The Political Economy of Japanese Finance: Its Changing Nature and Implications in the Post-Cold War Era*

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I. Introduction

One of the most important issues in the area of domestic as well as international political economy has been the relationship between finance and industry.(1) This constitutes the core mechanism of various types of capitalist economic development. How does the financial system of a country provide its industrial sector with required capital? What is the role of the state in the process of capital allocation? These two questions have attracted attention from many political economists, economic historians, and developmental theorists since the late 19th century.

Specialists on the political economy of Japan have also discussed the issue of industry-finance relationship in recent decades. Some of them pointed out the particular characteristics of the Japanese financial system

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(1) In the Marxist tradition there has been literature on the dichotomy between finance and industry and the development of finance capital. For example, V. I. Lenin, *Imperialism: The Highest Stage of Capitalism* (New York: International Publisher's Co., Ltd., 1967) and Rudolf Hilferding, *Finance Capital: A Study of the Latest Phase of Capitalist Development*, trans. by Morris Watnick and Sam Gordon (London and Boston: Routledge & Kegan Paul, 1981). It is rather ironic that the merging of bank capital and industrial capital was more complete in a late-coming capitalist country, Germany, than in the Great Britain in the late 19th and early 20th century. For criticisms on the British financial system for the lack of support for domestic industrial enterprises in this period, see L. Joseph, *Industrial Finance: A Comparison between Home and Foreign Developments* (London: The Frederick Printing Co., Ltd., 1911); H. S. Foxwell, "The Financing of Industry and Trade," *Economic Journal*, 1917 (London: Macmillan and Co.); P. L. Cottrell, *Industrial Fiance 1830-1914: The Finance and Organization of English Manufacturing Industry* (London: Methuen, 1980).

as the reason behind the Japanese economic miracle.[2] The Japanese financial system, they argue, supplied industry with enough capital so that corporate managers could invest from a long-term perspective with less cost burden.[3]

For example, Zysman compared financial systems of the major industrial countries and classified them into three categories.[4] Each category of financial system has a different way of financing industry and a different role of the state in the process of capital allocation. His work highlighted how the Japanese system was distinctive in its characteristics from the American or the English system.

As many observers admit, however, we are living in a period of great transition. The Japanese political economy is no exception and various aspects of it have also experienced gradual but important changes. For example, the nature of Japanese economy has been changing from a trade-oriented economy to an investment-oriented one.[5] Its pattern of foreign direct investments, government-industry relations and business-labor relations has been undergoing a significant change and is becoming more similar to those of advanced Western economies than before.

This paper aims to investigate the change in the mechanism of the Japanese financial system from a longitudinal perspective. I argue that the change is a fundamental and structural one which has implications of great significance for the Japanese as well as international political economy. The Japanese financial system, reflecting the change of domestic economic structure and Japan's status in the world economy, is losing its particular-

(2) Peter F. Druker, "Economic Realities and Enterprise Strategy," in Ezra F. Vogel, ed., *Modern Japanese Organization and Decision-making* (Berkeley: University of California Press, 1975), pp. 239-43. Chalmers Johnson also points out the role of the Japanese state in directing financial flow to certain strategic industrial sectors. See, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975* (Stanford: Stanford University Press, 1982), p. 10.

(3) Takashi Inoguchi and Daniel I. Okimoto, eds., *The Political Economy of Japan*, Vol. 2, *The Changing International Context* (Stanford: Stanford University Press, 1988), p. 15.

(4) They are capital market-based system, credit-based system with government-administered prices, and credit-based system dominated by financial institutions. See John Zysman, *Governments, Markets, and Growth: Financial systems and the Politics of Industrial Change* (Ithaca: Cornell University Press, 1983), p. 18.

(5) Economic Planning Agency, *2000 Nen no Nihon: Sekai Keizai, Takyoku Antei o no Dohyo* [Japan in the year 2000: Guideposts to the world economy, multipolar stability] (Tokyo: Okura-sho, 1982), p. 69.

ity. I call this shift of the Japanese finance from "a state-oriented model" toward "a market-oriented model." I will also attempt to explicate the implication of this change for the Japanese and the international political economy in the post-Cold War era.

Some studies were published in recent years on the change in the Japanese financial system such as liberalization and internationalization. But most of them were purely economic studies. There were not many politico-economic studies which explored the nature and the implication of this change from a dynamic and macro-historic perspective.[6] This study aims to fill the gap in research in this area.

