japan that kept absorbing overwhelming portion of the newly issued government bonds, in order to inject monetary base in the market to implement quantitetive easing (QE) policy. This maight have been a happy coincident with monetary policy. Another factor is that the holders of Japanese government debt, besides the Bank of Japan, is mostly Japanse residents who seem to trust that Japanese government will surely redeem the debt. This is in sharp contrast with the case of Greece, where more than half of her government debt are said to be held by non-residents who suddenly became skeptical that Greek government would not be able to redeem the debt and sold them in the market.

So, the continous accumulation of government debt in Japan apparently involves potentioal risk of fragility. If the Bank of Japan stops to absorb government bonds, or if the trust erodes of Japanese residents in the ability of the government to redeem the debt, then government bonds cannot be absorbed in the market as in the past. And holders of the debt may hasten to sell government bonds for the fear of not beeing redeemed. If that happens, there will be a glut of bonds in the market and the yield of bonds (long term interest rates) will sharply rise which will surely have detrimental effects on the economy.

What we need to know is that the "mouth of a crocodile" must be closed somehow in the long run. It is a cool economic principle throughout history that any people or a nation cannot live beyond the means in the long run, and that if some action is taken against this principle there will be a retaliation of one kind or other, such as hyperinflation to nullify government debt, sudden fall of the nation's currency in international market, or a big social disorder due to the loss in trust in the government (Reinhart and Rogoff 2011).

The planned raising of the consumption tax rate (from 8% to 10%) in October 2019 is one of those steps[6] to rectify the fiscal balance, but there are much more task for the government to improve the fiscal balance.

[6] Consumption taxes in other major contries are quite high: in UK, France, Australia 20%,

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Germany 19%, Sweden 25%.