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Before Main Banks

A Selective Historical Overview of Japan's Prewar Financial System

Frank Packer

Among lessons learned from Japan's prewar financial system: Business conglomerates that did not remain dependent on government patronage were more successful than others in making the transition to a modern industrial economy. And banks that made a conscious effort to reduce their dependence on central bank credit were more successful than those that did not.

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Summary findings

The postwar experience of the Japanese banking system has received considerable attention recently partly because conditions in defeated Japan in 1945 (including high inflation and the need to switch from a military to a civilian economy) are similar to those in transition economies today.

Policymakers in transition economies can learn a good deal from the experiences of Japan's postwar financial system but should remember that Japan also experienced extraordinary industrial growth and financial institution building in the late nineteenth and early twentieth centuries. Lessons to be learned from that experience include the following:

- Business conglomerates that did not continue to depend on government patronage were more successful than others in making the transition to a modern industrial economy.
- Banks that made a conscious effort to reduce their dependence on central bank credit were more successful than those that did not.
- The establishment of procedures for punishing defaulting borrowers helped the development of the payments system.
- Limits on the amount of lending to related parties appear to have contributed to financial stability (and could have contributed more if the newer "zaibatsu" had been as prudent as the older ones).
- Bank bailouts without accompanying reform (such as those the Bank of Japan undertook in 1920 and 1922) probably increased the likelihood of a more serious crisis, such as that of 1927.
- Capital standards — the minimum capital requirements established in the 1927 law — were a viable means of encouraging bank consolidation and more prudent lending.
- The public financial system served as a buffer when the banking sector was downsized.

This paper — a joint product of the Finance and Private Sector Development Division, Policy Research Department, and the Financial Sector Development Department — was presented at a Bank seminar, "Financial History: Lessons of the Past for Reformers of the Present," and is a chapter in a forthcoming volume, *Reforming Finance: Some Lessons from History*, edited by Gerard Caprio, Jr. and Dimitri Vittas. Copies of this paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Daniele Evans, room N9-061, telephone extension 202-473-8526, fax 202-522-1955, Internet address pinfo@worldbank.org. November 1995. (14 pages)

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Before Main Banks: a Selective Historical Overview of Japan's Prewar Financial System

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This paper was presented at a World Bank Seminar, "Financial History: Lessons of the Past for Reformers of the Present," and is a chapter in a forthcoming volume, Reforming Finance: Some Lessons from History, edited by Gerard Caprio, Jr. and Dimitri Vittas. The author wishes to thank the participants at that seminar and the editors for their comments.

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Discussion

The postwar experience of the Japanese banking system and its relevance to developing and transition economies has been receiving considerable attention recently.[1] This research has been motivated in part by the fact that the conditions in the defeated Japan of 1945 are similar to those in transition economies today, such as high inflation and the need to switch from a military to a civilian economy.

At the same time many of the postwar conditions in Japan were different from those faced by transition economies today. Prior to World War II Japan had spent more than sixty years experimenting with and developing modern financial institutions. This essay relates some highlights of that history, concentrating on the banks that sprung up from the large industrial conglomerates—*zaibatsu.*

How did the zaibatsu banks, the predecessors of the main banks of the postwar era, perform? They performed very well relative to their competitors and much differently relative to their postwar successors. Looking at the prewar setting also permits an exploration of banking stability. While the postwar Japanese system has been free of major bank failures, the prewar banking system experienced numerous banking panics and failures, even among zaibatsu banks.

The Main Bank System and Important Supplements

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*The views expressed represent those of the author and not the Federal Reserve Bank of New York or the Federal Reserve System.

[1]See, for example, the World Bank working papers on the Japanese main bank system by Aoki, Patrick, and Sheard (1994).

Theoretically, the main bank system refers to a network of bank-firm relationships in which most large firms have a main bank. The main bank can be identified by three principal qualities. It is the largest lender to a particular client, making between 15 and 25 percent of the loans to that client, and possibly more to many small companies. It holds a substantial block of shares in the client company and is always the largest financial shareholder, although it is often not the largest shareholder (because of ceiling regulations of 5 or 10 percent). And bank officers are commonly represented in the management of its bank's clients, particularly during times of financial distress. Proponents of the main bank system point to its strengths, such as the active role taken in disciplining management, reduced costs of reorganizing and restructuring firms in financial distress and thus reduced loan premiums, and lower agency costs of external finance (Aoki, Patrick, and Sheard 1994). Even the nonexclusivity features, some of which are guided by external regulations and can be motivated by managerial risk aversion, can be positive.[2] If firms borrow from several banks, they can discourage opportunism on the part of the main bank. Also, other banks become an integral part of the main bank system by monitoring the main bank.