II. Changing Nature of the Japanese Financial System: From a "State-oriented Model" toward a "Market-oriented Model"

The first oil crisis and the shift toward the floating exchange rate in the early 1970s marked a watershed in the history of the Japanese economy after World War II. Japan's economy underwent a structural change at the time and entered into a new period of low economic growth.

The high economic growth before the first oil crisis depended on the strategy of heavy investments in the manufacturing sector and exports. The Japanese economy was equipped with a financial system which could support the strategy most efficiently. The financial system in this period was geared to the goal of high economic growth in many aspects.

What, then, were the most important characteristics of the Japanese financial system in the period? First, it was a credit-based system in which indirect financing (bank loans) predominated over direct financing (stocks and bonds).[7] The share of indirect finance in the (external) supply

(6) For a recent study on the political dynamics of financial liberalization in relation to the theory of regulation, see Frances McCall Rosenbluth, *Financial Politics in Contemporary Japan* (Ithaca: Cornell University Press, 1989). For a comparative study of opening financial markets toward foreign banks in four advanced countries, see Louis W. Pauly, *Opening Financial Markets: Banking Politics on the Pacific Rim* (Ithaca: Cornell University Press, 1988). Another good study by a specialist on Japanese financial system is Yoshio Suzuki, *The Japanese Financial System* (Oxford: Clarendon Press, 1987). But none of these explored the politco-economic implication of the changing nature of Japanese industry-finance relationship.

(7) Zysman, *Governments, Markets, and Growth,* pp.234-51; Yoshio Suzuki, *The Japanese*

of funds for the corporate sector was almost above 90 percent throughout the high growth period up to the early 1970s.[(8)]

Second, the Japanese financial system in the high growth period was controlled rigidly by the government. Most of all, the government controlled interest rates. The Interest Control Law of 1948, one of the pillars of postwar financial regulation, authorized the Ministry of Finance to set low deposit and loan ceilings in order to promote economic growth.[(9)] The Bank of Japan has been an operating arm of the Ministry of Finance since it lost in the struggle in the 1950s.[(10)]

Third, the government controlled foreign transactions too.[(11)] Capital outflow as well as inflow was prohibited. For instance, Japanese corporations could not float foreign bonds and introduce impact loans. The purchase of equities by non-residents was also restricted. Through the government control, the domestic financial market was effectively separated from the foreign financial market.[(12)]

These three characteristics show that the Japanese financial system was mercantilistic and state-oriented. The state could not only control the financial system itself but intervene effectively in the process of capital allocation. Let us look at how the state influenced the financial flow.

After the ruin of the Japanese economy during World War II, the stock and bond markets in the post-war period were weak.[(13)] Thus, with in-

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Financial System (Oxford: Clarendon Press, 1987), p. 23.

(8) Suzuki, *Japanese Financial System*, p. 23.

(9) Rosenbluth, *Financial Politics*, p. 41.

(10) Johnson, *MITI and the Japanese Miracle*, p. 10.

(11) According to the Foreign Exchange and Foreign Trade Control Law of 1949, external transactions were to be prohibited in principle, with freedom of transactions as an exception. This law was amended by Law No. 65, dated 18 December, 1979. The new law that became effective on December 1, 1980 provided freedom in principle, with prohibitions of transactions as an exception. *Foreign Exchange and Foreign Trade Control Law*, as amended by Law No. 65, dated December 18, 1979 (Legal Division, International Finance Bureau, Ministry of Finance, March 1980).

(12) Suzuki, *Japanese Financial System*, p. 23.

(13) The securities market was underdeveloped and it did not help industry much in raising funds. The bond issuance market was controlled by the bank-dominated Bond Committee in the postwar period. The government set interest rates low, and the quantity was kept small and rationed. "The government in effect has severely restricted access to the bond market for corporate borrowers by generally fixing rates on new issues at levels below those prevailing in the secondary market and by preempting for itself... a large part of the supply of the funds 'available' at these artificially low rates." Y. Miyazaki,

sufficient accumulation of its own liquidity, the corporate sector had no other way than depending on outside funding and was forced to borrow from banks.(14) The Ministry of Finance, in this situation, set the interest rate artificially low. The state control of foreign transactions helped to maintain low interest rates. Owing to low interest rates, there was overborrowing by the corporate sector, which invested the borrowed money heavily in the industrial sector. The high ratio of GNP, in this way, could be directed toward investments in the manufacturing and the export sectors.

The other side of the coin in this mechanism was overlending by the banking sector. As the extension of credit exceeded the sum of deposits and their own capital, the private banking sector had to depend on borrowing from the Bank of Japan. This provided the government with the leverage to direct the flow of funds according to its own priorities in industrial policy. For example,

> "Commercial banks were able to get an explicit "reading" of the industries and companies which the government wished to favor from noting the companies to which the Japan Development Bank (JDB) made loans. The government made no attempt to supply all of the needs of companies in strategic industries through the JDB. In fact, the bank's loans were typically but a fraction of the firm's credit needs, but the JDB loan meant that the large commercial banks would then give these firms priority for funds."(15)

Also, there were institutions through which the Ministry of Finance and the Bank of Japan pursued indirect control of financial flow.(16) In the bond

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"The Japanese-Type Structure" in Kasuo Sato, ed., *Industry and Business in Japan* (White Plains, N.Y.: Sharpe, 1980), p. 267, as quoted in Zysman, *Governments, Markets, and Growth,* p. 245. The stock market could not be a means of raising new funds for corporations from the household sector either, and it remained mainly as an intercompany and interbank market. The weakened and underdeveloped securities market increased the lending power of the banks. Rosenbluth, *Financial Politics,* pp. 40-41.

(14) Suzuki, *Japanese Financial System,* p. 23.

(15) This practice is called indicative lending. General Accounting Office, *United States-Japan: Trade Issues and Problems* (Washington, D.C.: Government Printing Office, 1979), as cited in Zysman, *Governments, Markets, and Grwoth,* p. 249.

(16) The method of government intervention was explicit and direct in the period before the 1950s. For example, government designated certain industries as being of national importance, and private financial institutions were to supply loans to those industries. These designations were based on a few laws. Most of these legal measures became ineffective or abolished by the end of 1955. Thereafter the control was pursued through

market, there was the Bond Issue Committee (Kisaikai), which consisted of representatives of the largest banks and major securities companies. However, representatives of major banks controlled the committee and checked the development of the bond market. Even in this small bond market, the credit was rationed by the Committee in favor of bonds issuance by electric power companies and banks.[17] The Financial Institutions' Fund Council (Kin'yu Kikan Shikin Shingikai) and the Industrial Finance Committee (Sangyo Shikin Bukai) of MITI were other organizations which consisted of representatives of major banks and major users of funds. The views of government policymakers for fund allocation were clarified through these organizations.[18]

However, as the economy entered into a post-catch-up, low growth period since the mid-1970s, the state-oriented financial system in Japan underwent important changes. What are the contents of these changes in the pattern of industrial financing?

First, the Japanese financial system began to lose its substance of a credit based system which depends heavily on bank loans. The importance of bank loans in industrial financing has declined, which inevitably led to the change in the relationship between banks and corporations.

As the economic growth rate levelled off, the opportunities for rapid expansion and the demands for investments in plants and equipment were reduced. Furthermore, corporations, especially big ones, began to reap the rewards of their earlier investments. In other words, they could accumulate more funds in the form of retained earnings and reserves for depreciation than before. In the period of 1970-75, the ratio of internal fund to total capital for big businesses (capitalized at 1 billion yen or more), was a little more than 50 percent. But the ratio has increased to about 85 percent in the period of 1976-80, and a little more than 80 percent in the period of 1981-85.[19] The ratio of internal sources of funds

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some institutional measures in an indirect and implicit way. Koichi Hamada and Akiyoshi Horiuchi, "The Political Economy of the Financial Market," in Kozo Yamamura and Yasukichi Yasuba, eds., *The Political Economy of Japan*, Vol. 1, The Domestic Transformation (Stanford: Stanford University Press, 1987), pp. 238-41.

(17) Hamada and Horiuchi, "Political Economy of the Financial Market," p. 236.

(18) Hamada and Horiuchi, "Political Economy of the Financial Market," p. 240.

(19) Ohashi Hideitsu, "Kin'yu Shueki Isono Hukameru Chikuseki Kozo," [The Accumulation Structure that Deepens the Dependency on Financial Income], in *Keizai*, September 1987, No. 281, p. 167. See also Figure 4 in this article which is based on Okura-sho, *Statistics Yearbook for Corporate Firms.*

to sales in large-size manufacturing corporations has risen from 3 percent in the period from the latter half of the 1970s to the beginning of the 1980s, to 4 percent after the mid-1980s and 5 percent recently.[20] Thus, the demand for external financing decreased and there was a reduction in the ratio of external financing to total financing.