Important additions to this theoretical construct have been made, some of which were needed for the system to function effectively. For example, the postwar Japanese development banks were critically important, especially if long-term credit banks are considered to be development banks. Development banks provided a much larger percentage of long-term finance than did the zaibatsu banks in postwar Japan, allowing the zaibatsu banks to lower their burden of maturity transformation. During the high-growth era long-term credit banks provided more than 50 percent of the loans for plant and equipment investment in

[2]One common regulation among many financial systems limits the exposure that any one financial institution can have to one borrower. In the United States, according to the 1982 Banking Act, national banks can lend no more than 15 percent of their capital to any single borrower on unsecured (marketable securities) loans. In Japan, according to the thirteenth clause of the Revised Banking Act of 1980, city, trust, and long-term credit banks are allowed to lend no more than 20, 30, and 40 percent of their capital, respectively, to any one company.

1956 for many key industries. In 1966 they still provided 36 percent of all plant and equipment loans (Packer 1994b).[3] Development banks did not play as important a role in the prewar financial system of Japan.

The banks also had to be concentrated and profitable. Often in a main bank system a main bank takes over some of the bad loans of other banks, which can be modeled as part of a dynamic equilibrium. But if the sector is not profitable, in particular if a main bank is not profitable, then it is not likely to be able to fulfill this function for large quantities of nonperforming loans. This inability is what many notice around the edges of the Japanese main bank system today (Packer 1994a).

The system must also be able to credibly threaten businesses that fail with penalties, otherwise it runs the risk of offering soft budget constraints. The incentives for Japanese firms to cooperate with their banks in times of distress are increased by the fact that if they go bankrupt, the managers will be fired, and the shareholders will not be compensated.

Zaibatsu and Zaibatsu Banks

Morikawa has defined zaibatsu as "a group of diversified businesses owned exclusively by a single family or extended family."[4] In the late nineteenth century, during the early stages of industrialization, the zaibatsu did not dominate leading growth areas such as electric power and cotton spinning. And although zaibatsu did reorganize as more loosely knit networks after the dissolution of the holding companies (during the U.S. occupation), today they are very different institutions (Hadley 1970).

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[3]The literature on the role on development banks in Japan's postwar era is growing. Calomiris and Himmelberg (1994), Horiuchi and Sui (1993), and Vittas and Kawaura (1994) cover the role of the Japan Development Bank; Packer (1994b) covers the long-term credit banks.

[4]The following discussion of the role and evolution of zaibatsu banks draws heavily on Morikawa (1992), particularly Chapter 4.

Nonetheless, many of the names of the early zaibatsu are still familiar today. According to Morikawa most of the principal zaibatsu were originally political merchants—either financiers handling tax revenues or enterprises selling other goods to the government. In the preindustrial era Mitsui, the second oldest of the major zaibatsu, collected tax revenues from the economic zone around Osaka for the government located in what is now Tokyo. Rather than transport the cash directly to the government, they purchased promissory notes that merchants in Edo had written for purchases of Osaka goods. They then took these notes to Tokyo, collected from Edo merchants, and reimbursed the government. Yasuda was also in the exchange business, although it is a zaibatsu that was founded much later. Zaibatsu that were originally political merchants sold other goods to the government, such as military goods. Mitsubishi, for example, provided shipping services for the government and was granted a monopoly. Other zaibatsu had their origins as mining companies, such as the oldest, Sumitomo.

Although some of the zaibatsu were established after the industrialization and modernization of the late nineteenth century, all of the banks were founded by the early Meiji era. The zaibatsu that had begun as financiers—Mitsui and Yasuda—were the first to start banks, followed by Mitsubishi and Sumitomo. These four served as the major zaibatsu banks through the war era.