On the other hand, facing the unstable economic situation and the low economic growth, big businesses were concerned about the strength of their own financial structures, and began to pay back their bank loans to reduce the interest payment burden. According to a study, bank borrowing by large manufacturing firms dropped from 44.7 percent of all funding in 1975 to 16.6 percent in 1987, while bond and equity financing rose from 17.3 percent to 39.6 percent.[21] Thus, the dependence on bank borrowing in industrial financing has declined rapidly.

Instead of depending on the loan market, big businesses increased their dependence on the capital market. As we see from Table 1, the share of stocks and bonds increased from 16.1 percent during 1970-74 to 39.6 percent in 1980-4. According to another study, the ratio of fund-raising by securities (corporate bonds and stocks) and commercial paper to total external fund-raising increased substantially from 17 percent in 1985 to 35 percent in 1988, and borrowing from banks decreased from 81 percent to 63 percent.[22] This means that the links between banks and affiliated firms have gradually weakened.[23]

This trend, the increasing dependence on securities, is called "securitization". As the result of the rapid economic growth in the high growth period, Japanese corporations could accumulate huge amounts of financial assets. For instance, according to the flow of funds accounts, the amount of financial assets held by corporate firms and individuals increased 7 times between 1953 and 1963, 5 times between 1963 and 1973, and 2.7 times between 1973 and 1982. The corresponding figures were 2.2, 1.9, and 2.3 times respectively for the United States.[24]

Second, internationalization was another important change that occurred

(20) Bank of Tokyo, "Recent Structural Changes in Japanese Corporate Finance," *Tokyo Financial Review*, Vol. 15, No. 3, March 1990, p. 1-2.

(21) Takeo Hoshi, Anil Kashyap, David Scharfstein, "Corporate Structure, Liquidity, and Investment: Evidence from Japanese Panel Data," September 1988, mimeo., p. 27.

(22) Bank of Tokyo, *Tokyo Financial Review*, Vol. 15, No. 3, March 1990, p. 20.

(23) Takeo Hoshi, et al., "Corporate Structure, Liquidity, and Investment," p. 27.

(24) See Table 4 in Hamada and Horiuchi, "Polithical Economy of the Financial Market," p. 229. This table is based on the Bank of Japan, Flow of Funds Accounts in Japan.

Table 1. Trends in the External Financing for Big Businesses

(percent)[25]

External Financing	1970-74 Average	1975-79 Average	1980-84 Average	1985*
Loans	83.9	63.8	60.4	33.7
Denominated in yen	82.5	60.7	48.8	21.9
Impact Loan	1.4	3.1	11.6	11.8
Corporate Bonds	5.9	17.7	13.2	36.1
Domestic	6.0	13.7	3.4	15.6
Foreign	−0.1	4.0	9.8	20.5
Stocks	10.2	18.5	26.4	30.2
Domestic	10.2	17.9	25.1	29.4
DR	0.0	0.6	1.3	0.8
Total	100.0	100.0	100.0	100.0

1. Big business, all industries, based on the various issues of the Ministry of Finance, *Bureau of International Finance Yearbook.*

*Prediction.

to the Japanese financial system. This was closely related to the above-mentioned structural change in the financial flow. On the one hand, the decrease in loan demands by domestic corporations forced private financial institutions to expand their lending abroad.[26] City banks opened their branches abroad in the major capitals of the world and long-term credit banks and trust banks have also established offices in London, New York and other money centers.[27] Ten biggest banks in the world nowadays are Japanese banks and this tells us how rapid their expansion has been in recent years. For example,

> "Awash with liquidity and hungry for market share, Japan's banks increased their overseas assets at a compounded rate of 25 percent annually from 1984 to 1989, to $2 trillion. From Singapore to Boston, the world fretted during those years about the almost frightening magnitude of financial power Japan had suddenly

(25) This table is based on Hiromitsu Takemi and Keishi Shimpo, *Kikyo Fainansu no Atarashi Senryaku* [New Strategy of Corporate Financing] (Toyo Keizai Shinposha, 1987), p. 117 and Akio Kuroda, *Nihon no Kin'yu Shijo* [Japanese Financial Markets] (Toyo Keizai Shinposha, 1988), p. 128.

(26) As big businesses reduced their loan demands, city banks turned their attention to the medium and small size firms and domestic consumers as their clients.

(27) Suzuki, *Japanese Financial System,* p. 29.

unleashed — fretted, but grew dependent upon it."[28]

On the other hand, the share of financing in foreign currencies like impact loan, foreign bonds, etc., in total external financing has increased rapidly. For example, as we can see from Table 1, the share of foreign currency financing increased from 7.7 percent in 1975-79 to 22.7 percent in 1980-84 and 33.1 percent in 1985. The ratio of fund-raising through overseas bond and stock markets to the total securities issuance has increased to 40 percent in recent years from less than 30 percent in the early 1980s.[29]

The amendment of Foreign Exchange Control Law in 1980 was a reflection and recognition of this change in the cross-border financial flow. Through the amendment, there was a relaxation in regulations on foreign bond issues, and firms could issue bonds denominated in foreign currencies without government permission. During the period of 1977-84, foreign bond markets have increased eightfold in size.[30] Also, setting interest rate was easier and the procedure of issuing bonds was more convenient in foreign bond markets than in the domestic market.[31]

The third important change in the Japanese financial system since the mid-1970s is the deregulation or liberalization of the financial market. Most of all, the interest rate was deregulated reflecting the gradual change in the financial structure.[32] Once the corporate firms could forget the problem of liquidity after the accumulation of enough financial assets, they have become more sensitive to the yield. Thus, they began to seek profitability when they managed funds. For example, corporations shifted their funds from three- to six-month time deposits into the gensaki market since the mid-1970s in order to circumvent deposit interest rate controls.[33] The large budget deficit and accompanying flotation of government bonds in large scale since 1975, helped the expansion of transactions in the gensaki market. Small and medium size corporations and house-

(28) "Torrent to Trickle for Japanese Funds," *International Herald Tribune*, February 28, 1991, first finance page.

(29) Bank of Tokyo, *Tokyo Financial Review*, Vol. 15, No. 3, March 1990, p. 3.

(30) Takeo Hoshi, et al., "Corporate Structure, Liquidity, and Investment," p. 27.

(31) Akio Kuroda, *Nihon no Kinyu Shijo*, p. 130.

(32) Other areas of regulation in the high-growth period were separation of areas of business of financial institutions, exchange rate controls, and collateral requirements. Suzuki, *Japanese Financial System*, p. 45.

(33) The gensaki market is a short-term open market to repurchase or resell securities in which interest rates were determined freely by market forces.

holds could use medium-term government bond funds (chukoku funds) to get higher rate than the regulated rate of short-term time deposits. These challenges and that from postal savings led to the loss of market shares of banks. Thus, banks began to develop their own commodities of free interest rate like certificate of deposit (negotiable deposits of up to six months' maturity with free interest rates).(34) In October 1985, the interest rates on deposits (of three months to two years) with a minimum of 1 billion yen were completely liberalized.(35) The limitation on the minimum amount continued to be lowered thereafter and deregulation expanded. By April 1991, all deposit over 500,000 yen will pay money market rates.(36)

Also segmentation between banks and securities firms and among different types of banks were reduced as the result of the structural change in the financial flow. The exchange controls were relaxed and abolished. Collateral requirements in various financial markets were gradually relaxed.(37)

III. Implications for the Domestic and International Political Economy

What are the implications of these changes for the domestic political economy of Japan? First, the relationship between finance and industry, especially between banks and industrial corporations, has changed in its nature.

Financial systems can be classified into two types: the capital market-based system and the credit-based system.(38) In a capital market-based

(34) In 1985, money market certificates whose interest rates were linked to those of certificate of deposits but were made available for smaller investors, were introduced. Suzuki, *Japanese Financial System,* p. 47.

(35) Suzuki, *Japanese Financial System,* p. 47.

(36) "Downbeat: A Survey of Japanese Finance," *Economist,* December 8, 1990, p. 5. In 1988 only 37 percent of the city banks' deposits were paying interest rate at market rates. As of November 1990, the deregulated portion of their deposits is almost 70 percent and expected to increase to 85 percent by 1992. "Back to the Streets," *Economist,* November 3, 1990, p. 98.

(37) Suzuki, *Japanese Financial System,* pp. 48-50.

(38) Zysman classifies a credit-based system further into one with government-administered prices like those in Japan and France and the other dominated by financial institutions like that in Germany. I would like to focus only on the credit-based system with government-administered prices, because it is the typical cases for the credit-based system. See Zysman, *Governments, Markets, and Growth,* p. 18.

system, the central means of corporate financing is capital markets. In this system, long-term money is supplied directly by selling equity or bonds, and short-term money is provided by banks. Financial institutions in a well-developed secondary market for securities investment, tend to spread their risks across companies rather than commit themselves to specific companies from a long-term perspective. Thus, instead of monitoring the management of companies, financial institutions emphasize the stock-market values as the most important indicator of successful companies. Naturally, investors and industrial managers are forced to focus on dividends and capital return from a short-term perspective. In the system where capital is allocated by market mechanism, there exists an arm's-length relationship between financial institutions and industrial companies, leaving little room for government influence in the process of allocation. The British and the American systems belong to this category.