Many zaibatsu failed, particularly if they fell out of favor with the early Meiji government. The successful zaibatsu were those that were less dependent on government patronage. In fact, many made deliberate efforts to transfer out of the traditional businesses that depended on government patronage. Relatively early in the Meiji era Mitsui closed its bank branches that accommodated the government and eliminated many bad debts that were actually kickbacks to the government. Mitsubishi, after making a fortune from its shipping monopoly, downsized this business substantially after the government began to intervene. Yasuda, like Mitsui, also reduced its government deposits. The success of the zaibatsu was not

dependent on large-scale privatization efforts: several zaibatsu that were privatized failed and several succeeded.

The four major zaibatsu banks grew very rapidly, mirroring the growth of the zaibatsu. A few important aspects of their evolution should be mentioned. At the turn of the century Mitsui underwent a transition from an industrial to a commercial bank. At first, Mitsui bank had lent principally to companies of its own zaibatsu: more than 80 percent of their long-term loans were extended to Mitsui members. When a large proportion of these funds became uncollectible and this knowledge became public (in the late nineteenth century), deposits fell considerably. During a transition in leadership, a decision was made to greatly reduce the long-term loans disbursed to companies in their own group, and reported profits rose considerably.

In the four biggest banks efforts were made to reduce loan-to-deposit ratios as well as dependence on Bank of Japan credits. By the turn of the century Mitsui and Sumitomo were borrowing virtually nothing from the Bank of Japan. In all four banks profits grew considerably, while loans as a percentage of deposits declined.

Limiting lending to related customers came to be considered a natural, prudential policy. In 1890 the government passed a law limiting lending to related firms to 10 percent of capital. This law was repealed in 1895, principally because the banking industry protested vigorously. But at the same time the major zaibatsu banks developed their own lending policies much along the same lines.

Mitsui Bank was a prime example. It issued a representative public statement in 1904: "It's extremely unsound and improper for Mitsui to invest in its own enterprises' funds received on deposit from others." The bank increased investment and loans in electric power companies, railways, and local government operations that were outside of its group. By the early 1920s it was lending to only two of the nine major affiliates of the Mitsui group. A very small percentage of the liabilities of Mitsui zaibatsu

companies came from borrowing, and an even smaller percentage of these consisted of borrowing from the Mitsui Bank. In the Mitsubishi zaibatsu only Mitsubishi Trading borrowed from the bank, and corporate bonds were underwritten for only two of their subsidiaries. Sumitomo also set limits on internal lending.

Clearly, the major zaibatsu banks were making a deliberate effort not to be viewed as organ banks. Because this was an era where many banks failed, it was very important to develop the reputation for having a good set of internal prudential guidelines that governed lending behavior. In the late nineteenth century Mitsui had seen that a reputation for having nonperforming loans could lead to a decrease in deposits. Some of the troubled banks in Japan today may have wished that they had adopted in the 1980s some of the policies of the 1930s.

By 1932 loans were a fairly small percentage of large Japanese firms' finance (Hoshi 1993). This low percentage was partly the result of the policy shifts undertaken by Japanese banks in the early twentieth century to limit the growth of internal loans from zaibatsu banks. Of course, during the war and then in the postwar era, things looked very different. But Japan's prewar banking experience may carry its own set of lessons for transition economies.

The "Hard" Japanese Bankruptcy System and its Historical Origins

The origins of the "hard" bankruptcy system can also be found during Japan's early industrialization. This system would later influence the evolution of the main bank system. Active bank governance during times of financial distress is encouraged by a hard bankruptcy system.[5] The fewer alternatives the firm has (to its bank), the more likely it is to depend on its bank, and the greater latitude the bank has to impose its own solution to financial distress.

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[5]One recent approach to creating a hard budget constraint in Hungary has been the creation of a hard bankruptcy law (Caprio 1994).

Application to bankruptcy court in Japan is discouraged by the large up-front deposit payments required from the applicant. And even if the debtor can come up with the money, judges refuse to hear a large majority of the cases that come before them. They often refuse the bankruptcy application and refuse to issue a stay of creditor claims. Further, management and shareholders are punished severely. Management is usually fired, and shareholders are not compensated (Packer and Ryser 1993).

Another distinguishing characteristic of the Japanese bankruptcy system is that more than 90 percent of bankruptcies fall under the category "suspension of bank transactions." If a clearinghouse twice issues a notice of bills unpaid within a six-month period, all banks must suspend loans and current account transactions with the guilty party for two years. Because Japanese companies are so dependent on promissory notes to conduct transactions, suspending loans and current account transactions is the equivalent of capital punishment for the firm—it cannot survive if bank transactions are suspended. For this reason it is considered to be a category of bankruptcy by Japan's mercantile credit rating agencies.