In the credit-based system, the central means of corporate financing is loan markets. Usually, banks provide long-term funds and the capital market is underdeveloped. Because banks can not secure a long-term loan on the business of the client by any physical assets, they are concerned very much about the future solvency and try to monitor and influence the business of the client.(39) Thus, the relationship between banks and corporations is very close. On the other hand, since the source of bank lending is mainly short-term deposits, there is a risk when banks transform their short-term savings into long-term lending. The state, as the lender of last resort, absorbs part of this risk, and exercises strong influence in the financial system and capital allocation.(40) In this system, there is a tripartite coordination among corporations, banks, and the state toward the long-term development and prosperity of industry.

The Japanese financial system before the mid-1970s was a classic case of a credit-based system. However, due to the change since the mid-1970s, it began to lose the characteristics of the credit-based system.(41)

Most of all, as noted earlier, the relationship between banks and industrial firms has been changing. The influence of banks over industrial cor-

(39) Zysman, *Governments, Markets, and Growth*, pp. 62-3.

(40) Zysman, *Governments, Markets, and Growth*, pp. 62-3. Zysman's succinct explanation is that a capital market based system is weighted toward exit as a means of exercising influence while credit-based system is weighted toward voice.

(41) Okimoto also notices the erosion of the structural distinction of Japanese financial institutions. See, *Between MITI and the Market*, p. 44.

porations has weakened because of decreasing corporate dependence on bank loans. Also, securitization and deregulation of the Japanese financial market began to change behaviors of financial institutions and corporations further. They are increasingly concerned with the short-term profitability of their financial assets.

In this new situation, the previous type of cooperation between banks and industrial firms for the long-term development of industry will be less likely. An observer says that city banks will become money changers rather than financiers.[42] The function of merchant banking by financial intermediaries has been strengthened while other important functions such as risk-taking and information gathering have been weakened. The burden of risk-taking is being transferred to anonymous investors who can not monitor firms closely. After all, as the weight of market style debts (bonds and equity) has increased due to securitization and deregulation, the relationship between banks and corporations has become closer to an arm's-length relationship. It began to depend on market principle on a short-term basis rather than intimate cooperation from a long-term perspective. For example,

> "A related effect of the new cash abundance of Japanese companies is a slow but steady decline in the central coordinating and strategic role of the banks within their keiretsu group, as member companies stray from their traditional banking relationship. The combination of shrinking profit margins and eroding economic clout at home leaves Japan's banks only one real avenue for growth: international expansion."[43]

In the Japanese financial system before the mid-1970s, the main bank system took an important role in strengthening the close relationship between industrial corporations and banks. Though most corporations borrowed from many other banks, they maintained the closest relations with one particular bank in their own business group (keiretsu). The main bank was important because it implicitly committed to bail out the corporation when it was hit by financial difficulties.[44] However, the main bank system

(42) Leon Hollerman, *Japan, Disincorporated: The Economic Liberalization Process* (Stanford: Stanford University, Hoover Institution Press, 1988), p. 15.

(43) Richard W. Wright and Gunter A. Pauli, *The Second Wave: Japan's Global Assault on Financial Services* (London: Waterloo Publishers, 1987), p. 60.

(44) Commercial banks in Japan usually made loans on a short-term basis but the loans were rolled over automatically so that they actually became long-term loans. The tie was strengthened further by main bank's holding of bonds and common stocks of the corporations to which they made loans. Through maintaining the close ties, the main banks could reduce the cost of information gathering on the business of the firms.

itself has been changing in the current era of internationalization and liberalization. For example,

> "In Japan, the big corporations, many of them flush with funds, are shunning traditional financing and investment techniques and making increasing use of international markets. Relationships with main banks are shifting and loyalties diminishing. It is very difficult now for a company to ignore the possibility of raising funds in the international markets as an alternative to raising funds in Japan."[(45)]

Second, the role of the state in financial allocation has been weakening also. For instance, the proportion of public funding through the Fiscal Investment and Loan Program (FILP) has declined gradually since the early 1950s. In the early 1950s, it took nearly 30 percent of the total capital available to industry, but its share has declined to less than 10 percent in the 1980s.[(46)] In these days of affluent capital, the practice of indicative lending has also lost its effectiveness as a means of government influence over capital allocation.[(47)] On the other hand, almost all the factors that enabled the government to control the financial system effectively, have been weakened by the change of bank-firm relationship, securitization, interest deregulation, internationalization, etc.

> "In the past, Japan's money and banking system was highly controlled due to the dependence of firms on bank loans, to functional segmentation of the banking system, to the simple structure of the money market, and to Japan's insulation from international financial disturbance. Each of these factors will be less effective in the future."[(48)]

For example, when the Ministry of Finance deregulated bank-deposit rates, it reduced its own power to control events. In a deregulated financial market, what is most important for actors is "who can raise capital cheapest, not who has best access to the bureaucrats."[(49)] The power of the state to control events was weakened also by internationalization. Before the early 1980s, the Japanese financial system was effectively isolated from the influence of international capital markets. In this isolated system, the government could exercise an effective regulatory control of

(45) "Are Japanese Banks Losing Out?" *Euromoney*, September 1985, p. 105.

(46) The main financial source of the FILP are postal savings and insurance funds. See Daniel I. Okimoto, *Between MITI and the Market; Japanese Industrial Policy for High Technology* (Stanford: Stanford University Press 1989), p. 77.

(47) Okimoto, *Between MITI and the Market*, p. 77.

(48) Hollerman, *Japan, Disincorporated*, p. 52.

(49) "Downbeat: A Survey of Japanese Finance," *The Economist*, December 8, 1990, p. 4.

the financial flow from households to the targeted industrial sectors. But the Japanese financial system has become gradually exposed and vulnerable to international market forces through internationalization. In other words, the scope of business activities both for Japanese industrial firms and financial institutions has broadened from the national level to the international level at the cost of weakening state power to control.

The recent financial innovations through deregulation and internationalization not only have made the control process more complex, but have made it more difficult to evaluate the result of government policy.(50) This means that, as Japan's economy matures, the efficiency of government industrial policy through the financial mechanism diminishes. Encouraging industrial competitiveness through the financial system will be much more difficult than before in achieving its goal. The dilemma for the government is whether it will try to devise other means of industrial policy to supersede in the coming period of market principle and, if it will, how.

All these changes indicate that the Japanese financial system has been undergoing a qualitative and structural change from a credit-based system toward the direction of a capital market-based system. This is also a change from a state-oriented system to a market-oriented system.

We can observe this kind of change in the financial system when a late-comer capitalist economy succeeded in accumulating surplus capital through a trade-oriented strategy. As the result of enough capital accumulation, the financial mechanism which had been geared to the goal of economic development had to be changed. Ironically, the very success of the growth-oriented financial mechanism necessitated its own conversion. In a sense, the current change in the Japanese financial system reflects the fact that Japan's economy has finally arrived at a stage in which the state can no longer engineer it efficiently and only the market can take care of it properly.

A few economic hegemons in the modern history underwent similar changes when their economies began to be transformed from a trade-oriented economy to an investment-oriented economy.(51) In the case of

(50) Hollerman, *Japan, Disincorporated,* p. 15.

(51) Wallerstein also assumes that there exist three stages of hegemony; productive, commercial, and financial stages. He argues, "Marked superiority in agro-industrial productive efficiency leads to dominance of the spheres of commercial distribution of world trade... Commercial primacy leads in turn to control of the financial sectors of banking (exchange, deposit, and credit) and of investment (direct and portfolio)." See Immanuel Wallerstein, *The Modern World-System II* (New York: Academic Press Inc., 1980), pp. 38-39.

the 19th century Great Britain, we can observe a similar change in the banking system since about the 1870s. After the collapse of country banks in the Great Depression in the 1870s and the subsequent "amalgamation movement" (merger movements of small banks into big ones), financial institutions had little involvement in long-term financing of the British industry. When the highly liquid national capital market developed later, financial institutions provided only short-term working capital to the British industry. Instead of developing the institutional expert to serve domestic demands for long-term capital that arose at that time, British financial institutions exported their capital abroad heavily.(52)

The change in the Japanese financial system may not be as radical as the British one. There may not be such a deep separation between industry and finance in Japan as in Britain due to other different intervening variables. However, we certainly find some similarities between these two cases. The issue here is what will be the shape of the confrontation between the state and the market in the case of Japan and what lessons the Japanese state can learn from the experience of the former hegemon. This will remain as one of the most important issues in the area of international political economy in coming decades.

For example, it will be premature if we predict that Japan will follow the same pattern of previous economic hegemons like Britain and the United States, by letting the separation of industry and finance go on and by allowing industrial firms to lose their long-term time horizon and be preoccupied with quarterly profits as American firms are.