The suspension mechanism originated early in Japanese industrialization (Ryser 1993). The Tokyo clearinghouse was established in 1891 by eleven banks, and its purpose was to net bills and checks from companies across banks.[6] Generally, the bills and checks presented to the clearinghouse would represent claims on the firm, which could be drawn from a current account at its transaction bank about six months after issue. Even today, most small and medium-size Japanese companies are financed largely by trade credit through the issuance of promissory notes of this sort.

After the establishment of the clearinghouse, banks could submit promissory notes to the clearinghouse, which would net the claims and debts, allowing each bank to settle from its account at the Bank of Japan.

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[6]Osaka established a similar sort of clearinghouse earlier—in 1879—but reorganized it following the Tokyo model in 1896.

The historical record shows that the punishment for dishonored bills—when a firm did not have enough money in its account at the transaction bank to cover the obligation—gradually increased during the Tokyo clearinghouse's first ten years. In 1894 if a dishonored note was reported to the clearinghouse a firm was suspended until a single bank asked for its release. In 1898 the rule was changed to require a majority of the members of the clearinghouse to request the release. Two years later the clearinghouse began fining members that had extended a loan to or otherwise dealt with suspended parties.

What followed in 1901 appears, in retrospect, to have been the most important of the new rules—mandated public disclosure of the suspension. Disclosure helped to make suspension a harsh punishment: not only member banks, but all other creditors, including trade creditors that might otherwise accept future promissory notes, would know about the deterioration of the firm's finances. In 1904 repeat offenders were forced to wait two years before being able to appeal the suspension.

Suspension and dishonor rates dropped dramatically in response to these changes in regime. Defaulted bills as a percentage of total bills cleared dropped from 0.3 to 0.1 percent following the decision to publicly disclose suspension, and dropped to .05 percent in 1904. Meanwhile, the values of bills cleared multiplied and the use of promissory notes as a means of payment in Japan took off.

The Interwar Banking System and Financial Stability

The interwar era was a time in which several real and financial shocks hit the financial system. Most notably, the great Kanto earthquake struck in 1923, killing 140,000 people and causing property losses estimated to be about 40 percent of GNP. The earthquake immediately created a class of debt that couldn't be paid back. This debt overhang destabilized the entire banking sector until drastic reform and consolidation measures were taken in the late 1920s. Although bank panics occurred throughout the early twentieth century, the frequency and severity increased with the 1920s and culminated in the grand banking

panic of 1927, which helped to stimulate a new banking act. Finally, there was an ill-timed return to the gold standard in 1930, which was highly deflationary.

But even during this era of financial volatility the stock of private financial assets as a proportion of GNP increased dramatically—from around 1 percent in 1918 to about 2.5 percent in 1933 (Teranishi 1990). Time deposits in particular increased. Achieving a similar level of financial deepening after the postwar hyperinflation took more than twenty-five years. Financial deepening amid instability was achieved because alternative safe havens were available: the established zaibatsu banks and the postal savings system.

Also during the interwar era differences between the first- and second-tier zaibatsu became more apparent. The large zaibatsu were very conservative during the boom of World War I, and they benefitted from their conservatism in the unstable 1920s (Morikawa 1992). While firms of the large zaibatsu increased their use of bond and equity markets and the established banks increased their underwriting activities, many of the newer zaibatsu formed banks and achieved high war-time growth. But this growth was mostly leveraged to their related banks. The zaibatsu of Furukawa, Kawasaki, and Suzuki all had trouble in the 1920s because of their over-leveraged position; some of the newer zaibatsu banks, such as Asano and Fujita, failed.

The established zaibatsu banks increased their market share of deposits, as these banks were perceived to be secure. Their loan-deposit ratios were much lower than those of other banks, and they expanded their underwriting and securities business. They increased their corporate bond holdings more rapidly than their loans. The conservatism of zaibatsu banks was shown by the striking increase in bond issues and the transformation of the capital structure of large corporations (Hoshi 1993).