But we should not be overly confident in the ability of the Japanese state to prevent all these negative phenomena from happening.(53) Let me show one example. As mentioned earlier, Japanese corporations have been managing their accumulated assets in the form of various financial

(52) B. Elbaum and W. Lazonick, "The Decline of the British Economy: An Institutional Perspective," *Journal of Economic History*, 44 (1984), pp. 569-70.

(53) A recent survey of the Japanese finance says, "The belief in the power of administrators is as seductively convincing as it is wrong, since it is based on the extraordinary premise that Japan is somehow immune from the laws of economics. Japan's administratively managed economy may delay the impact of market forces, and even make them fuzzier at the edges, but it can never repeal them. When Japanese financial institutions and companies are, as now, faced with a huge increase in their cost of capital, it must have long-term consequences both on the way they do business and on the pricing of Japanese assets — whatever the perceived powers of the bureaucracy." *The Economist*, December 8, 1990, Survey on Japanese Finance, pp. 20-2.

instruments such as money market trusts, mutual fund shares, CP and so on. Especially, after 1985 when the monetary situation was eased to prevent high-yen led recession, they have become more sensitive to secure higher returns on investments and actually succeeded in attaining handsome net financial incomes through zai-tech boom. Zai-tech income has become a very important source in business earnings nowadays.[(54)] However, extravagant zai-tech speculation led to the financial crises of such big firms as Itoman, Shuwa, Hanwa, Azabu, Dai-ichi, etc., since the stock market crash and the fall of real estate prices in 1990.[(55)] This phenomena shows that, despite the popular belief in the capacity of the Japanese state to control and avoid the worst, the state could not do much about excesses of private firms.

IV. Implications for the Post-Cold War Era

There have been many economic explanations on the Japanese financial investments in recent years. For example, the rapid increase in the financial outflow from Japan since the early 1980s was explained by the imbalance between savings and investments or the accumulation of current account surpluses in Japan. Some explained the increase in Japanese foreign direct investments in the 1980s as a means to circumvent trade barriers in advanced countries in the period of high-yen.

However, there are not many politico-economic studies on the structural aspect of this change in the financial flow. This paper aimed to fill this gap. I argued that the change of the Japanese financial system was nothing but the reflection of the structural change of the Japanese economy. After all, the Japanese economy has grown so big that it can no longer be managed by a mercantilist financial system.

Internationalization and liberalization of the Japanese finance began to remove the last structural obstacle which prevented the Japanese economy from advancing toward the final stage of the capitalist development. Through internationalization and liberalization, Japan's economy is ready to act "rationally" in the global level according to market principles.[(56)] This means the departure of Japan's economy from the mercantilist assumption

(54) Bank of Tokyo, *Tokyo Financial Review*, Vol. 15, No. 3, March 1990, p. 5.

(55) See *The Economist*, September 22, 1990, p. 102; October 20, 1990, pp. 94-96; December 15, 1990, pp. 78-79.

(56) Rosenbluth, *Financial Politics*, p. 52.

that the rationality at the international level does not coincide with the rationality at the domestic level.

The removal of the structural impediment lying between the Japanese financial market and the international market will integrate the Japanese economy further into the world economy from a long-term perspective. This means increasing degree of interdependence in world financial market in coming decades of the post-Cold War period. Tokyo will influence other financial centers more than before and it will be influenced by them to the same degree.(57) A credit squeeze is going on currently but the international financial market will recover its momentum soon.

Though the market principle will guide the flow of the Japanese capital, Asian countries are likely to be influenced more easily by the Japanese financial power than before. Its rising influence in this area can be interpreted from two different perspectives. From an optimistic point of view, the financial power of Japan will be able to help economically difficult socialist countries such as North Korea, the Soviet Union, the PRC and Vietnam.(58) By helping economic reforms of the socialist countries, the Japanese finance will be able to prepare an economic base for ending the Cold-War in Asia.

However, from a pessimistic point of view, the other side of the coin is economic dominance of Asia by Japan. The influence of the Japanese finance in ASEAN countries is very strong already. Expanding influence of the Japanese finance further into socialist countries may increase worries of Asian people about the revival of the Japanese hegemony. How to deal with this dilemma remains as an important issue of Asian political economy in coming decades.

(57) The Japanese government seems to be somewhat reluctant to let the yen be used as an international currency, because it fears the loss of autonomy in domestic monetary policy.

(58) Especially, it is expected that there will be an increase in inyestments by Japan in the Soviet Union after some kind of agreement on the Northern territories in the near future. The negotiation with North Korea is going on, and investments in Vietnam has begun already.