The 1927 banking crisis led to substantial reform. Although there had been many banking panics prior to 1927, in most of these the Bank of Japan had stepped in and provided emergency funding.[7] This funding was extensive during the panic of 1920. Further, the Bank of Japan had provided large amounts of special loans to banks in the wake of the Great Kanto Earthquake. Teranishi (1990) claims that providing rescue credits greatly increased the Bank of Japan's risk-taking prior to the 1927 crisis, thus increasing the ultimate bill. The cost of rescuing or handling the failed banks in 1927 is estimated to have been 5 percent of GNP.

Which banks failed during the 1927 crisis? Part of the folklore of the 1927 banking crisis held that it was triggered by irrational runs that had little to do with the underlying solvency of the financial institutions. Amid a debate about bad earthquake bills, the Minister of Finance set off a run on one Tokyo bank early in 1927 when he testified before the Diet that the bank had failed. But the bank was still honoring bills. Runs on eleven other banks followed shortly thereafter. A few months later another crisis was triggered by a Diet debate on the same topic—twenty-one banks failed.[8] But Yabushita and Inoue (1993) have shown that the occurrence of bank runs was hardly random: proxies of solvency—such as dependence on the call market, the capital-deposit ratio, or the profit-capital ratio—were all negatively related to the probability of closing. Further, Teranishi (1990) showed that most of the banks that failed in 1927 had high debt exposure to related firms.

Banking reform, which had been in the works for while, was greatly accelerated by the 1927 banking crisis. A new banking law was passed soon after and came into effect in January 1928. The

[7]Yabushita and Inoue (1993) identify eighteen banking crises between the 1890s and 1927. At least eight appear to meet the Calomiris and Gorton (1991) definition of a "bank panic"—they involved a large number of banks in a brief time period and resulted in the suspension of convertibility, government relief measures, or both.

[8]The Bank of Taiwan failed when large city banks cut off loans to it in the call market.

minimum capital requirement was increased from 1 to 2 million yen for ordinary banks in Osaka and Tokyo. Banks were also required to become joint stock companies. Under these new requirements at least half of all banks were no longer eligible to function (Yabushita and Inoue 1993). There was also a move toward tougher collateral requirements in money markets.

After the 1927 reform the number of banks decreased dramatically—from about 1,400 at the end of 1927, to 600 in 1933, and 357 in 1940.[9] The trend toward concentrating the Japanese banking system—a central feature of the postwar Japanese banking system—started well before Japan's war economy. To the extent that the banking law passed in 1927 played a role, it may be worth examination by today's transition economies.

Teranishi (1977) documents that during the era of financial instability and rapid consolidation, the postal savings system grew dramatically as local banks went out of business. About 65 percent of the time savings deposits that left the local banking sector went into the postal savings system. While the zaibatsu banks gradually increased their share of deposits through the twentieth century, this event was largely independent of the consolidation of the banking sector and the fall in the number of banks. Zaibatsu banks "found it the best policy not to involve themselves in the structural change among local banks." Rather, postal savings served as the principal safe haven for risk-averse depositors, particularly when consolidation accelerated after 1927. Likewise, the official financial system (Treasury investments and loans), the principal outlet for postal savings funds during this era, handled the provision of funds owned by the failed local banks.

Lessons of the Prewar Experience for Transition Economies

[9]The greatest number of banks was 1,867, reached in 1901. The government took several measures to promote consolidation in the early twentieth century (Yabushita and Inoue 1993).

Although policymakers in transition countries can learn a great deal from the experiences of the postwar financial system in Japan, they should keep in mind that Japan also experienced extraordinary industrial growth and financial institution building in the late nineteenth and early twentieth centuries. Keeping this caveat in mind, at least seven stylized facts are worthy of note.

First, business conglomerates that did not continue to depend on government patronage were more successful than others in making the transition to a modern industrial economy. Second, banks that made a conscious effort to lower their dependence on central bank credit were more successful than those that did not. Third, the establishment of procedures for punishing defaulting borrowers had a beneficial impact on the development of the payments system. Fourth, limits on the amounts of lending to related parties appear to have contributed to financial stability (and could have contributed more if the newer zaibatsu had been as prudent as the older zaibatsu). Fifth, bank bailouts without accompanying reforms, such as those undertaken by the Bank of Japan in 1920 and 1922, probably increased the likelihood of a more serious crisis, such as that of 1927. Sixth, capital standards—the minimum capital requirements established in the 1927 law—were a viable means of encouraging bank consolidation and more prudent lending. Finally, the public financial system served as a buffer when the banking sector was downsized.

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